UNEP FINANCE INITIATIVE

GOOD GROWTH PARTNERSHIP

Deforestation Risks for Banks

Module 3
Part B

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

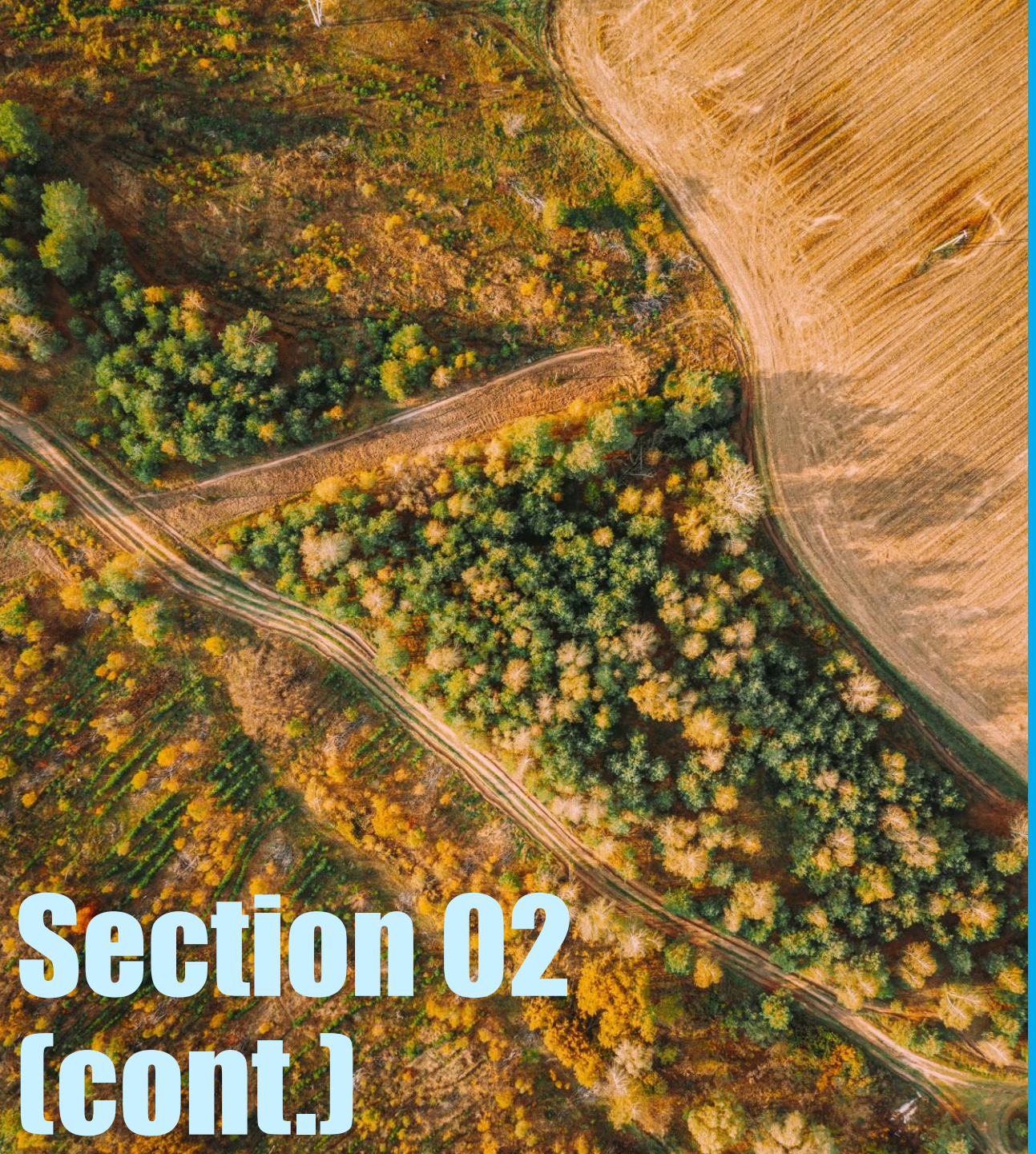
Learners should be able to:

- 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 03

Section 02 (cont.)

