SMEs and sustainability: Identifying challenges, opportunities and solutions

WHITE PAPER

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Introduction

Small and medium-sized enterprises (SMEs) represent 99% of all businesses in Europe[1] and produce 70% of Europe's industrial pollution.[2] Implementing sustainable business practices and addressing environmental issues is therefore not only the right thing to do, but it can also be a great business opportunity for the financial institutions (FIs) that manage to help these SMEs understand the related benefits and navigate through their green transition.

Recent years have also seen tremendous growth in consumer expectations for the companies whose services they use to be ethical and sustainable. Additionally, we have seen growing pressure from regulators on corporates to implement sustainable practices. However, many SMEs are not fully aware of the benefits of embracing sustainable practices. A recent World Economic Forum survey of more than 1,100 U.K. business owners showed that just 19% of respondents are aware of what environmental, social, and governance (ESG) is and only 12% are implementing formal practices.[3]

Navigating sustainable solutions can often feel complex and overwhelming for SMEs, especially for those taking their first steps into this space. For those that are ready to engage on this journey, sustainability reporting can be complex, expensive and time consuming.

To support SMEs to unlock the numerous benefits that come from engaging in sustainable business practices, and realize their sustainability goals, we can:

- Increase awareness and educate SMEs on sustainable practices and the associated benefits.
- Make greenhouse gas (GHG) reporting more accessible to SMEs.[4]
- Protect SMEs from any cyber risk resulting from the digitalization of their business, a key practice towards a more sustainable business.

Financial institutions, in partnership with Mastercard, are in a unique position to address SME sustainability needs.

The transition to a low carbon, regenerative economy presents a significant market opportunity for banks and other SME services providers. The global market for green technology and sustainability is projected to grow from $28.6 billion in 2024 to $134.9 billion by 2030, at a compound annual growth rate (CAGR) of 29.5% during the forecast period.[5] Businesses, starting with the largest ones, are undergoing a significant transformation by embracing green technology and sustainability initiatives, and companies are incorporating eco-friendly practices across their operations, from supply chain management to product development. Key drivers include increasing environmental awareness, stringent regulations and the pursuit of cost efficiencies.

Early adopters of sustainable business practices confirm that the relevance of banks in this space is increasingly important as they have access to a myriad of data that can be used in reporting. This white paper aims to uncover the challenges that SMEs across Europe face when it comes to engaging in sustainable business practices and identifies the joint opportunities that we can explore with financial institutions to support their sustainability needs.

Furthermore, it dives into how financial institutions can implement robust tools that support their own sustainability policies to optimize their offering to SME customers:

- Integrating sustainability ratings can lead toward adjusted financing rates and dynamic discounting.

- Offering additional value-added services like green loans to SMEs which can lead to acquisition of new customers.[6]

Together, we can support the evolving needs of SMEs, and create opportunities for them to leverage the benefits that come from engaging with and implementing sustainable business practices.

Challenges SMEs face when it comes to sustainability

With limited resources, SMEs are busy focusing on their core business and spend their time and energy on trying to find the best solutions to help them concentrate on growing sales.

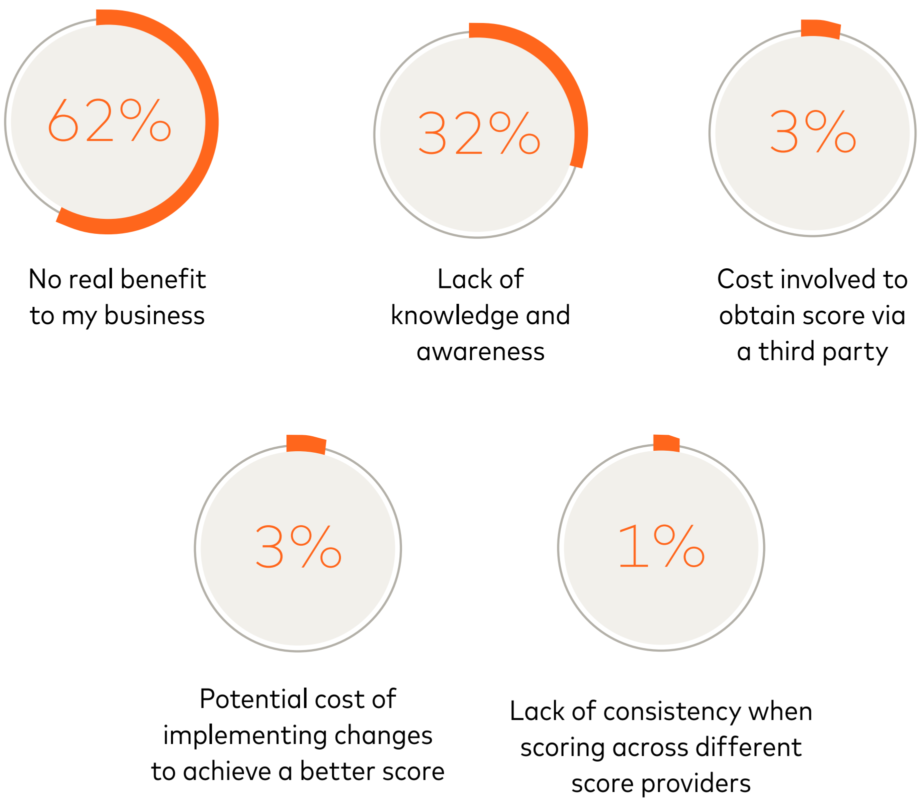
Sustainability is not a current priority

