UNIVERSITY OF CAMBRIDGE
INSTITUTE FOR SUSTAINABILITY LEADERSHIP

Banking Environment Initiative

Background Briefing

Bank Action Guide: Towards a just transition for small–medium enterprises (SMEs)

The University of Cambridge Institute for Sustainability Leadership

CISL is an impact-led institute within the University of Cambridge that activates leadership globally to transform economies for people, nature and climate. Through its global network and hubs in Cambridge, Cape Town and Brussels, CISL works with leaders and innovators across business, finance and government to accelerate action for a sustainable future.

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The Banking Environment Initiative (BEI) is a group of global banks committed to pioneering actionable pathways towards a sustainable economy. The BEI co-produces horizon scanning applied research, develops leadership tools and convenes academic and industry collaborations. It is a member-led, not-for-profit group convened by CISL and initiated in 2010.

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The purpose of the background briefing is to introduce the role of banks in a just transition, clarifying their sphere of influence and rationale for action. The briefing also justifies the focus on small–medium enterprises (SMEs) and sets the stage for our Bank Action Guide on Just Transition.

Net-zero transition should be just and inclusive

The net-zero transition is a whole economy challenge that will radically change how economies are structured, businesses operate, and people live and work. While the transition holds the promise of a sustainable future, it is essential to approach it with caution. If not executed with care and consideration, including by banks, there is a risk that the transition could intensify existing societal issues, placing undue burdens on vulnerable communities and supply chains. Such outcomes could challenge the acceptability of the transition to civil society and the social licence to operate banks. Therefore, a just transition approach is critical, especially by economy-wide actors such as banks, to deliver a net-zero transition future in which people and the planet thrive.

Banks' role in a just transition

Banks mirror the real economy. They succeed when the clients and communities in which they are embedded thrive. As the volatility of the transition intensifies, banks will become critical partners of vulnerable clients and communities. Not only are deposit-taking banks heavily exposed to small businesses and individuals, who are likely to be more vulnerable to climate-related transitions than major corporations, but their social licence to operate is bound to how these clients interact with their banks. This means banks face both reputational and financial risks by not pursuing a just transition approach to net zero.

Why a just transition of SMEs matters to banks

There is no net-zero transition without SMEs. They account for over 95 per cent of firms and 60–70 per cent of employment[1]. SMEs play a pivotal role in sectors at the forefront of the climate transition, such as energy, transport, agriculture and manufacturing. In the OECD countries, SMEs account for 50 per cent of greenhouse gas (GHG) emissions[2]. While the public discourse often highlights large extractive and power generation companies as the primary players in the climate transition, it is crucial to understand that SMEs are deeply embedded in these sectors and their supply chains. Their role is not just peripheral; they are often the innovators, suppliers and service providers that enable the larger corporations to function. As such, any meaningful transition to a net-zero economy must involve SMEs, not only because of their sheer number but also due to their significant influence in sectors that are critical to achieving climate goals.

Enabling an entire economy transition to net zero is a complex endeavour. While it is theoretically possible to achieve this transition even if it is unjust, such an approach would likely lead to significant problems and could ultimately fail. SMEs, many of whom face high climate-related transition risks, play a crucial role in this process. Their unique socioeconomic circumstances make them acutely vulnerable to these transition risks. Therefore, for a transition to be both successful and sustainable in the long run, there needs to be an explicit focus on SMEs and the challenges they face.

SMEs account for 33 per cent of GDP in high-income countries and even more in developing countries[3], so any full-service systemically important bank that mirrors the economy will have significant exposure to SMEs and often deep historical connections to the communities in which these businesses operate. A just transition will mean supporting these SME clients to navigate the climate-related transition risks they face and, first and foremost, those that are most vulnerable to these risks.