Responding to deforestation risks

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

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

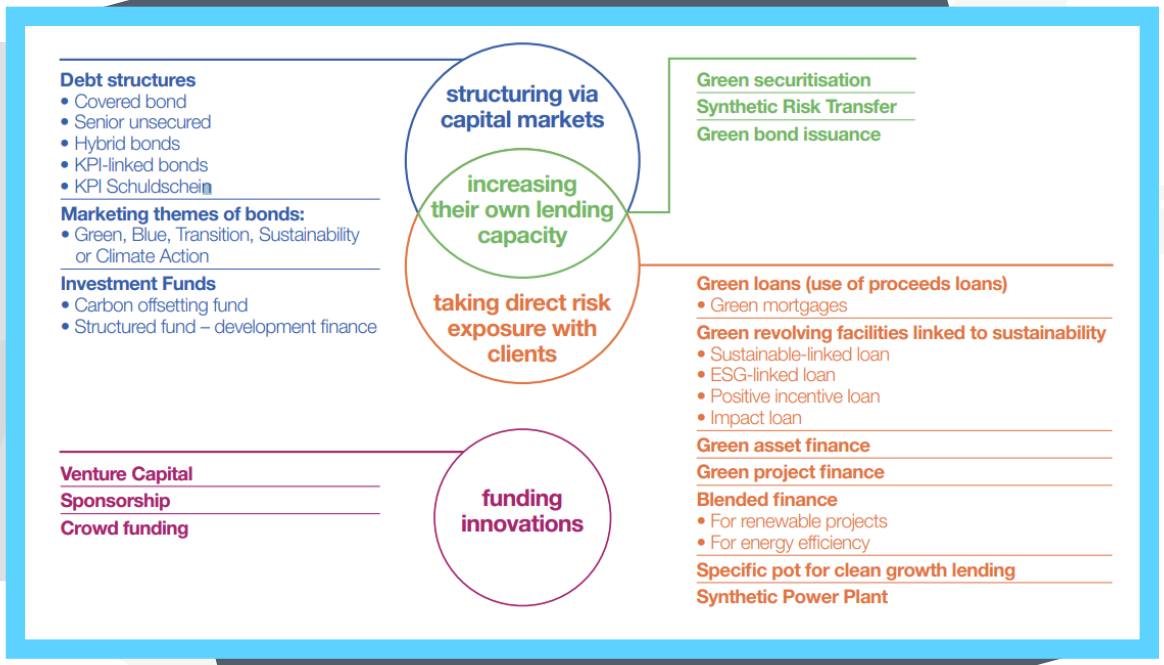
Actions to reduce deforestation risks

Explore Opportunities

May be appropriate when the assessment of deforestation risks indicated **potential to unlock value for the bank** (i.e. opportunities).

Four methods exist to channel capital for sustainable finance:

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



Source: CISL, 2021

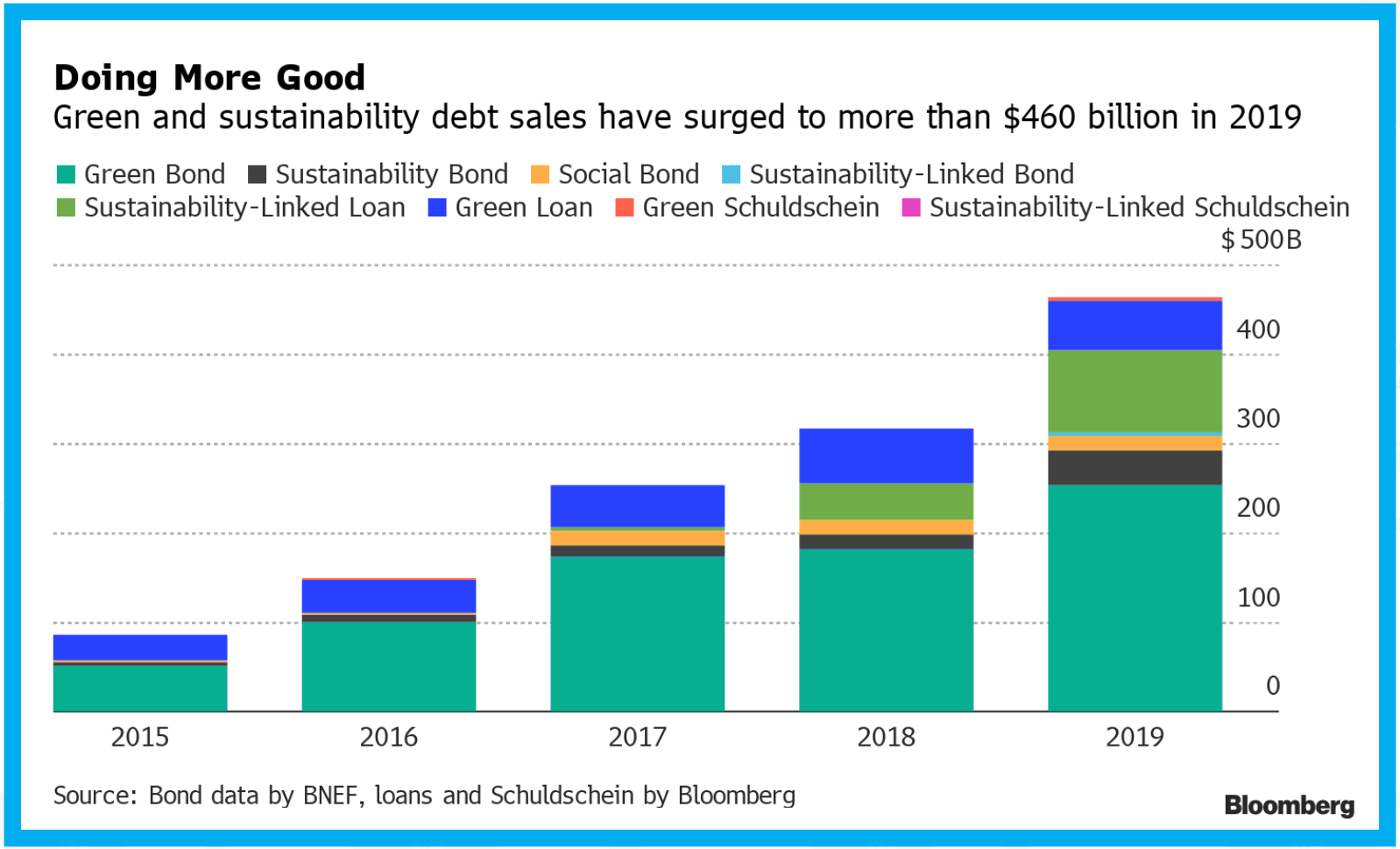
Actions to reduce deforestation risks

Market trends: transition to ethical supply chains

- **More than 400 companies globally have made commitments to deforestation-free supply chains:** a response to deforestation risks
- Market is likely to focus more on **landscape/jurisdictional approaches to commodity sourcing** → potential to reduce demand for commodities in areas with low environmental performance
- Consumer market for certified commodities are gaining traction, with consumers reviewing sustainability issues such as deforestation within the purchase decisions they make (The State of Sustainable Markets, 2020).
- For example in the United States, retail sales of sustainable cocoa grew 16% in 2017–2018, outpacing sales of conventional cocoa, which grew 5% in the same period (UTZ, 2017; Nielsen, 2018).

