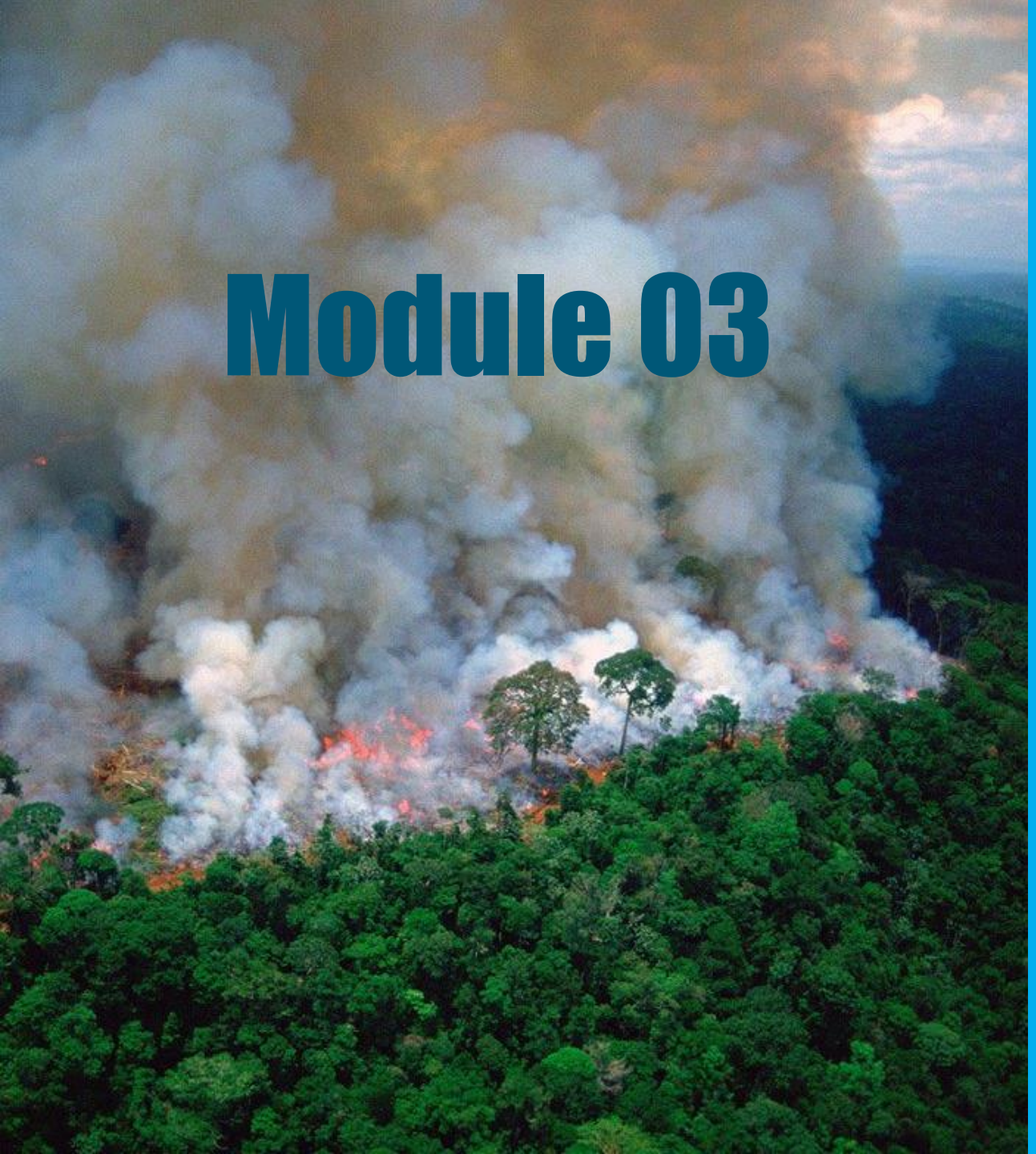
UNEP FINANCE INITIATIVE

GOOD GROWTH PARTNERSHIP

Deforestation Risks for Banks

Module 3
Part A



Module 3:

Responding to Deforestation Risks

- Building blocks to manage deforestation risks
- Selecting deforestation risk responses
- External Collaboration

Module 1 Recap

RISKS: FINANCIAL INSTITUTIONS

Supply chain risks can affect standard financial metrics such as revenue, asset valuation or cost, which can affect the credit worthiness of clients or market value of debts or equities of investee companies.

NON-PERFORMING LOANS

Clients may be unable to continue to service debt obligations in full and on time.

ASSET VALUES

Assets may become stranded if market conditions change requiring de-coupling of production from forest impacts.

REVENUE/PROFITABILITY

Market value may deteriorate as revenue and profits as impacted.

REPUTATIONAL

Financial institutions may be criticized and targeted by clients, NGOs, and the wider media if found to be financing destructive activities or companies.

RISKS: COMPANIES – SUPPLY CHAINS

Deforestation impacts by companies can lead to a variety of financially-material risks, which in turn can affect investors and lenders.

OPERATIONAL/ BIOPHYSICAL

Resource scarcity, biodiversity loss and ecosystem degradation can lead to decreased productivity for companies.

REGULATORY

Environmental breaches, as well as lack of preparedness for compliance with broader changes in regulations, can adversely impact the financial position of companies.

LEGAL

Companies that fail to manage environmental and social risks in their activities may be exposed to legal liabilities

MARKET

Structural change in societal preferences away from products and services that have a negative impact on forests, leading to a change in consumption patterns.

REPUTATIONAL

Companies may be targeted by NGO campaigns due to their involvement in destructive value chains and held accountable for due diligence and risk controls in managing environmental and social impacts.

Module 2 Recap

MODULE 2

MODULE 3

OBJECTIVE SETTING AND SCOPE

- Defining the breadth, depth, and lens

RISK EXPOSURE

- Exposure to deforestation-risk commodities and geographies

RISK LENSES

- Reputational
- Legal
- Financial

RISK RESPONSE

- Risk Governance
- Risk Responses
- External Collaboration

Overall Module Structure

Modules

01 Introduction to deforestation and business case

Learners should be able to:

- Understand global deforestation context, sustainability issues in commodity supply chains and why it matters to banks
- Understand risks associated with financing agricultural commodity production and trade

02 Risk Identification, Screening and Assessment

Learners should be able to:

- Describe how deforestation-related risks fits within the traditional risk management framework
- Understand where different deforestation-related assessment tools fall within risk management stage and how to use them.

03 Managing financial risk and exploring opportunities

Learners should be able to:

- Understand mitigation actions that banks can take to reduce their deforestation-related risks.
- Understand various opportunities and production innovation to support sustainable commodities production.

