How Can We Help SMEs Embark On A Sustainable Growth Path?

Introduction

Banks and financial institutions can make a significant contribution to sustainable development, considering the fundamental role they play in financing families and businesses. While on the one hand it is becoming crucial to identify the sectors and businesses most exposed to the new environmental and social risks to ensure effective management, on the other hand it is necessary to support a transitional economy, above all for small and medium-sized Italian companies (SMEs).

Climate change

Climate change is hitting harder and faster than many people expected. The temperatures recorded over the past five years have been some of the highest ever, natural disasters are becoming more intense and frequent, and we have been witnessing extreme and unprecedented meteorological phenomena throughout the world. The United Nations Sustainable Development Goals (SDGs) and the Paris Agreement on climate change, which call for the practical commitment of the signatory countries by the end of this decade, have given a considerable boost to government and financial intervention at a global level. One of the main challenges is to limit average global warming, with the target of restricting the global temperature rise to 1.5 degrees Celsius by 2030.

The Challenge:

You and your team have the task of creating a project for a service or innovative product which aims to support SMEs in reporting their environmental and social impact. This will make it possible to assist them in their transition process, while at the same time providing factors useful to financial institutions for identifying companies which are more sustainable and towards which capital should be directed.

You should focus on one or more of the following points:

- **SMEs and ecological transition**: As things currently stand, there are very few SMEs that have the tools for measuring and reporting their environmental and social impact. How can we make this transaction process easier for SMEs? What information must be obtained inside a company? Starting from the international parameters of reference for large companies (GRI, SASB, etc.) what are the indicators (consumption, good governance, rating, …) from which the sustainable value of Italian SMEs arises? Select one or two sectors of the SME world, focusing on the brown industries. Determine a few, but significant, measurable items concerning a company's ecological footprint and the means of measuring these and the tools required.

- **Storytelling and awareness**: How can we best relate the sustainability of SMEs? Is simplified non-financial reporting enough or should sustainability be an integral part of the corporate purpose? How can these transition processes be fostered among SMEs?
- **Business conversion:** The market is moving towards increasingly sustainable solutions and customer needs are changing too. The transition of SMEs towards these models should be carried out as quickly as possible, without this being forced upon them by unexpected outside events, as in the case of the pandemic that has caused technological development to accelerate. One solution might be the economic conversion of certain sectors which are carbon intensive for example. How can a business be converted, transforming a traditional company into a sustainable company?

Challenge Background Information:

Support for the transition: Next Generation EU, Just Transition and the NRRP

Extraordinary measures have been introduced at a European level to foster ecological transition and more, starting with the European Green Deal (which includes the Just Transition Mechanism[1]) and arriving at the recent NextGenerationEU and its expression at a national level, such as the Italian National Recovery and Resilience Plan (NRRP-PNRR).

NextGenerationEU is a programme worth 800 billion euros whose aim is to relaunch a European economy seriously hit by the consequences of the Covid-19 pandemic. In addition to setting its sights on laying the foundations for a greener, more digital and more resilient Europe, NextGenerationEU also aims at creating the bases for tackling current and future challenges in the best possible way.

The Just Transition Mechanism is a framework adopted by the European Union for dealing with the socio-economic consequences of the transition to a climatically neutral economy and ensuring that this occurs in a fair and sustainable way, without leaving anyone behind. The aim of the mechanism is to achieve the mobilisation of at least 55 billion euros between 2021 and 2027, focusing in particular on the regions, the industries and the workers who will have to deal with the more pressing challenges.

"*We must show solidarity with the hardest hit regions in Europe, including the coal-mining areas, to ensure that the Green Deal obtains the full support of everybody and can become a reality*", Frans Timmermans, executive vice-president of the European Commission, has stated.

Italy, for example, is particularly subject to extreme meteorological phenomena and hydro-geological disasters, including forest fires and drought. As a result, therefore, in the perception of the European Commission the transformation of this country to a climatically neutral economy calls for substantial public and private investment over a long period of time.

These investments have, to a large extent, been included in the Italian NRRP, an investment and reform package which is worth 191.5 billion euros and has as its leading objectives ecological and

[1] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/finance-and-green-deal/just-transition-mechanism_it

digital transition, innovation, training, combating inequalities, the reform of the public administration and civil justice system and an improvement to the healthcare system.

Mission 2 of the NRRP, "Green revolution and ecological transition", allocates a total of 68.6 billion euros, with the main goals of improving the sustainability and resilience of the economic system and ensuring a fair and inclusive environmental transition; through some measures as sustainable agriculture and a circular economy; renewable energy, hydrogen, network infrastructure and sustainable mobility; energy efficiency and requalification of buildings; protection of land and water resources.

Among the global challenges of our times the reduction of emissions is an imperative

A reduction in greenhouse gas emissions (GHG emissions) is increasingly on the agenda of international leaders, investors and executives. In fact, this is becoming a business imperative, one that cannot be simply considered a mere component of corporate social responsibility.

The recent announcements by GAFA[2] and other leading international groups show the extent to which emissions have taken on significance for businesses. Apple, for example, is committed to becoming carbon neutral across its supply chain by 2030[3]. Another nine large companies – including Starbucks, Microsoft, Unilever and Nike – are founding members of the Transform to Net Zero initiative[4], with the mission of accelerating the transition to a low-carbon economy.

In addition, more than 450 companies in the financial community have joined GFANZ (Glasgow Financial Alliance for Net Zero)[5], launched in 2021 with the aim of leading net zero initiatives and accelerating the move to net zero emissions by 2050. The Net-Zero Banking Alliance[6], which brings together banks worldwide representing ca. 40% of global banking assets, is one of these initiatives.