Only one-fifth of SMEs in the U.K. are aware of what environmental, social and corporate governance (ESG) is and most of them are doing nothing about it, a study by ID Crypt Global has found.

The study revealed that of the 1,124 U.K. SME business owners surveyed, just 19% are aware of what ESG is, while only 12% are implementing it.[7] Ninety-two percent of the respondents also stated they had no plans of actively implementing ESG practices in the future.[8]

Lack of knowledge and perception

The ID Crypt Global survey report also revealed the biggest barriers U.K businesses are facing when it comes to implementing ESG, with a lack of knowledge and the perception that implementing ESG practices do not have any real benefits topping the list.



Source: ID Crypt Global, "SMEs and ESG: SME survey results," February 24, 2023.

Additionally, implementing sustainable measures can feel like too big a task for SMEs, and they are far more likely to prioritize more immediate financial and expansion concerns than develop a long-term ESG strategy.

But SMEs will have to get onboard

"Change is coming for SMEs whether they like it or not," wrote Sanda Ojiambo, chief executive officer and executive director of the UN Global Compact.[9]

Increased regulation seems inevitable, and disclosure is likely to become a standard part of corporate operations, no matter the size of the company.

SMEs will therefore have no choice but to get onboard. Compliance with new regulations will have to become an inherent part of the way SMEs run their business if they are to remain compliant and attractive to investors, supply chains and consumers.

Sustainability solutions drive essential benefits for SMEs

Opening up new opportunities for SMEs to access capital

One of SMEs' largest recognized challenges is access to capital due to their low levels of collateral, limited financial track records, lack of financial literacy/financial management skills and risk perception for lenders and investors to adequately assess them.

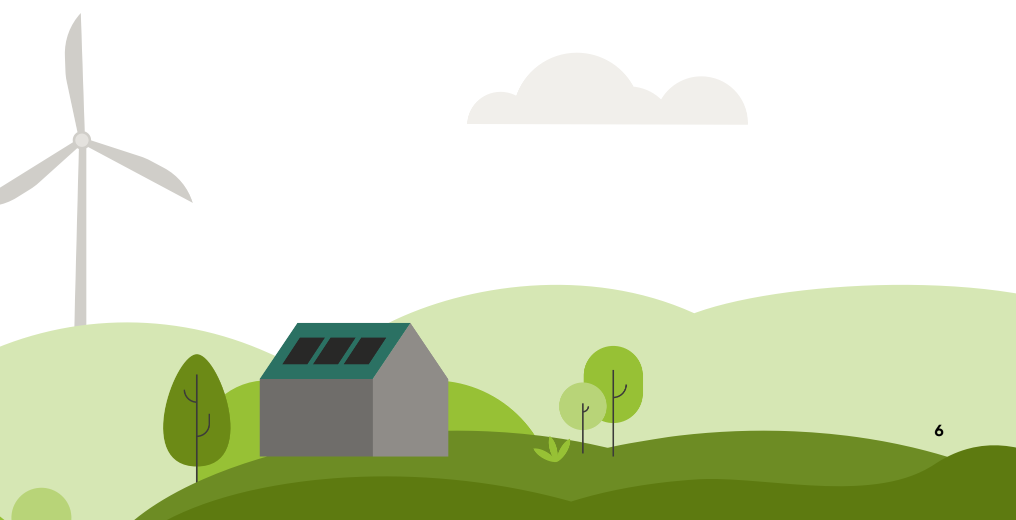
SMEs with strong environmental practices may find it easier to attract investment. The emergence of green bonds, impact investment funds, and other dedicated funding sources for environmentally sustainable projects can provide SMEs with additional avenues for securing capital which is specifically earmarked for sustainability-centred initiatives.