04 Nature-Based Solutions (NbS)

Learners should be able to:

- Understand how NbS can be used to mitigate land use risk
- Understand how NbS can be an investment opportunity for banks

Module 3 focus

MODULE 2

RISK IDENTIFICATION AND ASSESSMENT

Conduct deforestation risk identification processes and materiality assessment

MODULE 3

RISK GOVERNANCE

Ensuring strategy internal capacity, and governance system supports forest risk management

RISK RESPONSES

Actions to undertake in response to risk identification/assessment results: monitor, avoid, reduce

EXTERNAL COLLABORATION

Managing risks too big for one bank to manage alone

Module 03

Section 01

Responding to deforestation risks

- Building blocks to manage deforestation risks
- Selecting deforestation risk responses
- External Collaboration

Risk Governance

This section will cover the internal building blocks to manage deforestation risk, including:

- Setting up a **deforestation strategy** (policy, statement, or commitment)
- Building **internal capacity** on deforestation risk management
- Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

Setting a strategy: recap on deforestation commitments

The following commitments and concepts can be used to prioritize important areas or be used to detail activities which a client should and shouldn't do, within a bank's deforestation or land conversion commitment:

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

- Zero deforestation
- Zero net deforestation
- No deforestation, no-peat, and no-exploitation (NDPE)
- No conversion of High Conservation Value (HCV)
- No conversion of High Carbon Stock (HCS) areas
- Certification
- Legal/illegal production

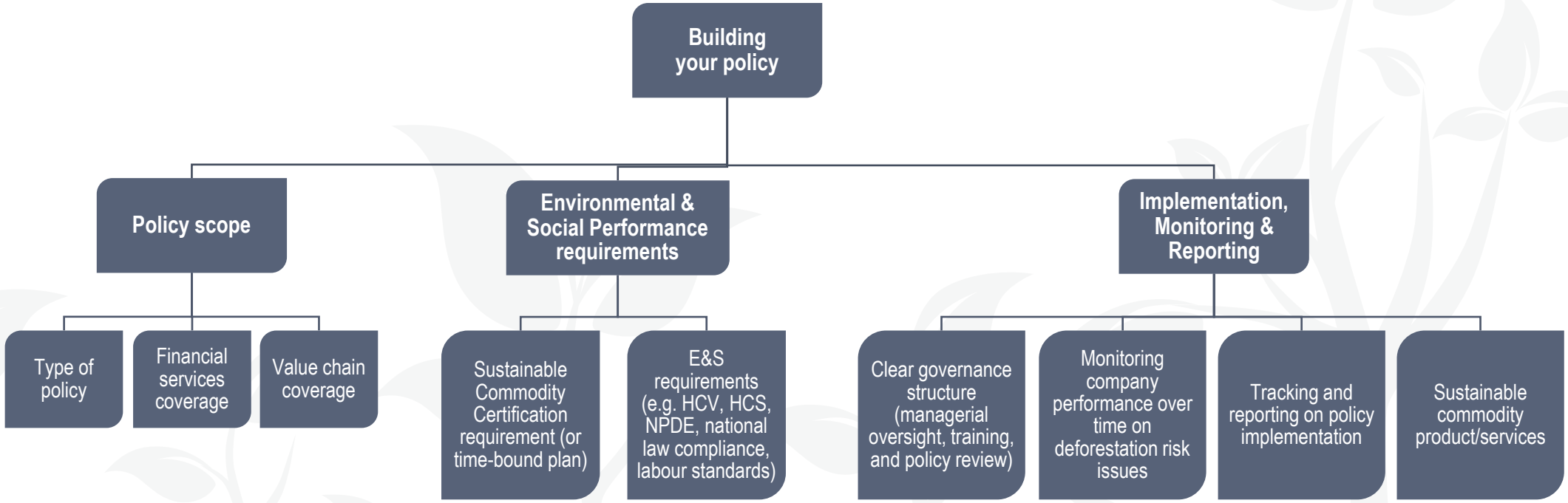
Setting a strategy: elements to consider

Translating commitments/priorities to policy

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk



Adapted from: UNEP FI, 2015

Setting a strategy: journey to achieve best-practices

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

Minimum (examples)

Disclose **general sustainability policy** or detailed stated addressing E&S broadly

Reference to **relevant commodity roundtables/certification** schemes when assessing client performance

Outline some **specific E&S requirements**

Discloses implementation and **monitoring efforts on general ESG or sustainability issues**

Best practice (examples)

Policy **addresses individual commodities** which applies to **all financial services** offered and all **stages of the value chain**

Encourage upstream companies to achieve relevant **commodity certification**, within a time-bound plan (e.g. RSPO, RTRS, GRSB), and downstream companies required to commit to increasingly source commodities which are certified

Disclose and ensure tracking/reporting on the implementation of the policy and it's performance is regularly conducted

Developed financial products and services aimed at promoting the production/trade of commodities sustainably produced

Adapted from: UNEP FI, 2015

Reflective exercise

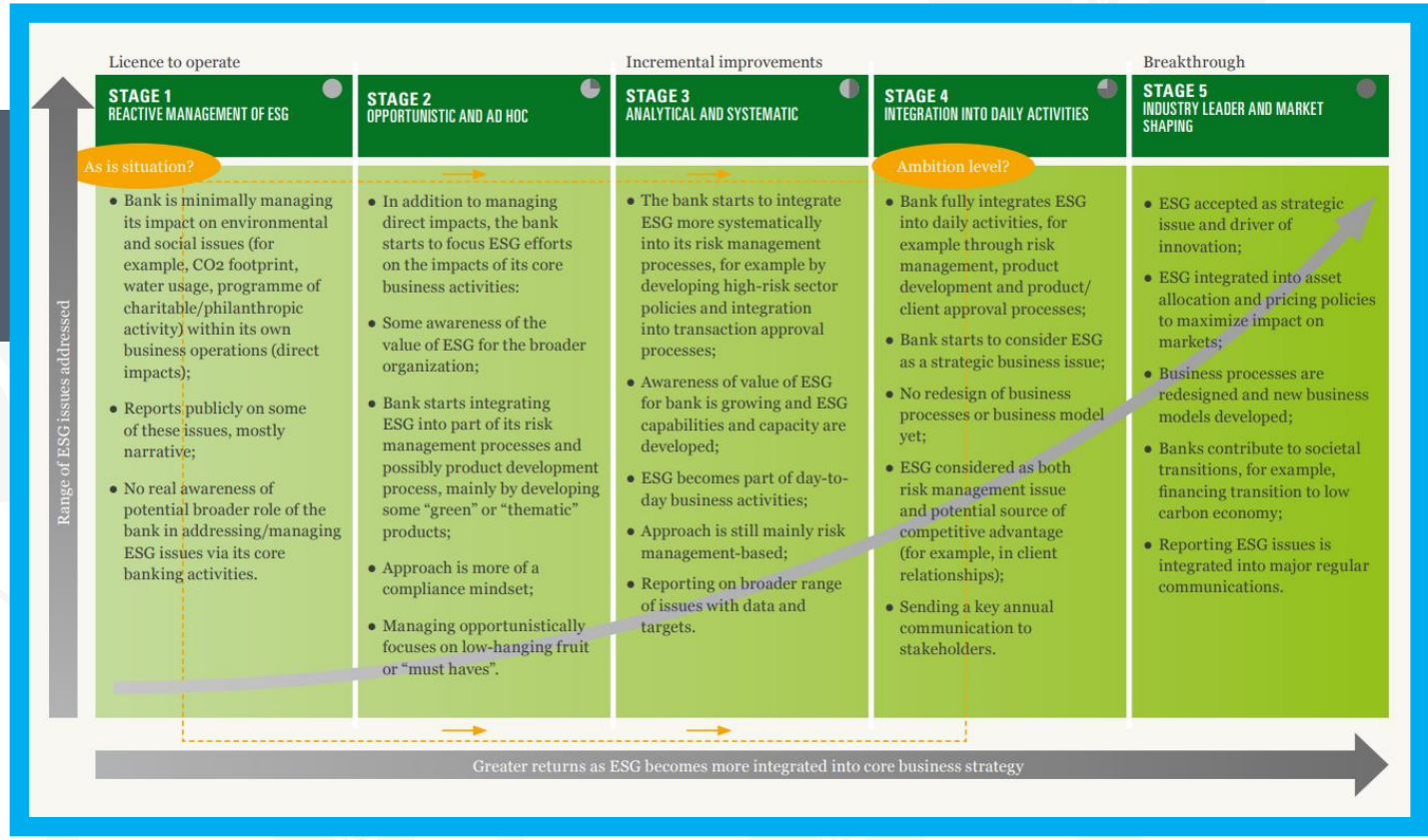
ESG Maturity Grid for Banks: journey to achieve best-practices

