The NCD Roadmap

Implementing the four commitments of the Natural Capital Declaration

Executive Summary

Natural Capital Declaration

Secretariat:

UNEP Finance Initiative
Innovative financing for sustainability

GCP
GLOBAL CANOPY PROGRAMME

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About UNEP Finance Initiative
The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions who are Signatories to the UNEP FI Statements, and a range of partner organisations to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

About the Global Canopy Programme
The Global Canopy Programme (GCP) is a tropical forest think tank working to demonstrate the scientific, political and business case for safeguarding forests as natural capital that underpins water, food, energy, health and climate security for all. We work through our international networks – of forest communities, science experts, policymakers, and finance and corporate leaders – to gather evidence, spark insight, and catalyse action to halt forest loss and improve human livelihoods dependent on forests.

About the Natural Capital Declaration
The Natural Capital Declaration (NCD) is a global finance-led initiative to integrate natural capital considerations into financial products and services, and to work towards their inclusion in financial accounting, disclosure and reporting. The NCD is the cumulative result of in-depth consultations with the finance community and other stakeholders and is signed by the CEOs of financial institutions. In Phase II of the initiative, signatory financial institutions are setting about implementing the commitments in the Declaration through the NCD Roadmap. This is to be done through a steering committee of signatories and supporters and four working groups, supported by a secretariat formed of the UNEP Finance Initiative and the Global Canopy Programme (GCP).

For further information please visit **www.naturalcapitaldeclaration.org** or write to **info@naturalcapitaldeclaration.org**

Executive Summary

Key messages

1. Natural capital issues have proven to be material for financial institutions on a growing number of occasions and for different types of products, including project finance, corporate finance, public equities, etc. Most of the evidence is on an anecdotal basis, although there is growing focus on systemic issues related to hidden natural capital risks.

2. This Roadmap marks the start of Phase II of the Natural Capital Declaration (NCD) and shows what implementation of the NCD can mean in practice for institutions that signed up or are interested in signing up. It also identifies gaps and options to structure work under the NCD.

3. The core objectives of Phase II of the NCD are to:
   a. Stimulate financial institutions that have signed up to the NCD to show progress towards implementing the NCD commitments.
   b. Develop practical tools and metrics to integrate natural capital in all asset classes and relevant financial products.
   c. Increase the number of signatories so as to build a greater level of acknowledgement within the financial sector about the materiality of natural capital.

4. Mainstreaming natural capital throughout the financial sector will only work if it makes business sense. More and stronger evidence on the risk side is needed, while the NCD also needs to actively work on the opportunity side.

Background

Although natural capital underpins global wealth creation, it does not appear on the balance sheets of financial institutions, and it is largely invisible in financial decision-making. The Natural Capital Declaration (NCD) is a finance-led initiative which seeks to address this gap by integrating natural capital considerations into the financial sector.

Phase I of the initiative focused on building momentum around this topic, and was successfully concluded with the official launch of the Declaration at the 'Rio+20' Summit in June 1992. As of April 2013, the Declaration has been signed by the CEOs of 41 financial institutions.

Signatories of the Declaration commit to work towards:

1. understanding the impacts and dependencies of financial institutions on natural capital (directly and through customers) which can translate into material risks or opportunities;

2. embedding natural capital considerations in financial products and services;

3. achieving a global consensus for the integration of natural capital in private sector accounting and decision-making; and

4. achieving a global consensus on integrated reporting and disclosure.

Now, in Phase II, signatory financial institutions are setting about implementing the four commitments in the Declaration, through the NCD Roadmap described in this paper. A lean management structure has been set up, jointly managed by UNEP FI and the Global Canopy Programme, to help financial institutions implement the NCD. Four working groups will tackle the critical challenges to incorporating natural capital considerations in the financial industry.

This report explains how the Declaration can be implemented, and what this can mean in practice for signatory financial institutions. It also identifies other government and corporate sector initiatives with a focus on natural capital and with whom the Natural Capital Declaration is seeking to collaborate - to ensure complementarity rather than overlap. Lastly, it provides a timetable for action.

Why natural capital is important for the financial sector

Financial institutions that endorse the NCD are part of a growing group of investors, banks and insurance firms that recognise the need for a broader understanding of emerging natural capital risks in bond and equity markets, as well as in insurance and lending.

Natural capital is material for the financial sector
Increasing pressures on natural resources in the past decade alone has reversed a 100-year decline in resource prices. Reduction in water quality, scarcity of water, loss of species, and degradation of ecosystems are material not only to project finance, but also to asset classes such as fixed income, public and private equity and debt, as well as various insurance lines.

Natural capital risks can be hidden in company supply chains
Risks associated with ecosystem degradation are often hidden in supply chains, for example through impacts on companies serviced by the financial sector. Clothing company H&M faces increasing prices for cotton for its products due to water shortages, which could be a problem if such costs cannot be passed on to customers and if other manufacturers don't face similar increases. And consumer products giant Unilever has estimated publicly that climate change is leading to a net cost to the company of around $265m annually.

Hidden natural capital risks can become material for financial institutions – sometimes suddenly
This includes reputational, regulatory and materiality risks related to ecosystem degradation. In early 2013, the Norwegian Government's Pension Fund, the largest pension fund in the world (as of June 2011), announced disinvestment from 40% of its holdings in palm oil related investments, stating they were incompatible with the Government's stated aim of curbing deforestation as a means of mitigating climate risk. Expansion of palm oil plantations is a major cause of the clearance and burning of rainforests, which is responsible for around 13-17% of global carbon emissions.

Defining Natural Capital

For the purpose of the Natural Capital Declaration, natural capital refers to the stock of ecosystems that yields a renewable flow of goods and services. It provides the ecosystem products and services that underpin our economy and provide inputs and direct and indirect benefits to businesses and society in general.