How banks can support a just transition for SMEs

Banks today have an opportunity to define their approach to financing the just transition and forge stronger bonds with their client base. This includes supporting SME clients and SMEs in the value chain of their corporate clients as part of Scope 3 emissions and

1 World Bank (2023). SME Finance. https://www.worldbank.org/en/topic/smefinance#:~:text=The%20International%20Finance%20Corporation%20(IFC,of%20the%20global%20MSME%20lending.

2 OECD (2023). Sustainable SMEs. https://www.oecd.org/coronavirus/en/data-insights/sustainable-smes.

3 British International Investment (2023). This Business is Transforming Access to Finance for SMEs – Here's How. https://www.bii.co.uk/en/impact-gamechangers/this-business-is-transforming-access-to-finance-for-smes-heres-how/#:~:text=Small%20and%20medium%2Dsized%20enterprises,90%20per%20cent%20of%20jobs.

the net-zero transition to manage financial and regulatory risks; meeting the growing demand from stakeholders for responsible business practices; and seizing new market opportunities created by the global shift towards a low-carbon economy.

Achieving the SME net-zero transition also requires a further USD 50 trillion of financing[4,5]. Banks will be integral to bridging this financing gap as the source of finance, the intermediary or as a trusted partner through the transition from which guidance is sought. Their expertise will be invaluable in mitigating the potential short-term social repercussions of this transition, especially for SMEs. By evolving their financial and non-financial services, banks can ensure that even the most vulnerable SMEs are not left behind.

Yet this transition also calls for a paradigm shift in banking practices. Banks have the opportunity to emerge as thought leaders, collaborating with regulators and leveraging initiatives such as Just Energy Transition Partnerships (JETPs)[6]. They can also form partnerships with multilateral agencies and governments to make financing a just transition more feasible. This shift requires banks to incorporate forward-looking metrics into decision-making, such as net-zero transition risks, and harness fintech and climate tech for smoother transitions.

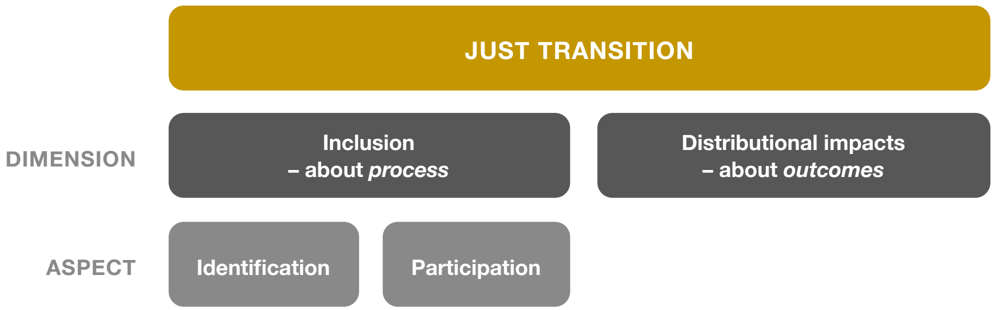
How banks can start action toward a just transition for SMEs

The concept of a just transition has broadened in recent years from (a) encompassing concerns for protecting workers and communities affected by the move away from unsustainable industries to (b) being concerned with addressing social and economic inequalities through fairer distributions of the costs and benefits of the net-zero transition.

The Just Transition Initiative[7] (2021) developed a framework that illustrates how achieving this ambition will require actions across two critical dimensions: **distributional impacts** and **inclusion**. Therefore, making progress toward a just transition – meaning how companies or financiers evolve operations to support a just transition – would mean making progress on either impacts or inclusion:

- The distributional impacts dimension of a just transition is about outcomes – how the benefits and harms of the transition are distributed and what the employment and social landscape looks like once the economy is decarbonised, for example, the availability of decent work.
- The inclusion dimension is about the *process* – how we get to a net-zero economy, for example, dialogue happening at all levels of society to ensure that the burden-sharing involved in transition is just and equitable.