Socially responsible investors are also showing a growing interest in businesses with a commitment to sustainability. SMEs that secure official certifications or adhere to established sustainability standards may find it easier to attract sustainability-focused capital, as these certifications provide credibility and assurance to investors and lenders. Additionally, many governments around the world offer grants, subsidies, tax deductions, low interest loans and support programs to promote sustainable practices by SMEs.

Keeping ahead of the regulatory curve with GHG emissions reporting

Caring about sustainability can help SMEs in building strong supply-chain relationships with large companies, sell to the government, export their products and get access to green capital.

Certain GHG reporting regulations apply to businesses depending on their size, sector and location in Europe. While all SMEs are not required to measure and report their GHG emission under current regulations, they should prepare for any upcoming changes on the horizon. The European Union (EU) has been working on sustainability initiatives which could impact SMEs in the near future.



Overview of current required regulations from the European Commission and Task Force on Climate-Related Financial Disclosures (TCFD)

Impacted players	Standards	SME should report their GHG emissions if they are involved in	What does this mean for SMEs?
Companies (250+ employees)	TCFD (U.K.)	**Supply chain**	Companies must report on GHG Scope 3 emissions, this includes the Scope 1 and 2 emissions of SMEs in their supply chain.
	CSRD (EU)	**Supply chain**	Companies must report using the EU Taxonomy (21 metrics), this includes ESG data of SMEs in their supply chain.
Investors	TCFD (U.K.)	**Value chain**	Investors must report on GHG Scope 3 emissions, this includes the Scope 1 and 2 emissions of SMEs in their investment chains.
	SFDR (EU)	**Value chain**	Investors must report using the EU Taxonomy (21 metrics), this includes ESG data of SMEs in their investment chains.
Banks	TCFD (U.K.)	**Value chain**	Banks must report on GHG Scope 3 emissions, this includes the Scope 1 and 2 emissions of SMEs they lend money to or invest in.
	SFDR (EU)	**Value chain**	Banks must report using the EU Taxonomy (21 metrics), this includes ESG data of SMEs they lend money to or invest in.
	GAR/BTAR (EU)	**Direct inclusion**	Banks must report lending to SMEs that is aligned with the EU Taxonomy as a % of total lending and investments.