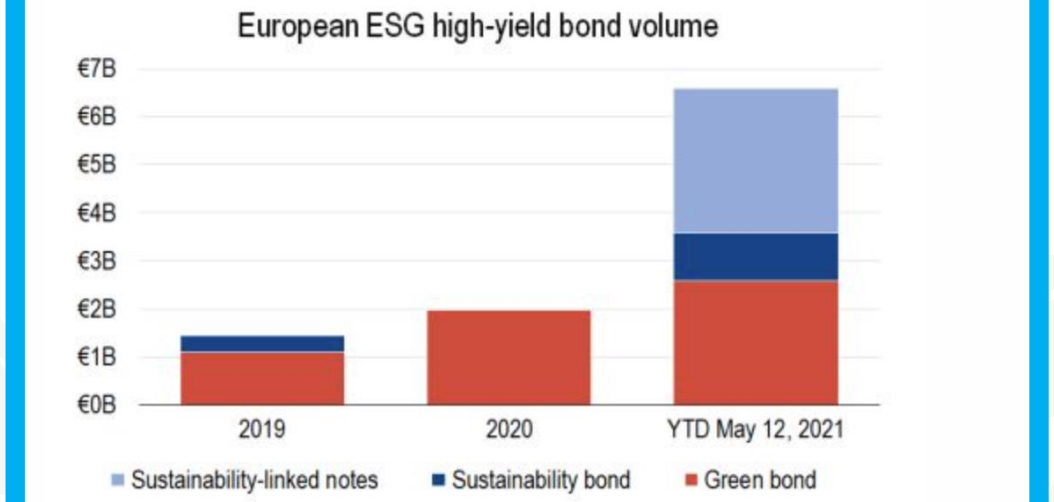
Actions to reduce deforestation risks

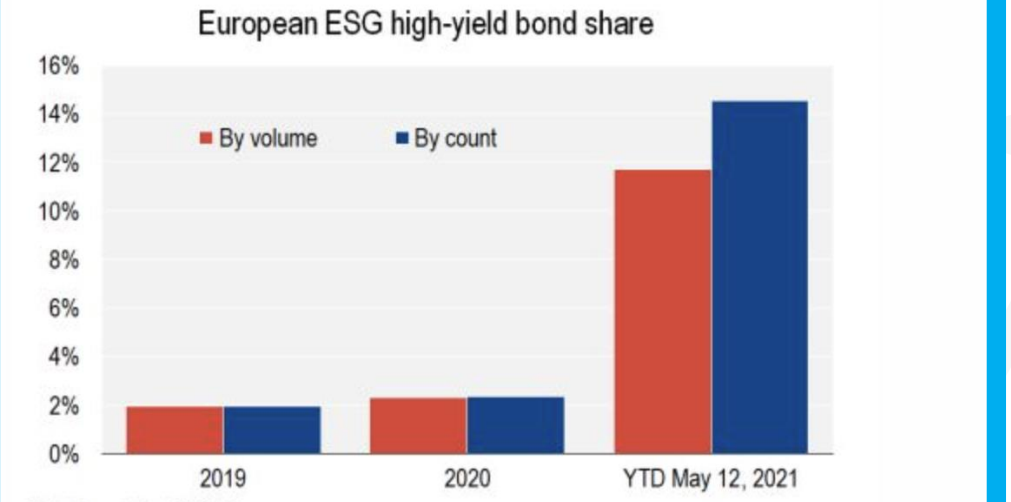
Market trends: sustainable finance on the rise



Actions to reduce deforestation risks

Market trends: sustainable finance on the rise





Actions to reduce deforestation risks

Explore opportunities – structuring via capital markets

Examples:

Debt structures

- Covered bond
- Senior unsecured
- Hybrid bonds
- KPI-linked bonds
- KPI Schuldschein

Marketing themes of bonds:

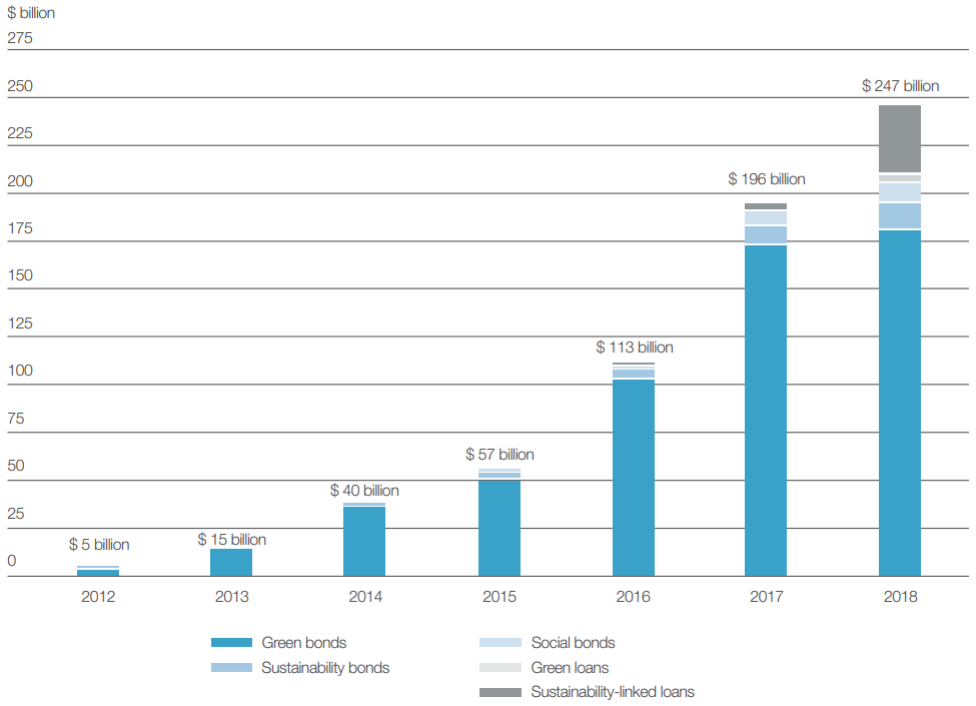
- Green, Blue, Transition, Sustainability or Climate Action