Figure 1: Dimensions of a just transition



Challenging unequal power relations and empowering vulnerable populations to influence and collectively own decision-making processes. This will remove symptoms of exclusion:

- Unequal access to resources
- Unequal participation
- Denial of opportunities

4 Half of the estimated USD 100 trillion investment needed to get global supply chains to net zero by 2050 will need to go to SMEs. For this calculation, SMEs are defined as businesses with <250 employees.

5 Colas et al. (2021). Financing The Transition To A Net-Zero Future. https://www.oliverwyman.com/our-expertise/insights/2021/oct/financing-the-transition-to-a-net-zero-future.html.

6 JETPs are a nascent financing cooperation mechanism that aims to help a selection of heavily coal-dependent emerging economies make a just energy transition. The goal is to support these countries' self-defined pathways to move away from coal production and consumption in a way that addresses the social consequences involved, such as by ensuring training and alternative job creation for affected workers and new economic opportunities for affected communities.

7 The Just Transition Initiative (JTI) is a collective effort by the Center for Strategic and International Studies and the Climate Investment Funds to build mutual understanding on how to advance just transitions. It has developed a JTI framework that can be used to assess current just transition principles and processes and help inform transformative practices.

Begin with a focus on the inclusion dimension

Inclusion refers to:

(1) *Identifying* marginalised groups, such as SMEs facing high climate-related transition risks.

(2) Enabling marginalised group *participation* in processes and decision-making processes that shape the character of net-zero actions that affect them.

The practical, actionable first steps toward a just transition are, therefore, about inclusion. These steps move a just transition from a high-level concept to a reality for institutions such as banks. They entail, first, identifying the needs of marginalised groups, such as SMEs, facing high climate-related transition risks and second, enabling them to participate in the process of defining net-zero actions intended to support such vulnerable groups. Consequently, there is a need to develop action guides for different stakeholders that will enable this inclusion and participation. This guide does just that by focusing on how banks can identify and integrate the perspective, knowledge, values and needs of SMEs through the net-zero transition.

CISL has developed a methodology to focus attention on those SMEs that are most vulnerable. This is a materiality approach of focusing on where in the system and portfolio a just transition is most needed. Acutely vulnerable SMEs face heightened risks due to climate-related transition challenges, and their inclusion is crucial for the legitimacy and success of the net-zero transition.

Figure 2: Some SMEs facing high climate-related transition risks also face socioeconomic and environmental challenges that make them acutely vulnerable