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

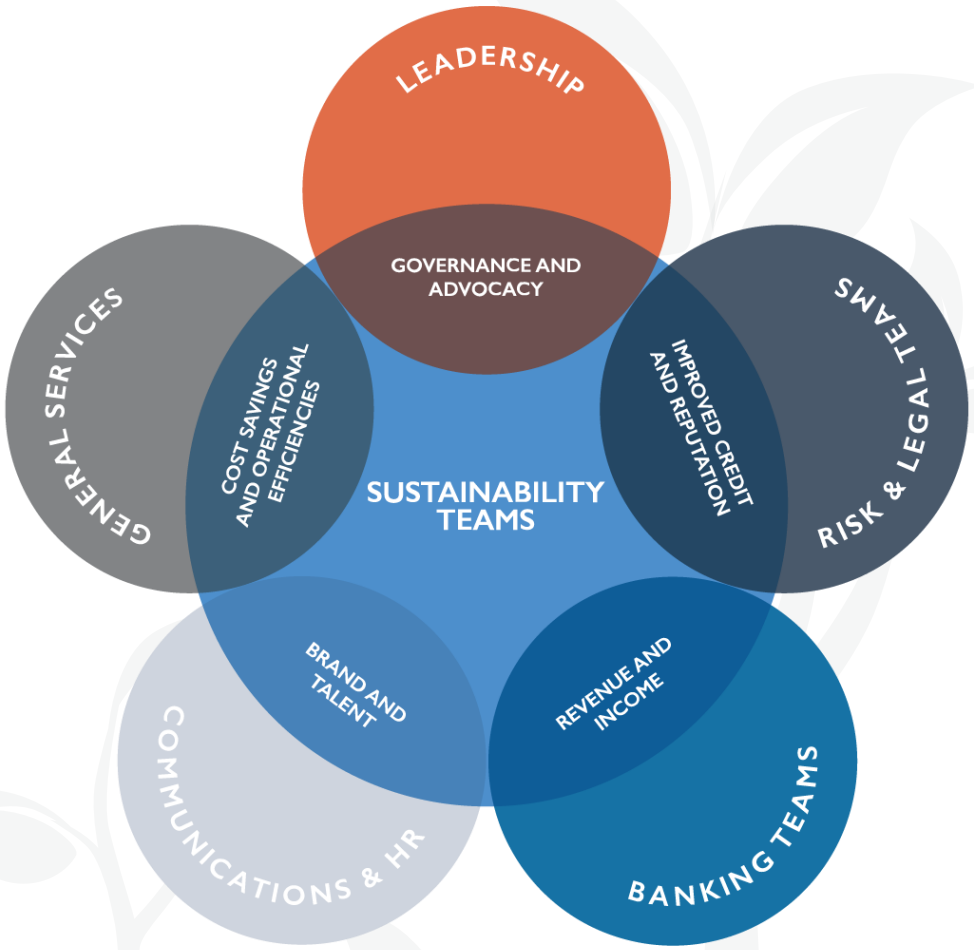
Where do you feel your bank is in the ESG Maturity grid, in terms of managing deforestation risk?



Source: WWF, 2014

Building internal capacity

- Effective governance should ensure there is an understanding, oversight and accountability for financial risks arising from deforestation at **all levels of the institution**. (adapted from Climate Financial Risk Forum, 2020)
- As the scope of deforestation risk expands, the responsibility for managing the risk should also **shift beyond the sustainability team**.
- Expanding the responsibility and capabilities from the E&S team to the broader bank is a key step in driving effective management of deforestation risk.
- Strong board-level oversight and ownership is also critical for institutions to take a long-term, strategic and firm-wide approach to deforestation risk.



Source: UNEP FI, 2016

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

Reflective exercise: Breakout Rooms

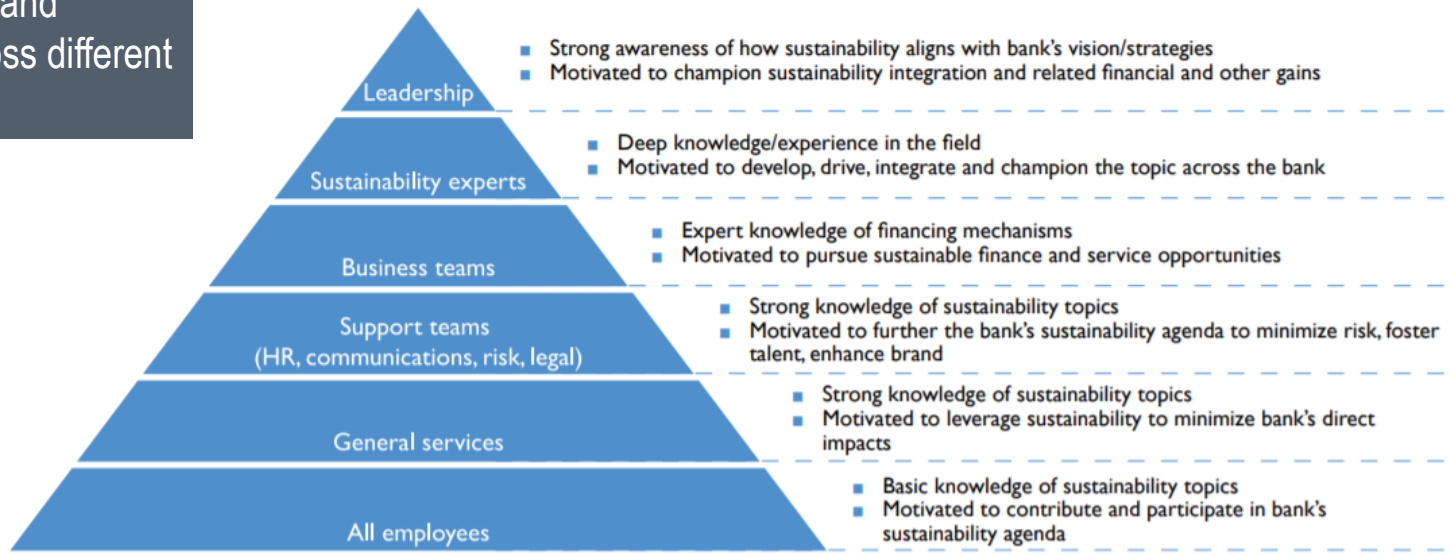
Building internal capacity

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

How do you see the need for deforestation knowledge and expertise distributed across different teams?