The European Union has shown the way by setting ambitious targets aiming to reduce net emissions by at least 55% over 1990 levels by 2030 and make Europe the first climatically neutral continent by 2050.

Every company and every industry are, out of necessity, going to have to adapt itself in order to put through its own sustainable transition. Engineers and scientists are working round the clock to discover how to decarbonise concrete, steel, plastic, logistics, road transport and aviation, agriculture, energy and construction.

Larry Fink has reminded CEOs that the next 1,000 unicorns will be sustainable and scalable innovators: start-ups that help the world in the decarbonisation process and in an energy transition that is within the reach of all consumers.

Carbon emissions represent 81% of total greenhouse gas emissions and companies are to a large extent responsible for this. The remaining greenhouse gas emissions consist of: methane (10%), nitrous oxide (7%) and fluorinated gases (3%).

In order to reduce their impact, companies must first and foremost monitor and communicate the level of their emissions using the leading business standard, the GHG Protocol[7], which classifies

[2] GAFA: Google, Apple, Facebook, Amazon

[3] https://www.bbc.com/news/technology-53485560

[4] https://transformtonetzero.org/

[5] https://www.gfanzero.com/

[6] The Net Zero Banking Alliance was set up by 43 founding members on 21 April 2021, since when its number has grown to the current total of 108 banks in 40 countries, which represent US$ 68trn of total assets and 38% of global banking assets, at the date of 5th April 2022(cfr. https://www.unepfi.org/net-zero-banking/members/)

[7] https://ghgprotocol.org/

these into three different "scopes": scopes 1, 2 and 3. The first two are subject to mandatory reporting while the third is voluntary and the hardest to monitor. Nevertheless, businesses that manage to report all three scopes obtain a considerable competitive advantage in terms of sustainability.

Scope 1 emissions are direct emissions from company-owned and controlled resources. In other words emissions are released into the atmosphere as a direct result of a set of activities at an enterprise level.

Scope 2 emissions are indirect emissions from purchases of electricity, steam and heat from third parties**.**

Scope 3 emissions are all indirect emissions (not included in scope 2) arising from activities that are not under the direct control of the company and have a different effect depending on the sector. For example, in the financial sector they mostly relate to emissions resulting from enterprises that lenders have financed.

It is not, therefore, only a question of reducing emissions, but also of obtaining all the information required to create a company's environmental footprint, both current and future. Only in this way can the rationale behind corporate strategies and the extent to which they will be resilient from a business standpoint be understood. Fortunately, recent European legislation is moving in this direction (for example with the Taxonomy Regulation[8] and the proposed Corporate Sustainability Reporting Directive[9]) and this example could also be repeated in other regions at a global level.

Companies are therefore going to have to be more transparent when communicating their environmental impact and the results obtained in terms of ecological transition.

Non-financial reporting

According to the Italian Banking Association (ABI)[10], 76% of Italian banks already report the initiatives they have carried out to foster better management of the climate change risks of their corporate customers. Nonetheless, banks still do not have all the information required at their disposal because only certain companies are required to disclose this.

Sustainability reporting contributes to the emergence of the social and environmental values that a company fosters. Their aim is to communicate a business's non-financial impact on all the stakeholders of reference with the aim of informing them about the economic, social and environmental results generated by the company in carrying out its operations.

These reports are generally prepared by referring to specific reporting **parameters and standards**, such as those issued by the Global Reporting Initiative (GRI), the most widely used. In the profit sector, reporting non-financial information is currently mandatory for listed companies and large enterprises in the banking-insurance sector (Legislative Decree no. 254/2016 which incorporates European Directive 2014/95/EU into Italian law), while it is voluntary for all other companies.

We are therefore talking about listed companies or large bond issuers (meaning those with over 500 employees and an annual turnover of more than 40 million euros or total assets exceeding 20 million euros) and enterprises in the banking-financial sector satisfying the same size criteria.

[8] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework ("Taxonomy") to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[9] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) no. 537/2014 as regards corporate sustainability reporting ("Corporate Sustainability Reporting Directive")

[10] ABI, Research into Non-Financial Statements (NFSs) published by the sector in 2020.

In addition to the requirements of the European directive, the Italian legislator has also provided for the possibility of drawing up a Non-Financial Statement (NFS) on a voluntary basis. The requirement to publish this document and submit it to audit follows automatically from the voluntary decision to prepare it.

In fact, only slightly more than 200 Italian companies are required by law to issue a non-financial statement.

European Directive 2014/95/EU made the communication of non-financial information mandatory for large public-interest entities, leaving this voluntary for SMEs.

In order to win the global challenge to reduce emissions and increase awareness on the subject it is becoming increasingly necessary to involve not only large companies but also small and medium-sized enterprises.

The main benefits that an SME could obtain by deciding to report non-financial information in its financial statements are as follows:

- risk assessment and mitigation (financial and non-financial risk);
- simpler relationships with the public administration;
- better access to the credit market and to funds;
- increased ability to attract and win the loyalty of staff with the right skills;
- development of a sustainable supply chain (both with suppliers and as suppliers);
- support from one's stakeholders;
- ease in business combinations;
- improved image and brand reputation.

Background Sources:

- Larry Fink's Annual 2022 Letter to CEOs | BlackRock,
- What are Scopes 1, 2 and 3 of Carbon Emissions? - Plan A Academy,
- Carbon Cycle Greenhouse Gases
- Eurobarometer, Future of Europe 2021
- Climate change: what the EU is doing
- Bank of England Annual 2022 Letter to CEOs

Financial Times Background Sources:

- Have we entered a new phase of climate change?
- Breaking the climate change cycle - Future World
- The rising costs of climate change for banks
- Carbon removal 'unavoidable' as climate change alarm bells ring
- Climate change is a global threat demanding national solutions