Quantifying Climate: How Carbon Accounting is transforming financial decision-making

The UK financial sector is embracing a transformative challenge: carbon accounting. As sustainability reporting evolves from a voluntary exercise to a regulatory imperative, financial institutions are seizing the opportunity to streamline their approach to measuring, reporting and managing their carbon footprint.

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This shift represents not just an environmental concern, but a core element of financial risk management and strategic planning.

The drivers of this change are manifold. The UK's ambitious commitment to net-zero emissions by 2050 and the establishment of the International Sustainability Standards Board (ISSB) are setting new benchmarks for sustainability reporting. As a result, carbon accounting, the process whereby businesses must measure and report the volume of emissions generated or avoided through their business operations, is becoming business critical. This is as regulatory pressures are complemented by shifting market dynamics, where carbon-intensive assets are increasingly viewed through a lens of heightened risk, influencing lending and investment decisions, valuations and insurability in unprecedented ways.

This is providing an impetus for businesses across multiple sectors to target greater reductions in their carbon emissions as well as to more accurately calculate and disclose their emissions data in order to stay ahead of competitors and remain attractive to investors and viable to

insurers.

Financed and insured emissions

Financed and insured emissions are both important factors in the effort to reduce carbon emissions, and financial institutions including insurers play a key role. Financed emissions apply to investors, with the emissions referring to the carbon footprint associated with the companies and projects that investors finance through equity, debt, or other financial instruments. Essentially, financed emissions represent the share of a company's or project's greenhouse gas (GHG) emissions that can be attributed to the investor based on the extent of their financial involvement. By accounting for financed emissions, investors can push for better environmental performance, fostering carbon reduction efforts across the businesses they invest in.

Investors, particularly institutional ones such as reinsurers and insurers, are increasingly required to account for the emissions linked to their investments. This is prompting them to prioritise funding for companies that align with carbon reduction goals. They may divest from or avoid high-emission sectors and instead invest in businesses focused on renewable energy. Similarly, by tracking financed emissions, investors can more actively engage with the companies they invest in, encouraging them to set ambitious decarbonisation targets.

Conversely, insurance-associated emissions stem from the activities supported by insurance contracts. This is important as the insurance and reinsurance industries are amongst the largest industries globally, holding significant assets under management. For instance, the total value of insurance policies and premiums written across both life and non-life insurance amounts to approximately eight trillion USD, which is equivalent to 6.8% of global economic output. In light of this, the insurance industry is pivotal in advancing the transition to a low-emission

economy. Moreover, the insurance and reinsurance industries are uniquely positioned, as both investment and underwriting activities are a feature of their balance sheets. As institutional investors, they can fund zero- and low-emission technologies and work with their investee companies on decarbonisation strategies. As risk managers, they must assess the exposure within their underwriting portfolios pinpointing carbon-intensive activities in high-risk sectors.

'Insured emissions' - the carbon emissions associated with assets and activities that financial institutions insure are at the forefront of the mainstream financial sector's evolving engagement with climate risk. They are reshaping how the insurance and broader financial services sector perceive their environmental impact. Insurers are among the financial service providers most keenly realising that their customers' emissions form a significant part of their carbon footprint. For instance, some insurance firms are grappling with collecting emissions data from upwards of 70,000 SME’s from their portfolio The challenge lies not just in the scale, but in improving data quality. While challenging, this data collection effort presents an opportunity for financial institutions to gain deeper insights into their client base and offer tailored financial products.

Information overload - The data challenge

The complexity of carbon accounting becomes particularly evident when considering the full spectrum of emissions. Scope 1 (direct emissions) and Scope 2 (indirect emissions from purchased energy) are relatively straightforward to quantify. However, Scope 3 emissions - those occurring throughout a company's value and supply chain - present a more nuanced challenge with its wider-reaching disclosure requirements. While currently elective they may be enshrined in the statute book in future and as such are already becoming a de facto business standard. Scope 3 emissions data is challenging to report accurately and often constitutes over 70% of a company's total greenhouse gas emissions. While many companies

report some Scope 3 data, full disclosure is difficult due to the complexity of gathering reliable information across all categories. Industries with complex supply chains, such as financial services, particularly struggle to account for emissions from suppliers and customers.