Investment Funds

- Carbon offsetting fund
- Structured fund – development finance

Growing number of green-labelled financial products
(80% of green finance activities in 2018 were in bond structuring):

Figure 13: Sustainable debt issued by instrument type (US$ billon, 2012–18) [121]



Source: CISL, 2021

Actions to reduce deforestation risks

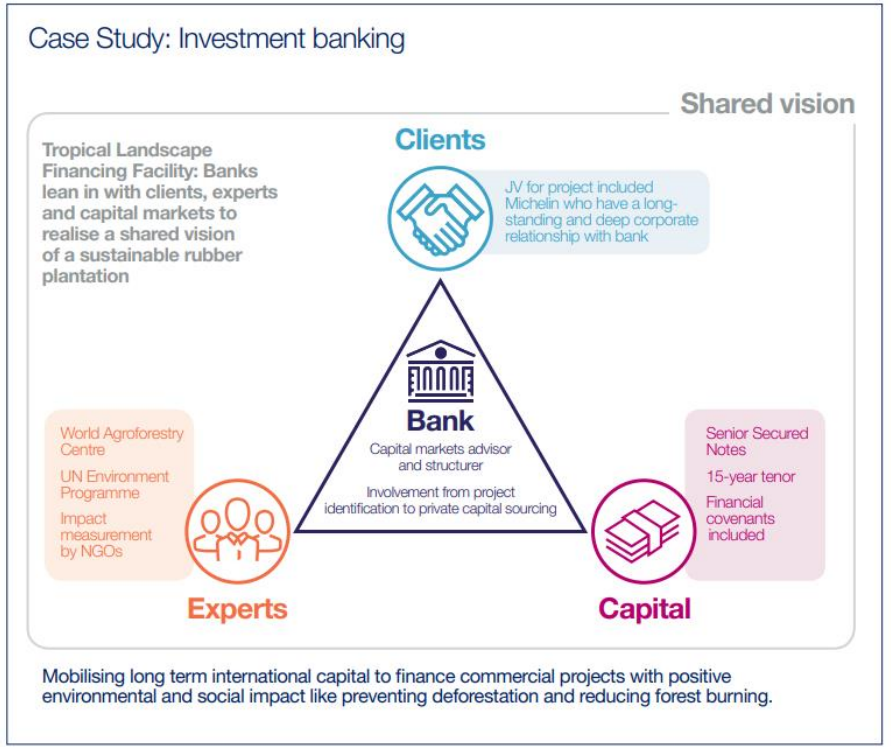
Explore opportunities – structuring via capital markets

Capital market example:

Tropical Landscape Finance Facility

- Collaborative financing for rubber plantation on degraded land
- The facility has **traded a sustainability bond** on capital markets.
- As appetite and experience grows, as well as standardisation and securitisation, it could become possible to facilitate more transaction such as this.

Figure 14: Key stakeholders in the TLFF transaction and the role of the bank



Source: CISL, 2021

Actions to reduce deforestation risks

Explore opportunities – structuring via capital markets

Marfrig

Marfrig announced transition bond sale to finance their purchase of cattle from the Amazon biome.

Net proceeds of the bond will exclusively be allocated to the purchase of cattle from suppliers respecting Marfrig's E&S criteria. (FAIRR)

Forest Resilience Bond

Blue Forest Conservation's Forest Resilience Bond where private investor capital can fund the upfront cost of forest restoration from forest fires. Multiple beneficiaries share the cost of reimbursing investors overtime

Actions to reduce deforestation risks

Explore opportunities – structuring via capital markets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A Bond that Protects Forests and Revitalizes Communities

The Kasigau Corridor REDD project provides income to the community and local landowners for protecting their land. © Vikram Widge/IFC

IFC Forest Bonds

- Channels funds to a private sector project that creates viable alternatives to deforestation.
- Project follows REDD scheme, offering economic incentives to reduce deforestation and invest in low-carbon growth.

- Investors in the IFC Forests Bond choose between cash or carbon credit coupon, the latter can be used to offset corporate greenhouse gas emissions or for selling to the carbon market.
- Investors do not face project risk, as IFC acts as an issuer.
- IFC Forest Bond supported the Kasigau Corridor Project in East Kenya which aimed to restore original biodiversity which was lost as a result of Cattle grazing, cutting for firewood, and farmland had to degradation of the dryland forest. The project received Gold level status by the Community and Biodiversity Alliance for it's exceptional biodiversity and climate benefits.

Actions to reduce deforestation risks

Nature based solutions: impact funds

The LDN Fund is expected to produce the following benefits:

- Directly result in the large-scale reversal or reduction of land degradation
- Contribute to climate change mitigation with projects storing a significant amount of additional CO2, and reducing GHG emissions compared to business-as-usual approaches
- Increase climate resilience for project areas, and the people that depend on them
- Support improved livelihoods
- Use biodiversity-friendly sustainable land management practices

"The Land Degradation Neutrality Fund aims to generate positive environmental and socio-economic impacts, alongside financial returns, through investments in sustainable land management and land restoration projects".

Mirova, 2019

Actions to reduce deforestation risks

Explore opportunities – taking direct risk exposure with clients

Examples of taking direct exposure with clients through lending activities:

Green revolving facilities linked to sustainability

- Sustainable-linked loan
- ESG-linked loan
- Positive incentive loan
- Impact loan

Green asset finance

Green project finance

Blended finance

Example: Revolving working credit facilities

- Sustainability-linked loans are one of the fastest growing segments in sustainable finance
- The payment rate will be adjusted based on performance against a pre-determined non-financial KPI or an external sustainability score.
- This can impact the interest rate by 3-5 basis points (bps) and is usually finance by the internal CSR budget.
- Although a cost to the bank, it is used to build a stronger client relationship and to open a dialogue with clients on sustainability-related topics.