Scope 1

emissions are direct emissions from owned or controlled sources

Scope 2

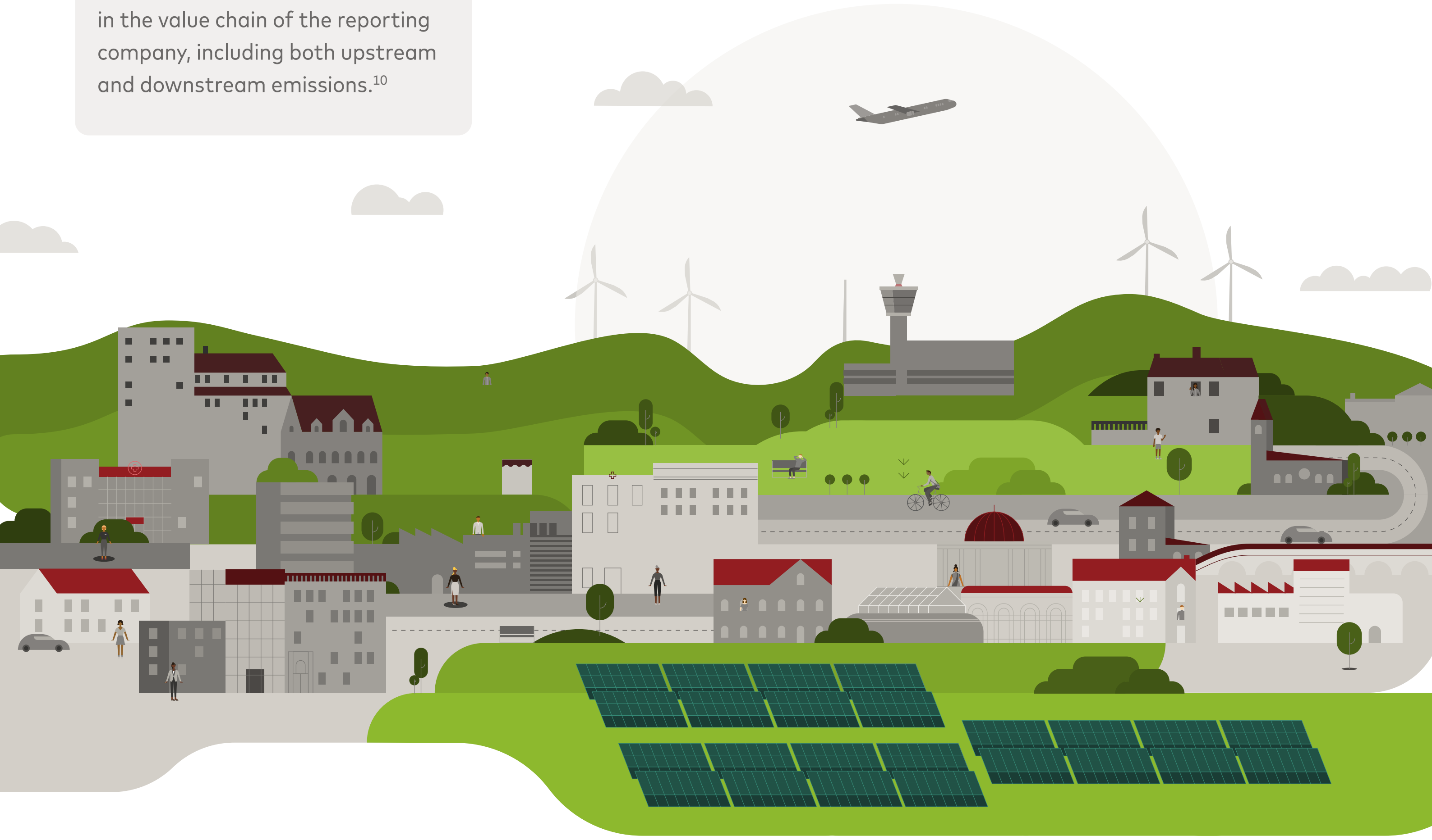
emissions are indirect emissions from the generation of purchased energy.

Scope 3

emissions are all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions.[10]

While current impacts of regulation are predominately on larger corporations, SMEs can be indirectly impacted through supply chain requirements or market expectations. For example, if an SME wants to become a supplier of regulated corporations or public sector bodies or export their products to markets where there are requirements, preference or increasing demand for sustainable and socially responsible products – they may need to report on their greenhouse gas emissions.

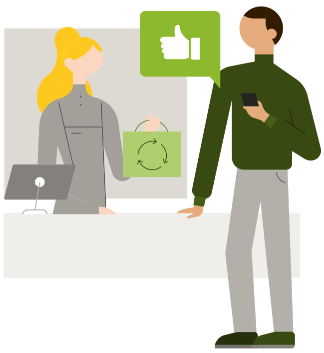
Providing SMEs with a comprehensive yet accessible sustainability overview of their company with the concrete goal to measure their business' GHG emissions help them reduce their GHG footprint to get certified against internationally recognized standards and will also educate them on the benefits that this new KPI may unlock. This could be a key opportunity for them and the trusted advisor who will guide their business through this transition.



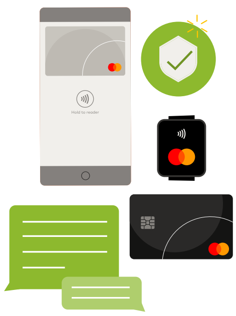
Gaining competitive advantages, saving on costs and more

Adopting sustainable business practices is not just about keeping up with regulation — it also makes good business sense. By implementing sustainable practices, SMEs can build strong competitive advantages, gaining an edge over competitors, and even save significantly on operational costs over time.

- The trend of consumers choosing more sustainable brands and businesses has been growing in recent years and being green certified can be a major differentiator helping those SMEs acquire and retain clients.
- One of the most significant challenges faced by SMEs when recruiting and hiring is the limited direct access to the market. Unlike large organizations, SMEs don't have the same resources and reach to promote their brand and job opportunities. It's often hard to find the best candidates, but sustainable businesses attract talent. Surveys show a growing trend of employees seeking purpose-driven and socially responsible workplaces, especially amongst millennials and Generation Z.