Evidencing the scale of transformation still needed; research from PwC has found that only 58 of the FTSE 100 report all materially significant Scope 3 categories, often leaving out key sources such as upstream supplier or downstream product emissions.

Despite this, addressing Scope 3 emissions is not just crucial for achieving net-zero targets; it's becoming a key differentiator in the investment landscape. The CDP (formerly Carbon Disclosure Project), representing an investor network with over $100 trillion in assets, rewards firms that report Scope 3 emissions with better scores. In an era where ESG considerations are paramount, these scores can significantly influence investment decisions, offering a competitive edge to early adopters. Similarly, with respect to insurance, the ability of firms large or small to engage in their specific business activities is limited without the support of insurance. By factoring emissions-associated risks into insurance policy decisions, insurers are also influencing decarbonisation efforts.

Opportunities for innovation

The implementation of advanced carbon accounting systems presents both challenges and opportunities. Data collection and quality assurance, particularly for SMEs in the supply chain, require innovative solutions. The journey towards measurement standardisation, despite efforts by organisations like the Partnership for Carbon Accounting Financials (PCAF), is ongoing, and integration with existing systems necessitates substantial IT investment. However, these challenges are driving exciting innovations in the accounting tech sector.

Carbon accounting platforms that streamline the data aggregation process, such as Climatise, are emerging to efficiently collect and process emissions data from multiple sources. By leveraging advanced technologies, they're making it easier for businesses of all sizes to accurately measure and report their carbon footprint.

AI-driven analytics are enhancing data quality and providing predictive insights on carbon-related risks, enabling more informed decision-making. These sophisticated tools, often integrated into comprehensive carbon accounting solutions, are helping financial institutions better understand and manage their climate-related exposures, particularly in navigating the complexities of Scope 3 emissions.

As the carbon accounting landscape evolves, user-friendly platforms are becoming increasingly vital. By simplifying data collection, analysis, and reporting, these tools enable businesses to focus on developing and implementing effective strategies to meet stringent regulatory requirements and be transparent about emissions. This is the first step in efforts to reduce their carbon footprint.

The path forward

For financial institutions, carbon accounting is rapidly becoming a strategic imperative, offering new avenues for risk management and product innovation. The integration of carbon risk into financial models and stress tests is not just a regulatory requirement but a competitive necessity. More broadly, according to the Green Finance Institute, the deterioration of our natural environment could result in UK Gross Domestic Product (GDP) being 6% lower than it would have been otherwise by the 2030s. This sobering projection underscores the financial materiality of environmental risks and the importance of robust carbon accounting practices.

The global landscape of carbon pricing mechanisms, now implemented in over 46 countries, further emphasises the need for comprehensive emissions accounting.

As the UK positions itself as a global green finance hub post-Brexit, mastering carbon accounting is becoming a key competitive advantage. Financial institutions that effectively measure, manage, and mitigate their carbon exposure are not just navigating the low-carbon transition - they're leading it.

In conclusion, carbon accounting represents a paradigm shift in the decision-making processes of the financial services giants that shape our economy and therefore for businesses in the real economy. As a result of this, all entrepreneurs and C-suite leaders must be alive to the opportunities and risks of good and poor carbon accounting in their enterprises. The demand for granular, real-time carbon data is driving technological advancements and making accurate emissions data collection feasible. Those who embrace this change, integrating carbon considerations into their core operations and decision-making processes, will not only gain a significant competitive advantage but also play a crucial role in shaping a sustainable future. Notwithstanding meeting their current and future regulatory requirements and avoiding penalties for non-compliance.

In the evolving landscape of finance, carbon is indeed becoming the new bottom line – this has the potential to drive efficiency, and long-term value creation. As the financial sector’s approach to climate risk continues to adapt and evolve, carbon accounting will undoubtedly play a central role in defining success, resilience, and leadership in the years to come.

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