Source: CISL, 2021

Actions to reduce deforestation risks

Explore opportunities – taking direct risk exposure with clients

ING	ING Wholesale Banking's Sustainability improvement loan: ESG performance indicators include – biodiversity, social supplier standards and green procurement – which can be linked to deforestation activities
FINAGRO	**FINAGRO** the first agro-environmental line of credit to incentivise sustainable livestock producers **to protect forests and restore** degraded livestock areas. One of the first steps in strengthening the institution's capacity in developing and implementing ES risk assessment policies (UN-REDD, 2019)
BUNGE	**Bunge, Santander and The Nature Conservancy** launched long-term loans to farmers willing to commit to deforestation free or land conversion free agricultural production (BUNGE, 2018)

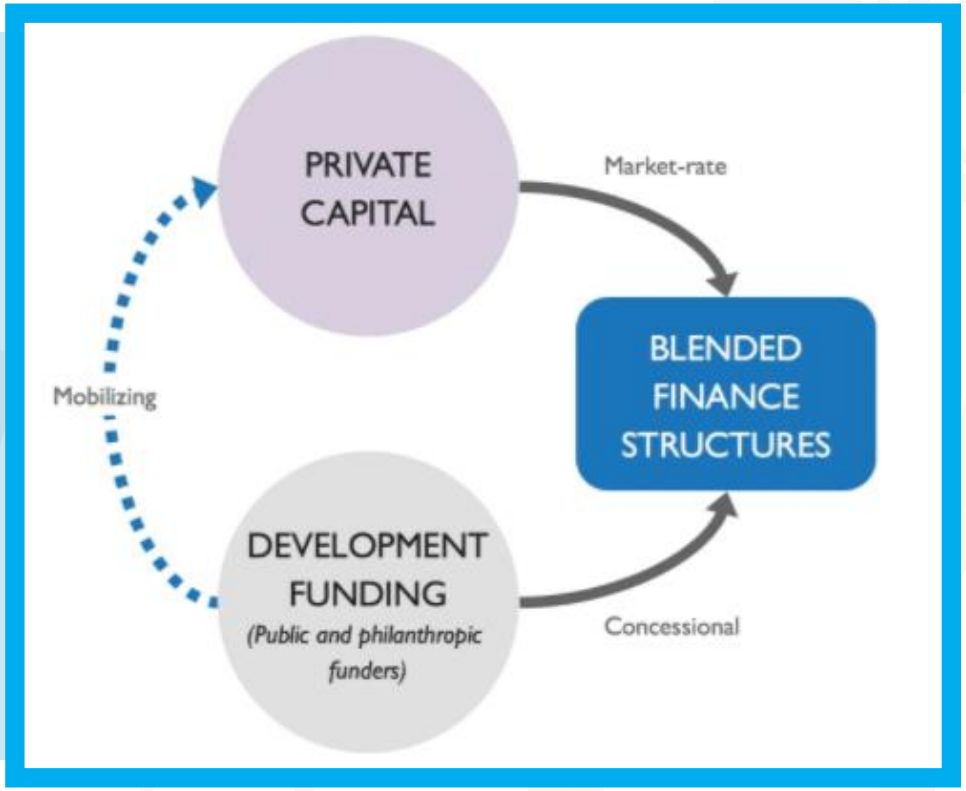
Source: CISL, 2021

Actions to reduce deforestation risks

Explore opportunities – taking direct risk exposure with clients

Example: Blended finance

- Blended finance is a structuring approach.
- It allows organisation with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or both)
- Main investment barrier addressed by blended finance are (1) high perceived and real risk and (2) poor return for the risk relative to comparable investment.