- Digitalization of operations reduces business costs. The automation of repetitive tasks (such as shipping and logistics, invoicing, marketing and more) improves efficiency. A study by McKinsey found that companies that invest in digital transformation are 23% more profitable than their less advanced peers.[11]
- Other sustainable practices like energy efficiency, waste reduction and responsible resource management can also lead to cost savings.



- And of course, doing well by doing good is top-of-mind for why SMEs would consider the implementation of sustainable practices in the future. Running sustainable businesses and leaning into sustainable business practices can ultimately lead to a lower environmental impact, which is particularly important considering that SMEs contribute to up to 70% of industrial pollution in Europe.[12]

Why should financial institutions care?

By implementing sustainability solutions and reporting metrics for SMEs, financial institutions (FIs) can address their own sustainability priorities while also meeting the needs of SMEs, ultimately helping them thrive. For financial institutions, the importance of establishing clear and compliant sustainability reporting metrics is becoming increasingly important, as banks will soon need to need to report not only Scope 1 and 2 but also Scope 3 of their GHG emissions, and more specifically, Scope 3.15 which covers their financed emissions across their entire lending portfolio.

This may not be a challenge when lending to large or regulated corporations that by law must report their GHG emissions. However, it becomes a hurdle when targeting the 24 million SMEs in Europe and staying compliant with the Sustainable Finance Disclosure Regulation (SFDR) — Europe's transparency framework. Setting out how financial market participants must disclose sustainability information can help investors who seek to invest in companies and projects that support sustainability objectives to make informed choices. The SFDR is also designed to allow investors to properly assess how sustainability risks are integrated in the investment decision process, so having a robust and reliable GHG emissions calculating tool is key.[13]

Sustainability solutions, specifically GHG emissions management, enables banks to optimize their Green Asset Ratio (GAR)[14] and Banking Book Taxonomy Alignment Ratio (BTAR)[15], which creates an opportunity to access trillions in government subsidized funds. Additionally, the European Banking Authority (EBA) will require around 150 lenders to publish their GAR from June 2024. GAR includes large enterprises but not SMEs, to which EU and U.K. banks have significant exposure.[16] Banks with large exposure to SME segments are therefore at a structural disadvantage when seeking to boost their GAR. To meet these regulatory requirements, banks need a dedicated carbon dioxide equivalent (CO_2e) dataset containing pre-audited metrics for their SME portfolio.

To offer SMEs green loans at competitive rates while optimizing for BTAR, it is our recommendation for banks to have a fully automated, compliance centric CO_2e estimation engine with unique quality score. Some banks, however, may find it time-consuming and costly to build such solutions in-house and would instead prefer to outsource to third-party solution providers. These solutions can enable easier access to capital for SMEs and lower the cost of capital for banks. This ultimately also positions banks as trusted advisors for Europe's SMEs, helping them do well by doing good.

Mastercard solutions: Supporting a sustainable and secure digital future

"At Mastercard, we believe in doing well by doing good, and these new solutions support our banking partners as well as SMEs on their sustainability journey. By offering a reliable GHG emissions measurement tool, transition plans supported by digital and secured assets and internationally recognized certifications, we are unlocking opportunities for FIs to support SMEs to become more sustainable, while making it easier for our FI partners to comply with regulation, report a better asset ratio and better serve their SME clients. "

— Valerie Nowak
Executive vice president of product and innovation, Mastercard Europe

Mastercard recently partnered with Omnevue, a financial-grade ESG and CO_2e accounting platform, to provide a set of solutions to help FIs support their small business cardholders through their decarbonization transition and optimize their own sustainability needs.

The solutions aim to build awareness and educate SMEs on the benefits of implementing sustainable practices through an education hub, help small businesses mitigate and off-set their GHG emissions via assessment, reporting and transition plan tools, and provide them with certifications, enabling greater access to green loans, subsidies and other forms of incentives that come from reducing their GHG emissions.

SMEs are mission critical to improving compliance and raising BTAR, but this data is often scarce and poor quality, and SMEs can therefore be more difficult to lend to than larger corporates. Through Mastercard's partnership with Omnevue, we're able to offer a fully automated, compliance-centric carbon reporting estimation engine and a unique quality score. Issuers and their customers can directly assess their GHG footprint as the engine provides a comprehensive carbon emissions view of their business by connecting to an online banking account or integrating it within their own digital bank. The quality score is an indicator of confidence in the accuracy of CO_2e emissions reported. It addresses the issue of poor quality and inconsistent CO_2e reporting by assessing the completeness and relevance of an SME's underlying data.