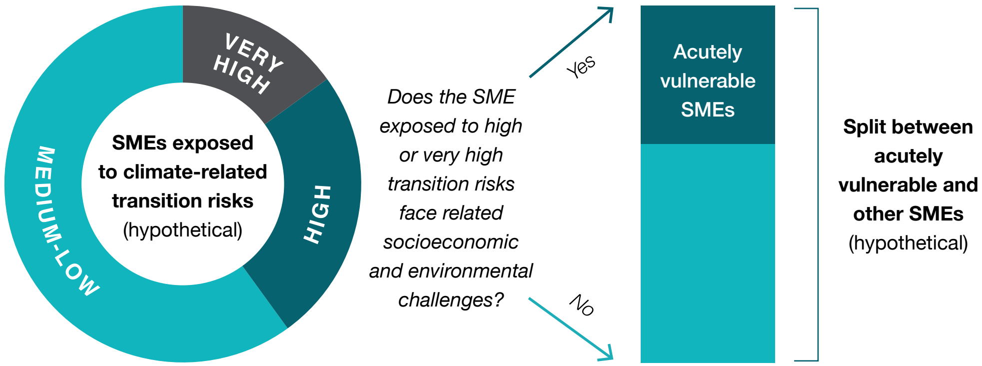


Table 1: Snapshot of climate-related transition risks faced by SMEs

Climate-related transition risk	Risk characteristics	SME vulnerability
Policy and legal	• Increased pricing of GHG emissions (scope 1, 2 and 3) or emission-intensive activities • Enhanced emissions-reporting obligations • Mandates on and regulation of existing products and services • Exposure to litigation	• May face challenges in navigating complex regulations and policies related to emissions reduction, measurement and disclosure, particularly in sectors and geographies with limited government support • May face indirect impacts of policies that change the economic context in their value chain
Technology	• Substitution of existing products and services with lower emissions options • Unsuccessful investment in new technologies • Costs to transition to lower-emissions technologies	• Are at risk of being left behind as new technologies and processes are adopted, particularly those in high-carbon industries that are undergoing rapid technological change
Market	• Changing customer behaviour • Uncertainty in market signals • Increased cost of raw materials	• May face increased competition from larger companies and struggle to access new markets for clean and sustainable products and services, particularly in international markets
Reputation	• Shifts in consumer preferences • Stigmatisation of sector • Increased stakeholder concern or negative stakeholder feedback	• Are at risk of damage to their reputation and brand image as customers, financial backers and other stakeholders increasingly prioritise environmentally sustainable products and services

Exposure to environmental, economic and social factors can significantly impact some SMEs' ability to overcome climate-related transition risks. Consequently, some SMEs may also need help to participate effectively in formulating net-zero actions. The result is that some SMEs are likely to be acutely vulnerable to climate-related transition risks.

Environmental factors

SMEs in specific geographies are at greater risk of extreme weather events, including those caused by climatic volatility (e.g., heatwaves, floods):

- The burden on SMEs to administrate or pay for recovery responses to extreme weather events can inhibit their ability to make investments in assets and human resources enabling them to participate in the just transition.
- SMEs that manage to incorporate adaptation and mitigation measures into their business model ultimately fare better than those that do not. Mitigating climate risk not only helps to protect business assets but also reduces the risk of job losses for SMEs: the International Trade Centre (ITC) found that resilient companies are five times less likely to lay off workers[8].
- Supply chains, which might span multiple geographies, can also be disrupted by environmental events. An SME might be in a relatively stable environment but could source materials from a region prone to floods or droughts. Such disruptions can lead to increased costs, delays and potential loss of business.

Economic factors

SMEs with limited financial resilience, including those with limited access to credit or insurance, are also more vulnerable to climate-related transition risks.

- Economic instability in a country, such as high inflation, currency devaluation or political instability, can reduce the availability of financing and increase the cost of borrowing, making it more difficult for SMEs to access the capital they need to participate in net-zero actions.
- SMEs located in areas with limited access to essential services, such as electricity, internet and water, have reduced resilience to climate-related transition risks.

Social factors

The transition to a net-zero economy can amplify existing societal inequalities (and vulnerabilities) for the marginalised communities where many SMEs are based. Existing inequalities may take the form of:

- Ownership rights over natural resources and land.
- Rights to repair products and consumer protection.
- Access to further education, adult education, civic services or legal aid.
- Access to adequate income support to assist employers through economic shocks, such as those induced by climate-related transition risks.
- Access to public sources of financial support and insurance.
- Employee welfare in the absence of safety nets.
- Limited employment opportunities for vulnerable communities.

Transition risks faced by vulnerable SMEs are critical, given the importance of SMEs to economies and communities. As key actors that mirror the economy, banks must therefore take proactive measures rather than disengaging, delaying action or, paradoxically, pulling back from supporting vulnerable SMEs because vulnerability makes them riskier customers to bank.

Our Bank Action Guide focuses on enabling this proactive action, namely, identifying acutely vulnerable SMEs and enabling them to participate in shaping the net-zero actions of the bank. Divided into three phases, the Guide aims to help banks map SME vulnerabilities and appropriate responses (actions) from banks so that SME vulnerabilities to the net-zero transition are mitigated and a more just transition is achieved.

8 International Trading Centre (2021) SMEs Competitiveness Outlook. https://intracen.org/news-and-events/news/launch-of-green-recovery-plan-for-small-firms-to-face-climate-crisis.