Source: Convergence

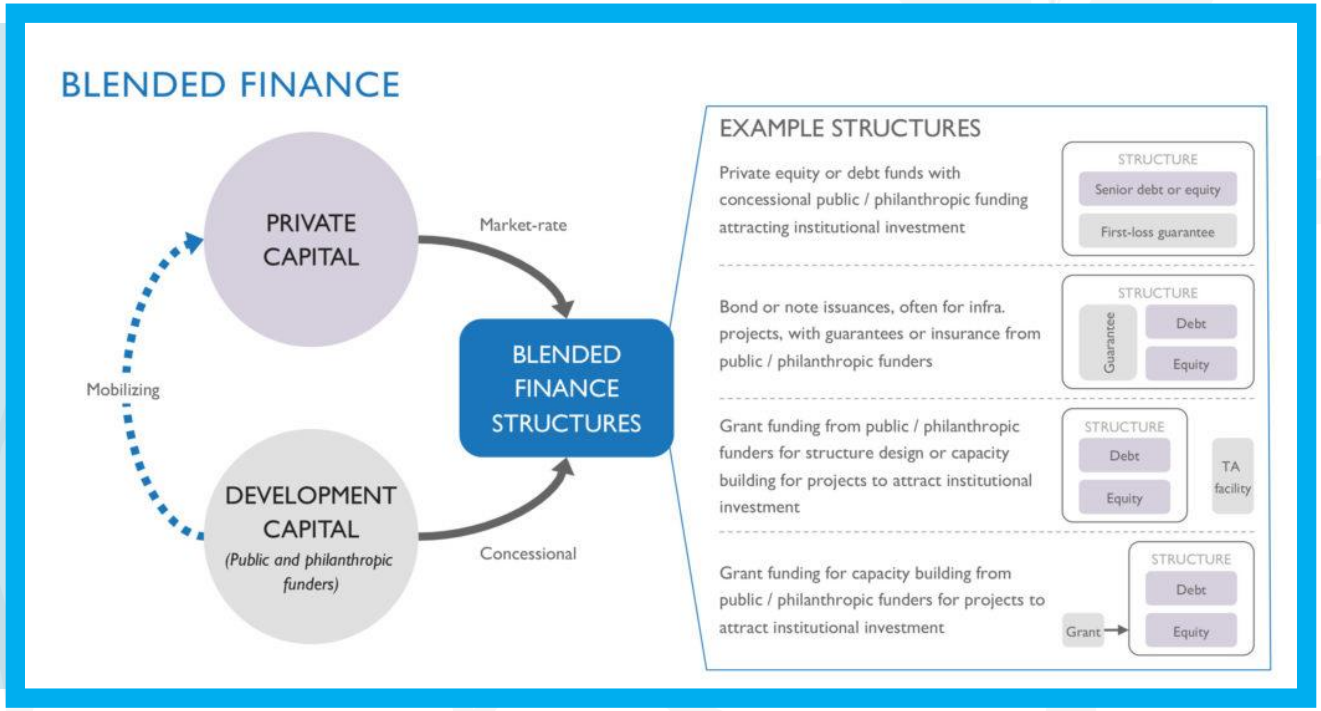
Actions to reduce deforestation risks

Explore opportunities – taking direct risk exposure with clients

There are four common blended finance structures:

1) Concessional capital
2) Guarantee or risk insurance
3) Technical assistance funds
4) Design stage grants

Concessional debt or equity has been the most common archetype.

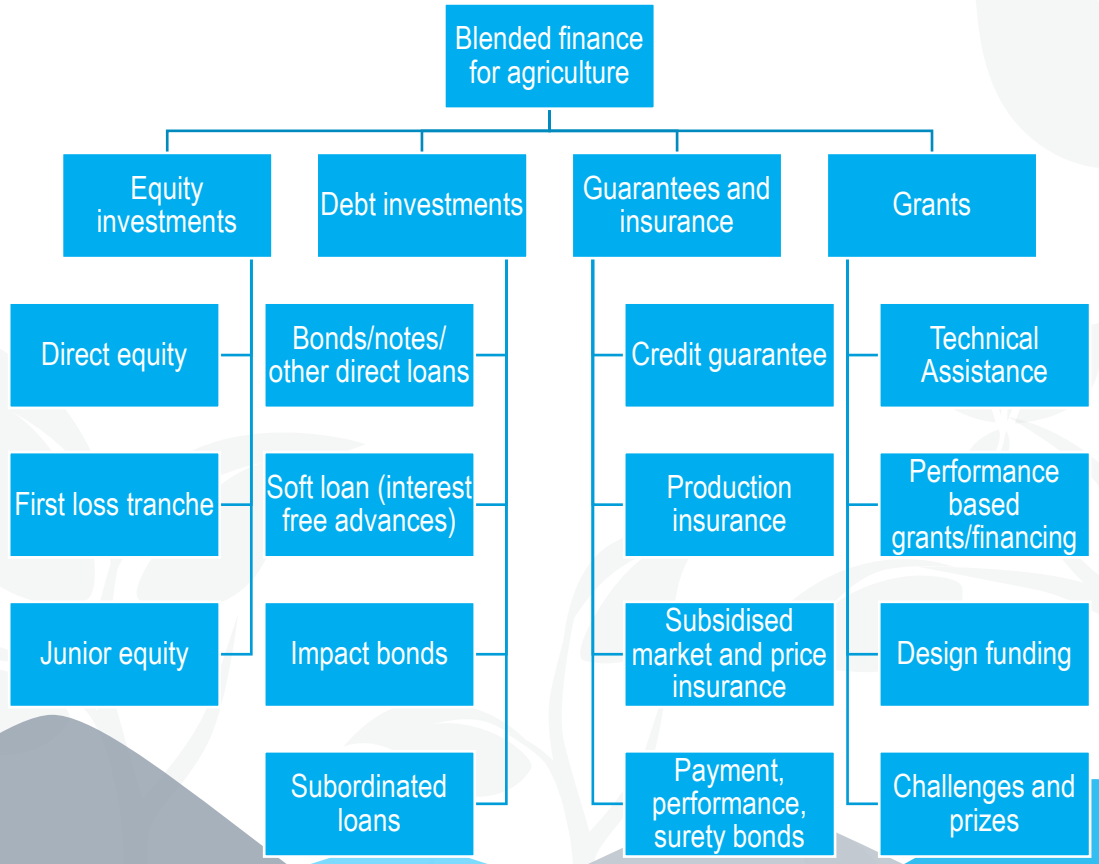


Source: Convergence

Actions to reduce deforestation risks

Setting a strategy: elements to consider

Blended finance for agriculture financial instruments



Source: Havemann et al, 2020

Actions to reduce deforestation risks

Blended-finance

Blended finance examples related to restoration degraded land or are provided with incentives to not deforest areas:

AGRI3

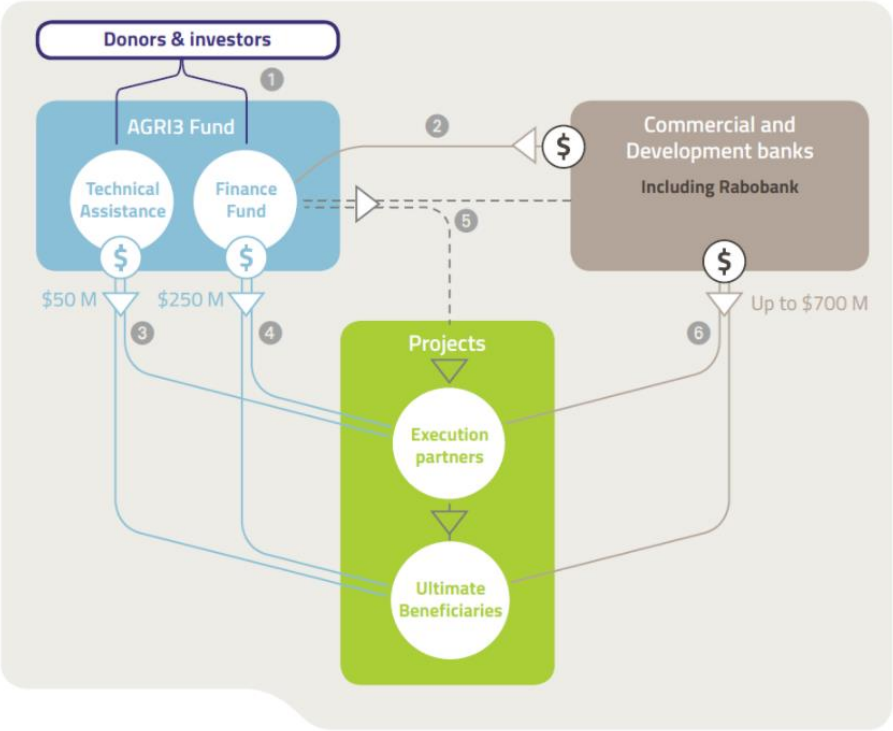
Consists of a junior capital fund and Technical Assistance Fund