Source: UNEP FI, 2016

Deforestation-related skill examples

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

	Front Office (Relationship manager)	**Middle Office** (risk officers, ESG analysts, financial reporting analyst)	**Back Office** (Data analysts)	**Executives (C-Suite/Leadership)** (CEO, Board, Advisory Board)
Skills	❖ Understanding of potential deforestation risk with new clients (and knowing when to escalate) ❖ Substantially engage/assist clients in building a deforestation risk mitigation plan.	❖ Understanding of deforestation risks to the bank and relevant sustainability standards ❖ ***Risk officers and ESG analysts:*** Identify and measure severity of deforestation risk ❖ ***Financial reporting analyst:*** Identify and measure financial impact of deforestation risk	❖ Understanding how to support the middle office to process data relevant to deforestation risk (e.g. spatial data) ❖ Understanding of datapoints to capture deforestation risk (reputational, legal, financial)	❖ Awareness on how deforestation risk can influence financial materiality

Source: UNEP FI, 2016

Building internal capacity: information needs

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

- Understanding how different tools inform different steps in the risk management process is important.
- **Different steps would require different information.**
- Knowing **what** information is needed, **when** this is needed and **how** to use the results is key.
- The figure shows an example of how different external tools could assist in different stages in risk management.

Tools within risk management logical flow example

	Step 1: Information	Step 2: Action Plan	Step 3: Engagements	Step 4: Monitor & Report
Forest 500				
ZSL SPOTT Tool				
TRASE Tool				
WRI Global Forest Watch				
Satelligence				
Sarvision				
Planet				
20Tree				
Sustainalytics				
MSCI				
Vigeo Eiris				
ISS ESG				
Chain Reaction Research				

	= Not useful		= partially useful		= useful		= very useful

Step 1: Understanding your exposure – risk and baseline assessment
Step 2: Planning- Developing a policy and action plan
Step 3: Acting – Implementation and engagement
Step 4: Monitor and Report

Source: Sustainable Finance Platform, 2020

Platform voor Duurzame Financiering

A Guideline on the use of Deforestation Risk Mitigation Solutions for Financial Institutions

From the Sustainable Finance Platform

Ensure good corporate governance

Clear roles and duties through the three lines of defense

Setting up a deforestation **strategy** (policy, statement, or commitment)

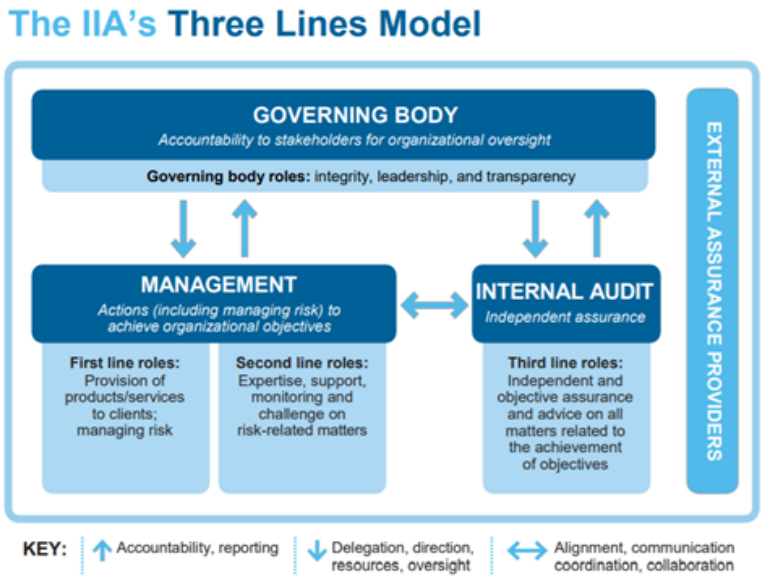
Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

- The three lines of defence enhances the understanding of risk management and control by **clarifying roles and duties**.
- When these three lines have been properly structured, banks would have an increased probability of being effective in managing risks. (COSO)

*"Institutions are expected to assign responsibility for the management of climate-related and environmental risks within the organisational structure in accordance with the **three lines of defence** model."*
European Central Bank, 2020

FIRST LINE OF DEFENSE	SECOND LINE OF DEFENSE	THIRD LINE OF DEFENSE
Risk Owners/Managers	Risk Control and Compliance	Risk Assurance
• operating management	• limited independence • reports primarily to management	• internal audit • greater independence • reports to governing body



Source: IIA, 2013

Ensure good corporate governance

Clear roles and duties through the three lines of defense

Setting up a deforestation **strategy** (policy, statement, or commitment)

Building **internal capacity** on deforestation risk management

Ensuring **effective implementation** with clear roles and responsibilities on deforestation risk