See Annex 4 for more detail.

Natural capital can also become a systemic risk for investors with long-term investment horizons
A study commissioned to Trucost by the Principles for Responsible Investment (PRI) and UNEP FI used the 'universal owner theory' which says that a portfolio investor benefiting from a company externalising costs might experience a reduction in overall return, as environmental externalities adversely affect other investments in the portfolio and overall market return. The largest 3000 listed companies in Trucost's database, which represent a major part of the global equity market, were responsible for USD 2.15 trillion in environmental costs in 2008. It found that for a typical portfolio the unaccounted value of such externalities for investee companies can amount to 50% of combined earnings and 7% of profits. (As stock duration has slightly increased over the past three decades - stock turnover has increased by a factor three - this issue is relevant for investors that hold stocks for a significant period of time, while short-term focused investors are passing 'the buck' to the next.)

Such examples show that our world is increasingly experiencing complex environmental phenomena that can impact investors, banks and insurance firms in different ways.

How to make the Natural Capital Declaration a success

1. **Focus on opportunities as well as risks**
   Most importantly, Phase II needs to demonstrate how and when natural capital is financially relevant on the risk side, while at the same time identifying the ways in which considering natural capital can lead to business opportunities. There is a role for governments and financial regulators to make certain types of financial products more attractive either by having it count more positively towards Tier 1 capital ratios, by taking away some of the credit risk through guarantees or options, or through other de-risking manners.

2. **Practical metrics analysis must be developed for specific asset classes and financial products**
   Integrating natural capital will require a different process depending on the type of asset class and financial product. While this is largely known for project finance, and to a lesser extent in corporate finance and in public equities, it is much less clear how it can be done for many other products.

3. **Actual change must be demonstrated**
   For the NCD to be effective, financial institutions need to show how they are meeting the commitments to integrate natural capital factors into their business operations.

4. **Greater endorsement from the financial sector is needed**
   Greater endorsement of the Natural Capital Declaration by the CEOs of financial institutions, both from developed and emerging markets, would increase the level of recognition and help drive this initiative forward.

What does implementation mean for financial institutions and the global monetary and financial system?

Table 1 opposite shows what implementation of the NCD can mean in practice and what sort of ripple effects can be expected in the global monetary and financial system. It also offers guidance how to structure the four Working Groups that are being set up to implement each of the NCD commitments, in the period from 2013 until 2015.

NCD Commitment	What does implementation mean for financial institutions?	What does implementation mean in terms of changes to the global monetary and financial system?
1. Understand "Build an understanding of the impacts and dependencies of natural capital relevant to our operations, risk profiles, customer portfolios, supply chains and business opportunities."	This work stream seeks to develop a quantitative or qualitative framework for financial institutions to better understand risk exposure related to impacts and dependencies on natural capital.	Visualisation of impacts and dependencies related to natural capital will lead to a greater degree of understanding about the potential risk exposure for a bank or investment firm. This may also help insurance firms understand linkages with existing and/or future insurance schemes.
2. Embed "Support the development of methodologies that can integrate natural capital considerations into the decision making process of all financial products and services - including in loans, investments and insurance policies."		
2a. (Investment) "Apply a holistic approach to evaluate bonds and equities through the integration of natural capital considerations in short, medium and long-term forecasts of investee companies."	This work stream seeks to develop metrics for bond and equity products that allow investors to assess, value and incorporate natural capital factors in credit risk models while providing the financial rational for doing so.	The incorporation of natural capital and other ESG factors in mainstream credit risk analysis, stock picking, weighting and bond analysis, will send a signal from capital markets to investee companies, whose stocks are traded on exchanges or which issue bonds, to rethink their own impact and exposure with respect to natural capital. This may ultimately be reflected in the cost of capital.
2b. (Lending) "Systemically consider and value natural capital in credit policies of specific sectors, including commodities, that directly or through the supply chain affect natural capital."	One possible output of this work stream could be a set of guidelines establishing: 1) for what types of environmentally sensitive sectors credit policies need to be developed; 2) what requirements should be asked of clients; and 3) what industry standards or principles the credit policies can refer to.	An increase in and alignment of credit policies for the entire lending business of banks may lead to a strong signal to corporations to better understand how impacts on the environment are related to reputational, regulatory or credit risk exposure and adjust their business practices accordingly.
2c. (Insurance) "Systemically consider and value natural capital in core insurance business strategies and operations, including risk management, risk underwriting, product and service development, and investment management."	This work stream aims to integrate natural capital in all relevant non-life insurance products, primarily in risk management and underwriting alongside other material ESG factors.	Clients that actively mitigate environmental risk exposure could benefit from lower insurance premiums.
3. Account "Work towards integrating natural capital into private sector accounting and decision-making."	This work stream seeks to develop industry standards and well-defined metrics for financial institutions by which they can value and account for natural capital.	By visualising natural capital on a company's balance sheet, financial institutions can directly encourage companies to examine and reduce their exposure to natural capital and other environmental risks by reducing impacts and using natural resources more efficiently.
4. Report/disclose "Work towards building a global consensus for the integration of natural capital into private sector accounting and decision-making, supporting, when appropriate, the related work of the TEEB for Business Coalition, and other stakeholders."	Ultimately, the financial sector needs data and commonly agreed metrics to assess exposure, and to value and price natural capital. Disclosure is an important instrument for this. In addition, embedding natural capital in integrated reporting frameworks can ensure that third parties have a better understanding of natural capital risk exposure and opportunities for individual companies and financial institutions.	

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For more information visit
www.naturalcapitaldeclaration.org
or contact us at
info@naturalcapitaldeclaration.org