Fund created out of a partnership between UN Environment and Rabobank

CASE STUDY:

Sao Paulo State – Sustainable production of sugarcane
Received a BRL 50 mln 10 year facility with a 3 year grace period from AGRI3 Partnerbank to finance a combined package of investments consisting of reforestation activities and further expansion of sustainable agricultural practices.

Expected impact includes increased forest protection and restoration, sustainable agriculture and rural livelihoods.



Actions to reduce deforestation risks

Blended-finance

Blended finance examples related to restoration degraded land or are provided with incentives to not deforest areas:

TLFF

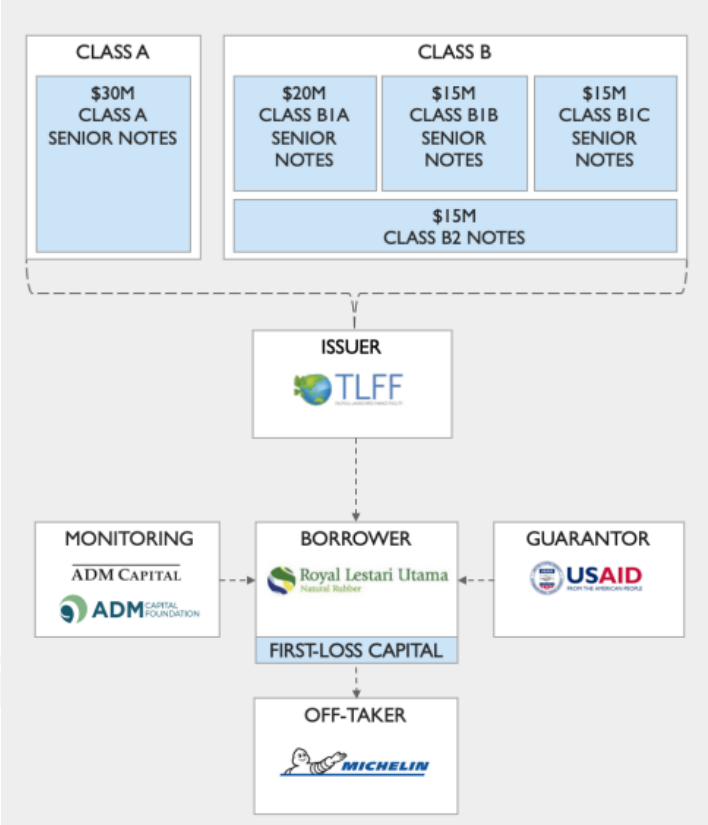
Provides **credit guarantees** to finance commodity supply chain projects in approved jurisdictions

CASE STUDY:

PT Royal Lestari Utama (RLU)
Providing finance to the development of three sustainable rubber concessions operated by RLU in Jambi through the purchase of 15 and 7 year Notes, organised by BNP Paribas and monitored by ADM Capital under the Tropical Landscape Financing Facility (TLFF).

Environmental return where 18,730 ha for conservation on the Jambi concessions has been set aside due to HCV and HCS studies.

Social return where the total number of households benefitting has increased by 741 between 2018-2019



Source: Convergence,and TLFF, 2019

Actions to reduce deforestation risks

Explore opportunities – increasing lending capacity

Examples:

Synthetic securitisation

Becoming an increasingly popular instrument.

Banks scaling this avenue for capital distribution requires:

- Appropriate knowledge and tagging
- In-house expertise that can use the knowledge architecture and build the pipeline
- Active approach with clients, experts and capital markets to build up portfolio and capital to fund it

Synthetic risk transfers

- Third party offers risks protection.
- Example: IFC provides $85 million credit risk protection to Credit Agricole on a $ 2 billion trade finance portfolio. The protection freed up regulatory capital for the bank to lend an additional US$510 for projects in emerging economies.

Source: CISL, 2021

Actions to reduce deforestation risks

Explore opportunities – funding innovations

Examples:

Venture/equity capital funds/incubators

- Straightforward way for banks to support innovation
- Example: Wells Fargo Innovation Incubator offers non-dilutive grants to companies to validate technologies in the agriculture or clean technology fields.
- This capital supports start-up involvement in low carbon economy and leverages banks access to these customers.