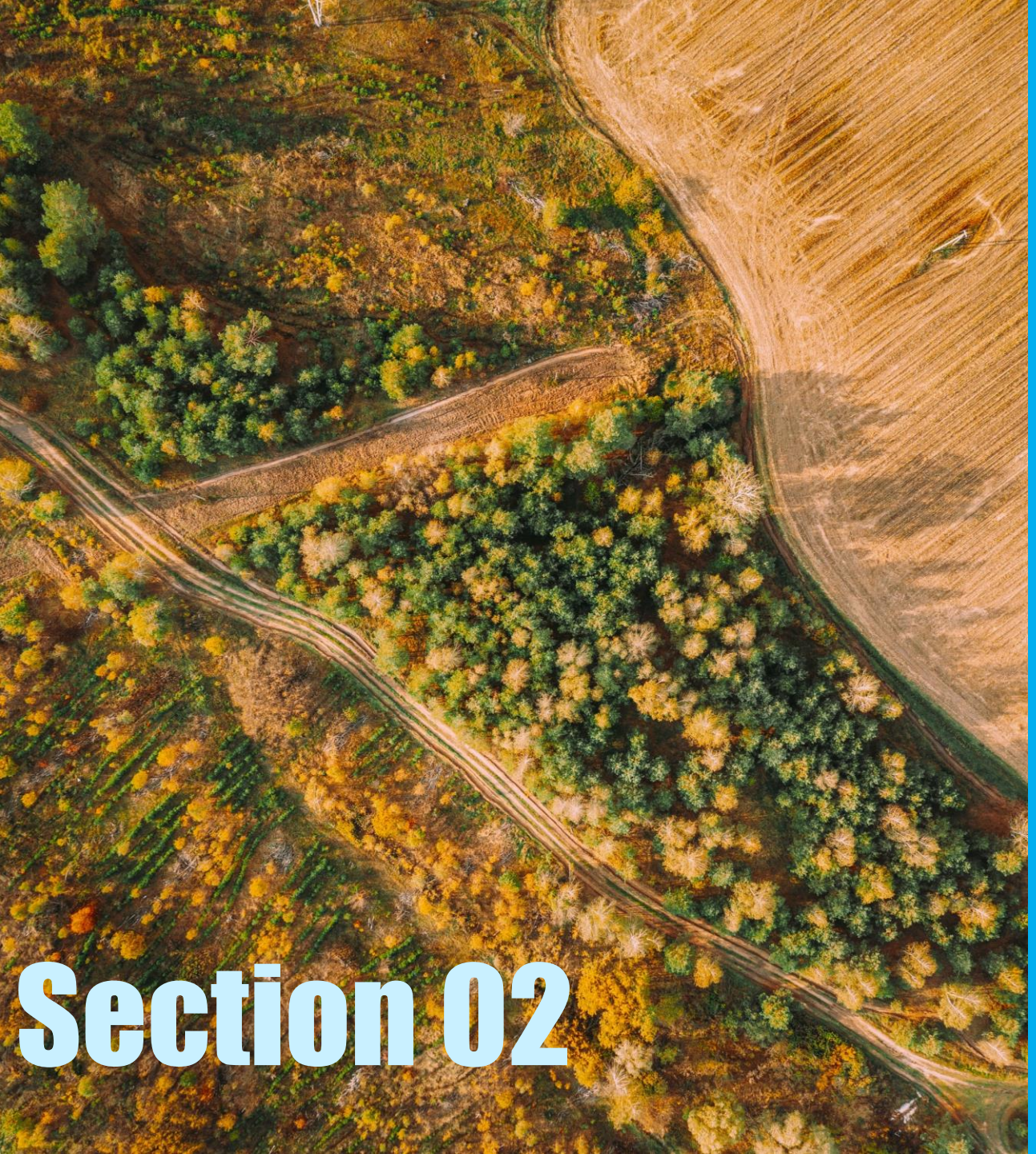
	Example activities
First line Risk owners (*Business units, such as the front office and customer-facing activity*)	❖ Conduct deforestation **risk assessment** when onboarding clients or during periodic review ❖ **Engage with clients** to understand deforestation risk within their supply chains and mitigation plans ❖ Understand, assess and **consider uncertainties and emerging deforestation risks**
Second line Risk Control and compliance *(Middle Office and Governance, e.g. risk officers, ESG analysts, financial reporting analyst)*	❖ **Support the first line defence** to consider uncertainties and emerging deforestation-risks ❖ **Create deforestation risk policy** and risk management framework ❖ **Develop tools** for identifying and assessing deforestation risk ❖ Develop scenarios and **undertake stress testing** ❖ Deliver deforestation risk **training**
Third line Risk Assurance (*Internal and external audit functions*)	❖ Review control and risk management design and execution ❖ Report to the board and audit committee ❖ Provide assurance to regulators and external auditors

Adapted from: Climate Financial Risk Forum, 2020

Section 1 Summary and Key Messages

We have explored the three key building blocks for managing deforestation risks:

- **Setting a strategy**
  - Starts with defining desired commitments such as zero net deforestation, before translating these commitments into policy. Guidelines are available to help banks on the journey to best-practice, including UNEP-FI's recommendations, and the ESG Maturity Grid.
- **Building internal capacity**
  - Deforestation risk must be managed at all levels and in all areas of a financial institution. Building internal capacity requires an awareness of the different skills needed in different business functions, and the key synergies required between different teams.
- **Ensuring effective implementation**
  - Good governance may be achieved using the IIA's Three Lines of Defense model. The model provides a simple way to enhance communications on risk management and control by clarifying essential roles and duties. The three lines are operational management, risk management and internal audit.



Module 03

Section 02

Responding to deforestation risks

- Building blocks to manage deforestation risks
- Selecting deforestation risk responses
- External Collaboration

Categories of risk response

Monitor

Avoid

Reduce

Key considerations to be observed when selecting risk response options, including:

- Results from your risk identification and risk assessment
- Business context
- Costs and benefits
- Obligations and expectations
- Prioritization of risk
- Risk appetite
- Risk severity

Monitor: No immediate action to change the severity deforestation risks

Monitor

Avoid

Reduce

May be appropriate when deforestations risks are:

- within the risk appetite and unlikely to become more severe
- seen as too low to justify the cost of a response beyond simple client compliance screening.

Accepting the risks often requires monitoring changes to assumptions in the future.

Adapted from COSO ERM Framework

Avoid: removing the risks

Monitor

Avoid

Reduce

May be appropriate when all or certain **deforestation risks are not tolerated** by the bank.

Actions are oriented towards:

- avoiding deforestation risks entirely
- making risks less likely to occur

Example: A bank has identified that its portfolio is highly exposed to deforestation risk and it currently has no specific policies on relevant deforestation-related exclusion criteria which could protect the bank reputationally, legally or financially.

Adapted from COSO ERM Framework

Actions to avoid deforestation risks

Eligibility criteria

Providing finance to clients which meet requirements and/or activities related to sustainable land use management in **criteria list**.

Blacklisting

Avoiding the lending of capital to specific companies, sectors, and/or geographies

Divesting

Reducing deforestation risk exposure by minimising existing lending and/or total lending to specific sectors or clients

Actions to avoid deforestation risks

Eligibility criteria

Factors included within eligibility criteria could be linked to the results of your risk assessment to address potential reputational, legal or financial risks.

- Potential elements to include within your eligibility criteria could include:

Legal compliance

Past and current deforestation-activity of clients

Deforestation-related commitments in place

Certification of commodities

Traceability

Actions to avoid deforestation risks

Eligibility criteria

Exercise:

Reflecting on Module 1 & 2, which risk(s) do you think these eligibility criteria seek to address?

In what context would banks include these criteria within their policies?

Can these relate to any of the deforestation commitments discussed earlier?

- Legal compliance
- Past and current deforestation-activity of clients
- Commitments towards no/zero deforestation
- Certification of commodities
- Traceability

