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PCAF PUBLISHES DRAFT GLOBAL CARBON ACCOUNTING STANDARD FOR THE FINANCIAL SECTOR

Governance and Impact – Part of the Horizon Scanning series

This summer, PCAF (the Partnership for Carbon Accounting Financials) has emerged as the front-runner for a harmonised international accounting standard for greenhouse gas (GHG) emissions financed by banks, investment managers and insurers through their investment and lending activities (so-called "financed emissions"). It has attracted commitments from several high-profile financial institutions in recent weeks, and has also published a draft Global Carbon Accounting Standard for the Financial Industry (the "Standard") for global consultation

What is PCAF?

PCAF was created in the Netherlands in 2015, but has expanded significantly since its global launch in autumn 2019. It now comprises a global membership of over 74 banks, asset managers and insurers, which represent over $11.8 trillion of financial assets. Member institutions include Bank of America, Citi and Morgan Stanley in the US, Investec and NatWest Group in the UK, and ABN AMRO, Danske Bank and Rabobank in Europe.

Member institutions must sign a commitment letter which includes:

- a recognition that the challenges of climate change and of decarbonising the economy are more urgent now than ever; and
- a commitment to measure and disclose the GHG emissions associated with their investment and lending activities within three years, using jointly developed carbon accounting methodologies.

The ultimate goal of PCAF is to create a harmonized global accounting standard for the measurement and disclosure of financed emissions, which will in turn enable financial institutions to set science-based targets and to align their portfolios with the Paris Climate Agreement to keep global temperature rises this century below 2 degrees Celsius above pre-industrial levels. PCAF recognises that the financial sector is uniquely positioned to drive the transition to a decarbonised economy, and is well on its way to achieving the 100 signatories that it has set out to achieve. Since its global launch last autumn, PCAF has observed a "*surge of interest*" from banks and investors worldwide, looking for a clear and transparent set of rules which will help them to measure their financed emissions; assess their climate-related risk exposure; manage the impact of their operations on the climate; meet the disclosure expectations of stakeholders; and assess the progress of global climate goals.

As an industry-led partnership, PCAF is governed by a steering committee of six of its member institutions. Once a global carbon accounting standard has been established, PCAF has suggested that responsibility for implementation or monitoring may be transferred to an independent body with other engagement in the climate finance space (such as the IASB, the CDP or the World Resources Institute)

Publication of the draft Standard

On 3 August, PCAF published the draft Standard and launched a global stakeholder consultation that will run until the end of September – feedback can be provided by anyone using an online survey. The draft was prepared by the PCAF Core Team, comprising sixteen PCAF members, and was also observed by other industry organisations including Barclays and the Green Climate Fund.

The draft Standard seeks to address this by providing detailed guidance for the calculation of financed emissions across six classes of financial asset:

- **Listed equities and bonds**: Financed emissions should be calculated using reported emissions (where available), or otherwise based on the issuer's physical activities (e.g. volume of materials consumed and produced) or economic activities (e.g. turnover). A formula is then applied to apportion those emissions to the number and value of securities held by the financial institution.
- **Business loans**: Financed emissions should be calculated using reported emissions (where available), or otherwise based on the borrower's physical activities (e.g. volumes of materials consumed or produced) or economic activities (e.g. turnover). A formula is then applied to apportion those emissions to loan participation held by the financial institution.
- **Project finance**: Financed emissions should be calculated using reported emissions (where available), or otherwise based on the physical nature of the project (e.g. volumes of materials consumed or produced) or the economic performance of the project (e.g. turnover), and then adjusted for avoided emissions and/or removed emissions where relevant (see below). A formula is then applied to apportion those emissions to the investment of the financial institution.

Following the consultation period, the Standard is expected to launch in November.

In the absence of a globally-accepted methodology for the measurement and disclosure of financed emissions, financial GHG disclosures have been relatively uncommon and (in the limited cases where they have been made) have been prepared on an inconsistent basis, hampering transparency, comparability and accountability.

- **Commercial real estate**: Financed emissions should be calculated using the actual emissions of the building (where available), or otherwise estimated based on floor space or number of buildings. A formula is then applied to apportion those emissions to the particular investment of the financial institution.
- **Mortgages**: Financed emissions should be calculated using the actual emissions of the mortgaged property (where available), or otherwise estimated based on floor space or number of buildings. There is no adjustment for the size of the mortgage participation – any lender who has taken a mortgage over a property is deemed to finance 100% of the emissions from the property until the mortgage is released.
- **Motor vehicle loans**: Financed emissions should be calculated using the actual emissions of the vehicle (where available – e.g. where the fuel consumption and distance travelled are known), or otherwise estimated based on vehicle models/types and volumes. For consumer motor vehicle loans, there is no adjustment for the size of the financial participation – any lender who provides consumer vehicle finance is deemed to finance 100% of the emissions from the vehicle. For commercial motor vehicle financing, a formula is applied to apportion the emissions to the proportion of credit provided by the financial institution.

In reaching these calculation methodologies, the draft Standard sets out to reflect the borrower's/investee's:

- **direct GHG emissions** (i.e. those which are generated from sources that are directly owned/controlled by the borrower/investee);
- **'upstream' indirect GHG emissions** (i.e. those which are generated by the borrower's/investee's supply chains, such as from the generation of electricity consumed and from the production of raw materials used); and
- **'downstream' indirect GHG emissions** (i.e. those which are generated as a consequence of the use of the borrower's/investee's products or services). This third element will be the key factor when assessing the GHG emissions that result from investment in, and lending to, the oil and gas sector.

As well as recognising "*generated emissions*" (i.e. GHG emissions that result from financial activities), the Standard also provides carbon accounting credit for "*avoided emissions*" (i.e. GHG emissions that are prevented through financial activities, such as investment in renewable or energy-efficient projects) and "*removed emissions*" (i.e. GHG that is removed from the atmosphere as a result of financial activities, such as investment in reforestation projects). In that sense, the draft Standard should be thought of as both a 'green' and a 'brown' carbon accounting regime, although those labels are somewhat reductive.

While the draft Standard recognises that limited data is often the main challenge in calculating financed emissions, it should not be used as an excuse not to begin the process of carbon accounting and disclosure. The Dutch founder institutions state that, even using estimated or proxy data, they have already been able to identify carbon-intensive hotspots in their lending and investment portfolios and respond accordingly.

Interaction with other climate-related frameworks

The Standard is intended to complement existing climate-related frameworks. In particular, one of the Task Force on Climate-related Financial Disclosures (*TCFD*) recommended disclosures relates to GHG emissions and related risks. PCAF provides a framework for financial institutions to disclose not only the GHG emissions that they themselves generate, but also the GHG emissions that they finance, with the Standard providing detailed guidance on what 'shall' be disclosed (i.e. mandatory), and what 'should' be disclosed (i.e. recommended). Member institutions who do not provide the 'shall' disclosures will need to explain why they have not. This will be of particular relevance to financial institutions with a premium London listing, given the FCA's current consultation on the introduction of the TCFD disclosure framework into the Listing Rules on a 'comply or explain' basis (see our separate briefing here for further information).

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

Jeff Twentyman
T +44 (0)20 7090 3476
E jeff.twentyman@slaughterandmay.com

Richard Hilton
T +44 (0)20 7090 3611
E richard.hilton@slaughterandmay.com

21 August 2020