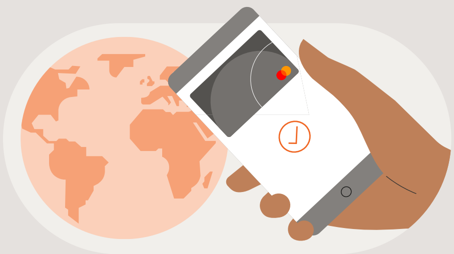
This consolidated data collection from SME counterparties will enable banks to be compliant with regulations, while lowering cost of equity at the same time. It also helps them to steer preferential financing terms for SMEs and green loans that are aimed at reducing GHG emissions.

A range of Mastercard digital tools are also available to support SMEs to reduce their GHG emissions by moving into the digital space via digital invoicing, digital loyalty programs and ecommerce channels. Our cyber security solutions, which include Mastercard Trust Center, ID Theft Protection, Cyber Quant lite and Risk Recon, offer protection against cybersecurity threats that may come with the digital transformation of SMEs. At the same time, the solutions also address the sustainability needs of FIs with large SME portfolios.

Contact SME.Community@mastercard.com for more information on our digital tools, cyber security solutions and offerings in partnership with Omnevue. To find out more about sustainability at Mastercard, read our 2023 ESG Report.

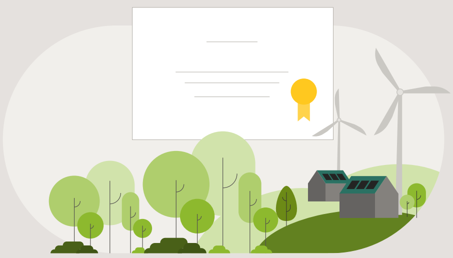
Awareness

- Interactive educative hub, in partnership with Omnevue
- Mastercard self-assessment tool
- Carbon reporting calculator, in partnership with Omnevue



Mitigation

- Mastercard digital and cyber security solutions
- Net zero transition plan, in partnership with Omnevue



Certification

- SME green certifications, in partnership with Omnevue
- GHG quality score, in partnership with Omnevue

Endnotes

1. European Commission, "SME Performance Review."

2. Xynteo, commissioned by Mastercard, "Mastercard Sustainability-based growth strategy," December 15, 2021.

3. ECAEW, "ESG for SMEs: what if you do nothing?," August 15, 2023.

4. European Commission, "SME Performance Review."

5. Research and Markets, "Global Green Technology & Sustainability Market by Offering (Solutions, and Services), Technology (IOT, AI & ML, Cloud Computing, Edge Computing, Digital Twin, Blockchain), Vertical (Manufacturing, Energy & Utilities) and Region - Forecast to 2030," February 2024.

6. AiteNovarica, "Top 10 Trends in Commercial Banking & Payments, 2023," January 2023.

7. ID Crypt Global, "SMEs and ESG: SME survey results," February 24, 2023.

8. Ibid.

9. World Economic Forum, "Small businesses are key to a more sustainable and inclusive world. Here's why," March 8, 2023.

10. Greenhouse Gas Protocol, "FAQs."

11. Software Development UK, "How much does digital transformation cost?," October 30, 2023.

12. Xynteo, commissioned by Mastercard, "Mastercard Sustainability-based growth strategy," December 15, 2021.

13. European Commission, "Sustainability-related disclosure in the financial services sector," 2023.

14. Green Asset Ratio (GAR) has been established by the European regulatory authorities as a key performance indicator (KPI) for measuring the proportion of Taxonomy-aligned on-balance-sheet exposure in relation to the total assets. The GAR aims to create a comparable KPI enabling more transparency in reporting different institutions' "green" exposures. These exposures are assessed and reported according to eligibility and alignment with the EU Taxonomy.

15. The Banking Book Taxonomy Alignment Ratio (BTAR) is a measure of the consistency between a company's financial reports and the EU taxonomy. GAR plus SMEs plus non-NFRD/CSRD undertakings (that is not subject to disclosure regulations) invested in EU Taxonomy-aligned economic activities as a proportion of total assets.

16. The EU Non-Financial Reporting Directive focuses on non-financial elements, such as social and employee-related factors, the environment, human rights, corruption and board diversity. Collectively, this includes reporting on gender equality, health and safety or greenhouse gas emissions, among others. These reporting rules apply to large public-interest companies with more than 500 employees.

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