Actions to avoid deforestation risks

Eligibility criteria - examples

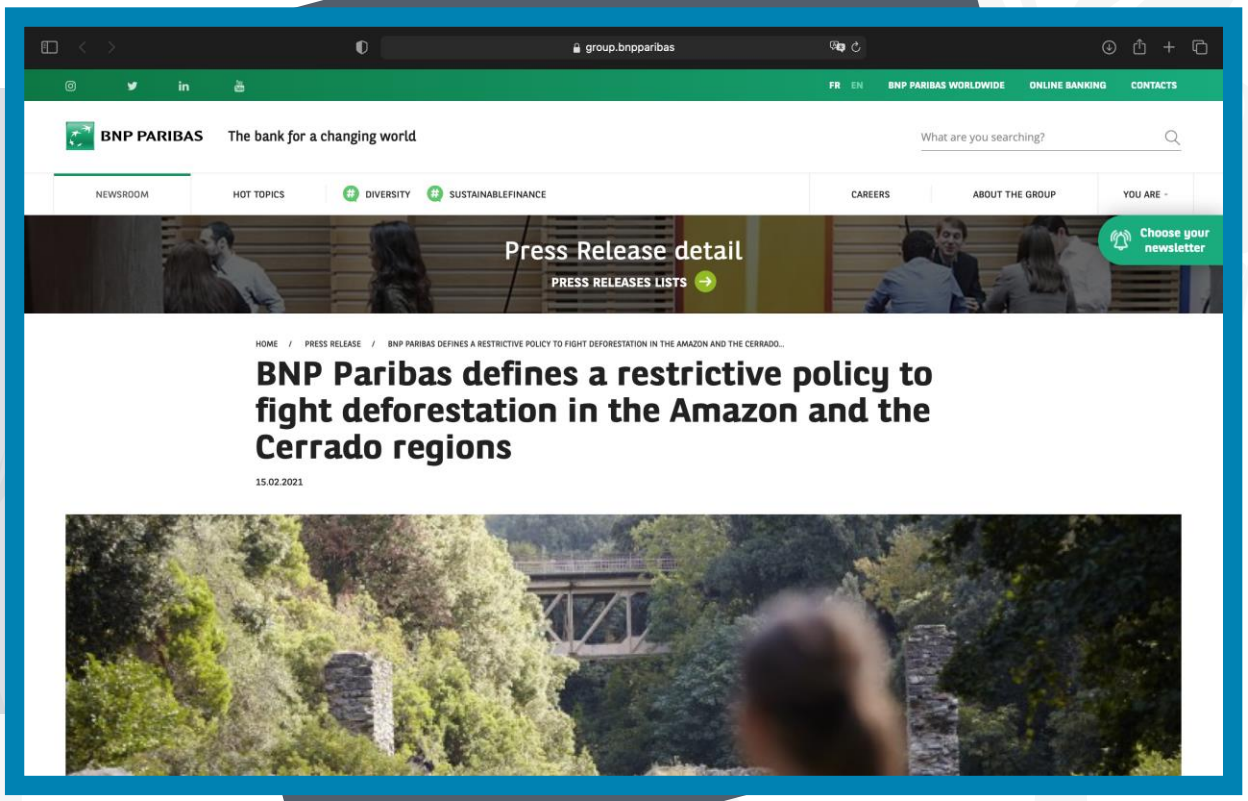
- The Nature Conservancy (TNC) created two Environmental Frameworks for soy and cattle to guide lenders on deforestation and conversion-free approach.
- Core elements:
  - ✓ **Legal compliance** (environmental laws, labour legislation, no overlapping with protected areas and others);
  - ✓ A **clear cut-off date** for no conversion and deforestation (January 2018)
  - ✓ Irrigation (Water permits and predicted water stress)

The Nature Conservancy

Actions to avoid deforestation risks

Eligibility criteria - examples

- BNP Paribas used **cut-off dates** in its in eligibility criteria to align with the Brazilian Forest Code (avoiding legal risks):
  - *"BNP Paribas will not finance customers producing or buying beef or soybeans from land cleared or converted after 2008 in the Amazon."*



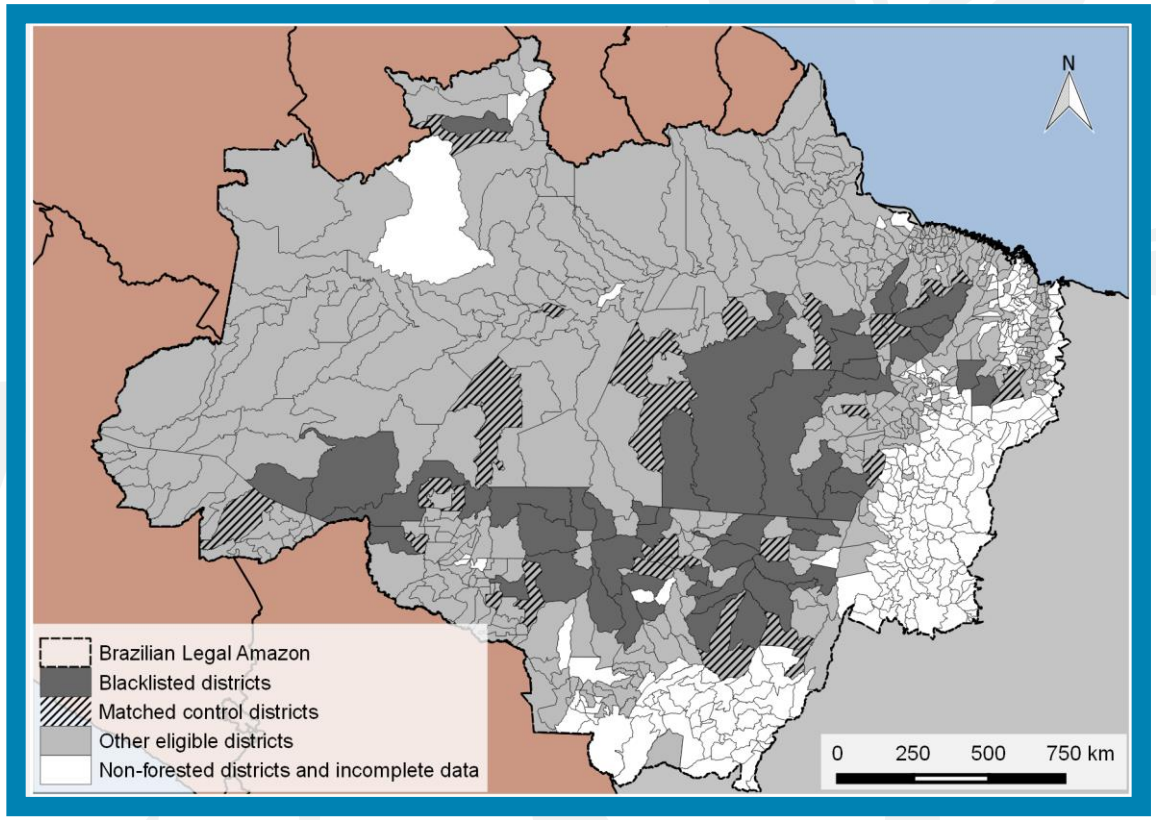
Actions to avoid deforestation risks

Black-listing

Blacklisting is a blanket exclusion: should be **seen as a last resort**

Focus could be on:

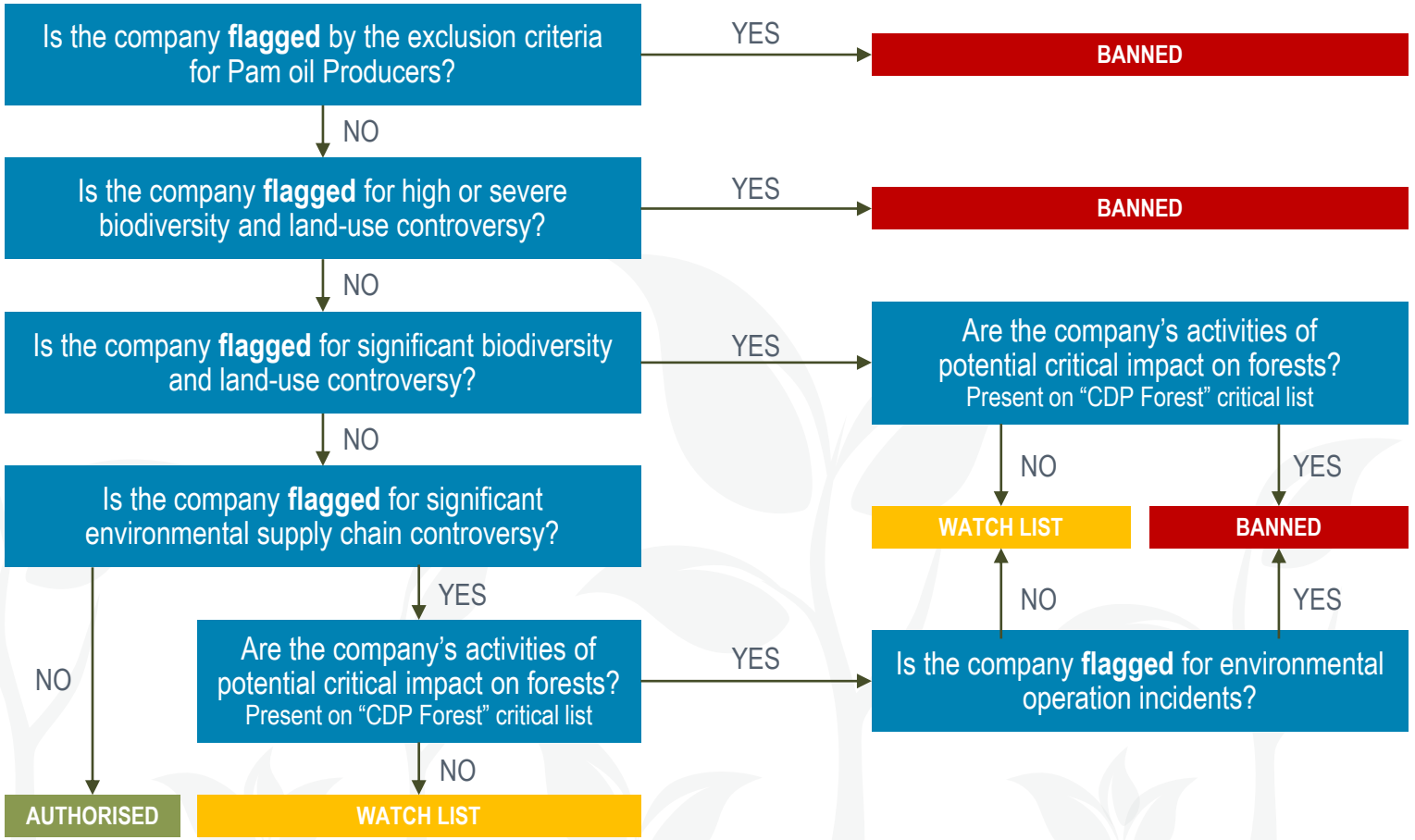
- **Geographies**
  - High-deforestation risk jurisdictions
- **Sectors**
  - E.g. ING does not invest in oil palm plantations
- **Companies**
  - low performing forest-risk companies
  - reputationally/legally risky companies.



Source: Cisneros et al, 2015

Actions to avoid deforestation risks

Black-listing companies - example



Actions to avoid deforestation risks

Divesting

Approaches can include:

- Identifying clients which have **substantial revenue** from deforestation risk associated commodities and;
- Developing an **internal database on ESG issues** at a country, industry and company level to monitor fund's exposure to unacceptable risk in commodity-driven deforestation

Note: *Although divestment is an option for banks, it can be problematic as the risk is transferred to other financiers who do not have as stringent criteria* (WWF, 2019)

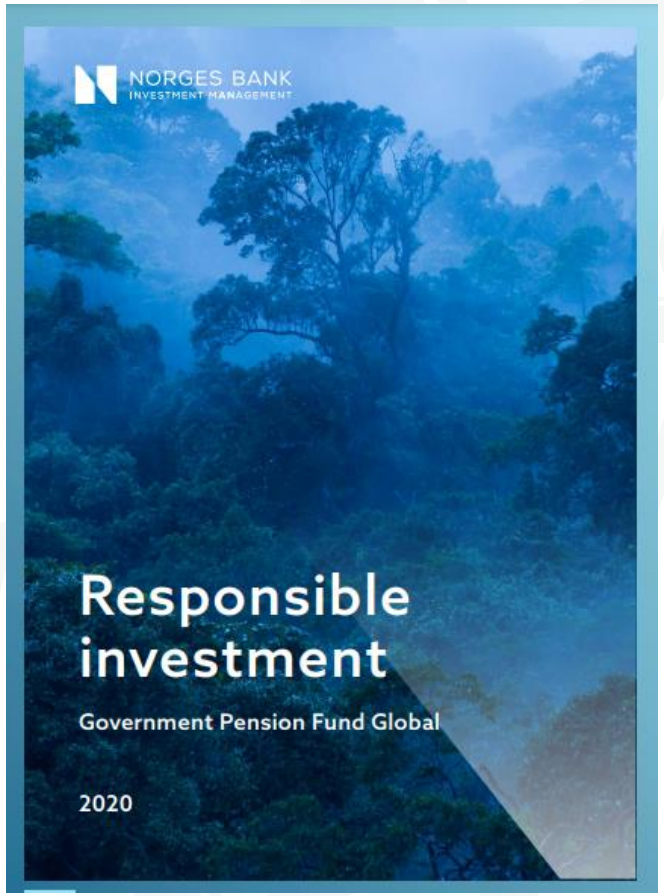
Source: Cisneros et al, 2015

Actions to avoid deforestation risks

Divesting

Norges Bank Investment Management divested from companies associated with:

- Serious sustainability incidents, such as breaches of laws (in human rights, deforestation, negative impact to local communities)
- Substantial revenue from palm oil and rubber production in areas of tropical deforestation and those that do not comply with sustainability standards.



Source: NBIM, 2021

Actions to reduce deforestation risks

Monitor

Avoid

Reduce

May be appropriate when the **severity of deforestation risks, based on your risk assessment, is higher than the bank's risk appetite**.

Implies accepting some level of deforestation risk, but working towards reducing unmitigated risks.

Actions can be oriented towards:

- **Client engagement**
- **Contractual & financial responses**
- **Exploring opportunities**

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Contract and Financial Response

- Change in tenor
- Change in terms
- Forgo the grace period
- Risk-adjusted cost of capital
- Change in interest rates
- Collateral and guarantees

Opportunities

- Structuring via capital markets
- Increasing lending capacity
- Taking direct risk exposure with clients
- Funding innovations

Actions to reduce deforestation risks

Client engagement

- Performance requirements
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Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Banks can use deforestation-related **performance requirements** to reduce risks, ensuring alignment between banks' internal objectives and/or strategy.

Difference between:

- Eligibility criteria: to be met to access finance (*ex-ante*)
- Performance criteria: to be met after finance is granted (*ex-post*)

The criteria should be clearly communicated to the clients and to the front office.

Requirements are many times stated on the banks risk policy.

Should be included within **contractual agreements**.

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

The following aspects can be considered:

- **No Deforestation**, No-peat and No-Exploitation (NDPE) requirements
- No conversion of High Conservation Value and High Carbon Stock Areas (**HCV/HCS**)
- **Certification** related requirements
- **Traceability** related requirements

Reflection:

What are the considerations of choosing one over another?

What risk does this cover?

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

BNP Paribas Performance requirements for the Cerrado and Amazon:

- For all its customers, BNP Paribas will require full traceability of beef and soy (direct and indirect) channels by 2025.
- BNP Paribas will encourage its clients not to produce or buy beef or soybeans from cleared or converted land in the Cerrado after 1 January 2020, in line with global standards.

*"BNP Paribas is committed to **encouraging its customers to become 'zero deforestation',** and now imposes **demanding traceability criteria** on companies wishing to benefit from its financial services."*

Said Antoine Sire, Head of Corporate Engagement at BNP Paribas.

BNP PARIBAS

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Banks can **support clients in making the transition towards no or reduced deforestation** through:

Identification of potential deforestation risk

(support the client to understand the problems and the ways the bank can help)

Creating a deforestation mitigation plan

Technical assistance to support mitigation/transition plan

Directing clients towards sustainable financing

(product, opportunities, financial support, others)

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Rabobank's Sustainability Policy Framework (Rabobank, 2018) includes aims to:

- Increase awareness of sustainable farming practices and **support their clients in making the right decisions towards sustainable business operation**.
- Support sustainable farming innovations by supporting initiatives which contribute to the sustainable livestock sector through funding, knowledge and products

Rabobank

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Banks can undertake actions with their clients who do not comply with established policies, including **corrective action plans**.

These could include:

- **Establishing exclusion conditions and 'continuous improvements towards compliance' conditions**, which would include a stepwise action plan toward compliance and monitoring progress
- Inclusion of **time-scales within contractual agreements** to ensure clients achieve performance in a multi-year loan
- Stressing the need for clients to **improve traceability of commodities** within their supply chain and the importance of ensuring their suppliers comply with buyers' policies.

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Policy Compliance example

There may be exceptional circumstances where customers meet the spirit, but not the letter of this policy, including customers subject to RSPO Complaints, non-submission of Annual Communication of progress or inability to certify due to external restrictions. In such cases HSBC **engages with the customers, seeks action plans to resolve the issues and monitors progress**.

HSBC

Actions to reduce deforestation risks

Client engagement

- Performance requirements
- Support clients making the transition
- Response to non-compliance

Contract and Financial Response

- Change in tenor
- Change in terms
- Forgo the grace period
- Risk-adjusted cost of capital
- Change in interest rates
- Collateral and guarantees

Opportunities

- Structuring via capital markets
- Increasing lending capacity
- Taking direct risk exposure with clients
- Funding innovations

Actions to reduce deforestation risks

Contract and Financial Response

- Change in tenor
- Change in terms
- Forgo the grace period
- Risk-adjusted cost of capital
- Change in interest rates
- Collateral and guarantees

- Credit enhancement tools (such as guarantees) to **de-risk deforestation-free investments**, including sustainable activities that requires **longer tenors to reach break-even and then profitability**
- Financial institution can submit investment proposal to the Fund when the intended contract's tenor is significantly longer than what is normally transacted by the institution.
- The proposal should be aligned with the impact objectives of the fund: improvement of rural livelihoods and at least of the two following objectives, (i) sustainable land use and (ii) forest protection and reforestation

AGRI3 FUND
FOREST FARMERS FOOD

Actions to reduce deforestation risks

Contract and Financial Response

- Change in tenor
- Change in terms
- Forgo the grace period
- Risk-adjusted cost of capital
- Change in interest rates
- Collateral and guarantees

- Banks are increasingly encouraged to offer **preferential conditions** on cost of capital to clients who demonstrate **superior sustainability performance**
- Concept built on the **premise that sustainable clients perform better financially** and experience lower delinquency
- Greater **emphasis placed on good governance**, long-term strategies that promote resilience, adaptability and efficiency and a greater respect of their clients and stakeholders.
- Its application takes many forms, either at the investment/project level (green and social loans/bonds) or at the firm level (sustainability-linked loans, which are conditioned on the ESG performance of the entire company)

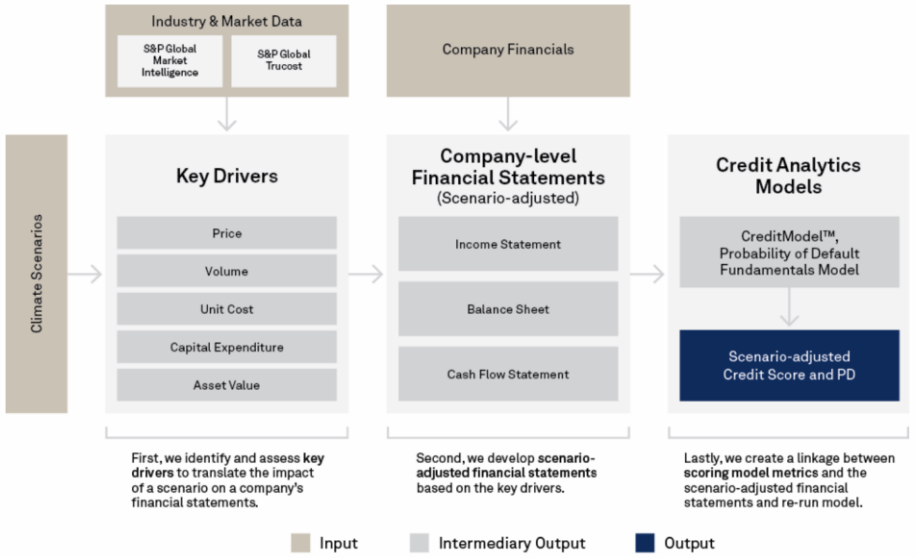
Actions to reduce deforestation risks

Contract and Financial Response

- Change in tenor
- Change in terms
- Forgo the grace period
- Risk-adjusted cost of capital
- Change in interest rates
- Collateral and guarantees

- Evidence showing **links between poor ESG practice and loan delinquency and default rate**
- Banks increasingly **factoring the credit risk increase into a equivalent increase in the interest rate**, to compensate for the heighten exposure to potential loss
- A common method is to include the bank's **approved sustainability metrics as one of the parameters in the calculation of the client's credit score**

Figure 1: Climate Credit Analytics Methodology



Source: Methodology: Climate Credit Analytics, S&P Global Market Intelligence. For illustrative purposes only.

Schematic showing S&P Climate Credit Anlytics framework model to calculate impacts on credit scores and probabilities of default.

Section 2 Summary and Key Messages

We have explored three categories of risk response:

- **Monitor**
  - No immediate action is taken to change the severity of identified deforestation risk. This approach may be used in cases where the deforestation risk may be seen as too low to justify the cost of a program.
- **Avoid**
  - Three different ways to avoid risk: eligibility criteria (providing finance to clients who meet requirements related to sustainable land use management), blacklisting (avoiding the lending of capital to specific companies and/or geographies), divesting (reducing deforestation risk exposure by minimising lending to specific clients).
- **Reduce (to be continued)**
  - When the risk severity is higher than the risk appetite. Actions to reduce risk can be oriented towards three different areas: client engagement, contractual & financial responses, and exploring opportunities (including capital markets and blended finance).