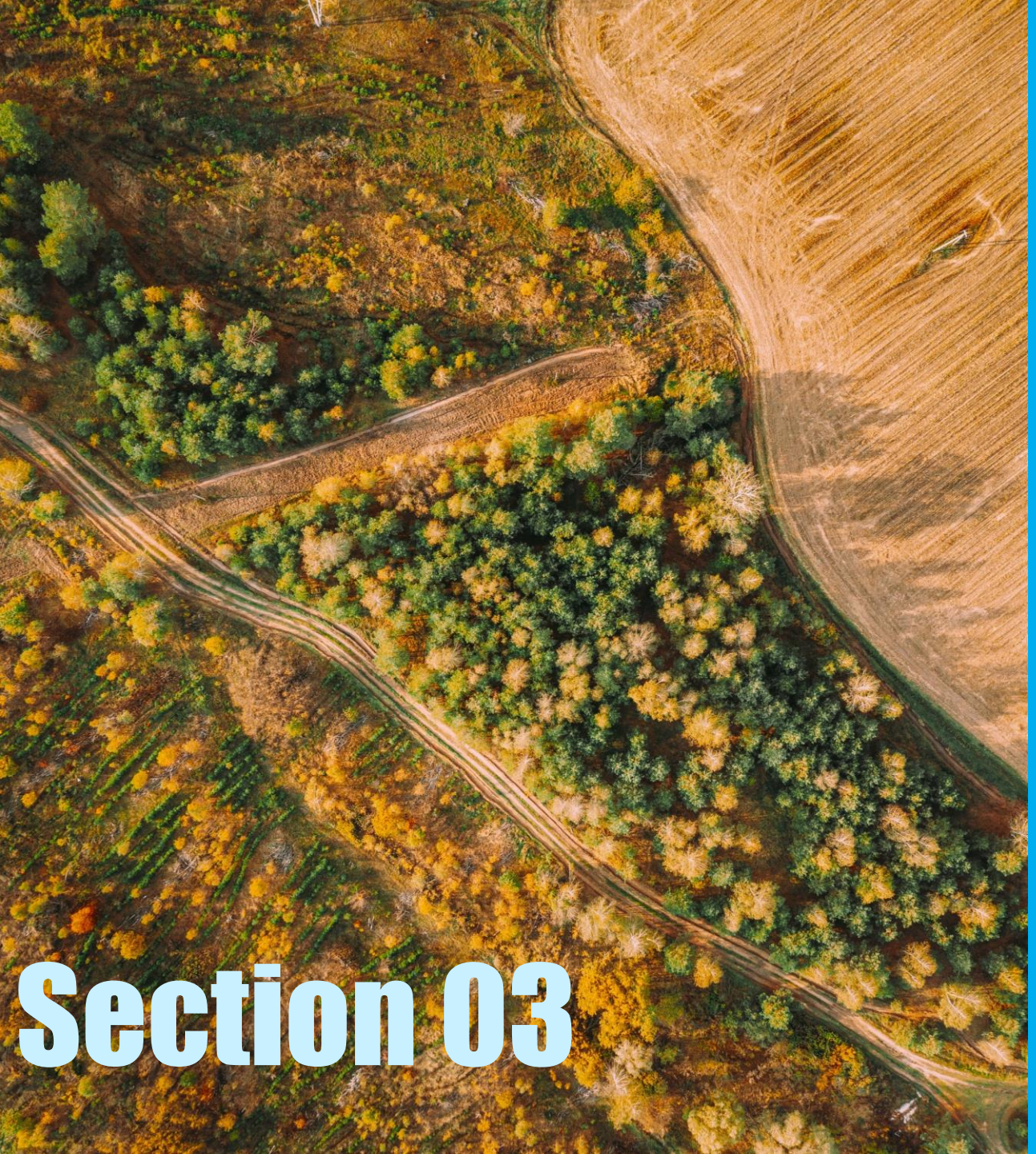
Sponsorship

- Partnership or sponsorship of sector experts working on innovative technologies represents another way banks can secure privileged access to knowledge on the future trajectory of the sustainable economy.

Personal Reflection:

What opportunities do you think might arise from your own portfolio?

Source: CISL, 2021



Module 03

Section 03

Responding to deforestation risks

Building blocks to manage deforestation risks

Selecting deforestation risk responses

External Collaboration

External collaboration

May be appropriate to **eliminate some of the risks to individual banks** when deforestation risks are considered to be too large or complex for one bank to manage.

Potentially involves sharing information, resources, activities and capabilities.

A shared response to the risk you have identified might include collaboration with:

- Peers
- Multi-stakeholder initiatives
- Regulators
- Global initiatives
- NGOs

Collaborate externally

There are several examples of collaborating externally which include:

Peer engagement

Multi-stakeholder initiatives

Enabling environment

Global Initiatives

NGOs

- **Peer engagement** – forming collaborations with organisations to share technical knowledge, such as the Soft Commodities Compact
- **Multi-stakeholder initiatives** – becoming a member of certification bodies (RSPO, RTRS, GRSB) and engaging in Roundtable events to support sustainable production
- **Enabling environment** – engagement with policy makers/regulators through collaboration groups to encourage greater participation of the banking sector within policy environment towards sustainable production of commodities
- **Global Initiatives** – Signing up to global initiatives on which commit towards reducing deforestation such as The New York Declaration
- **NGOs** – Collaboration between corporates and NGOs provide support to towards addressing deforestation within supply chains, an example of this is Nestle's partnership with The Forest Trust

Collaborate externally

Peer engagement

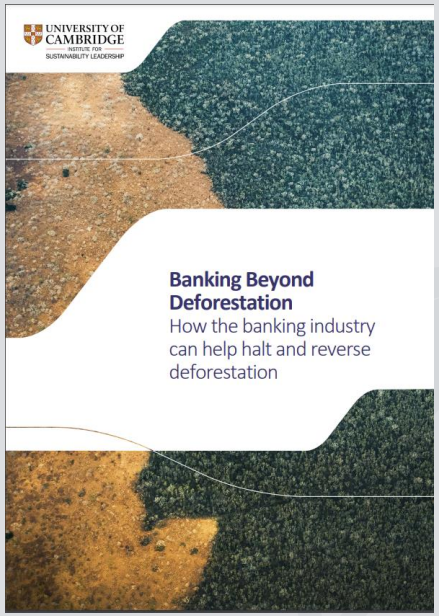
Multi-stakeholder initiatives

Enabling environment

Global Initiatives

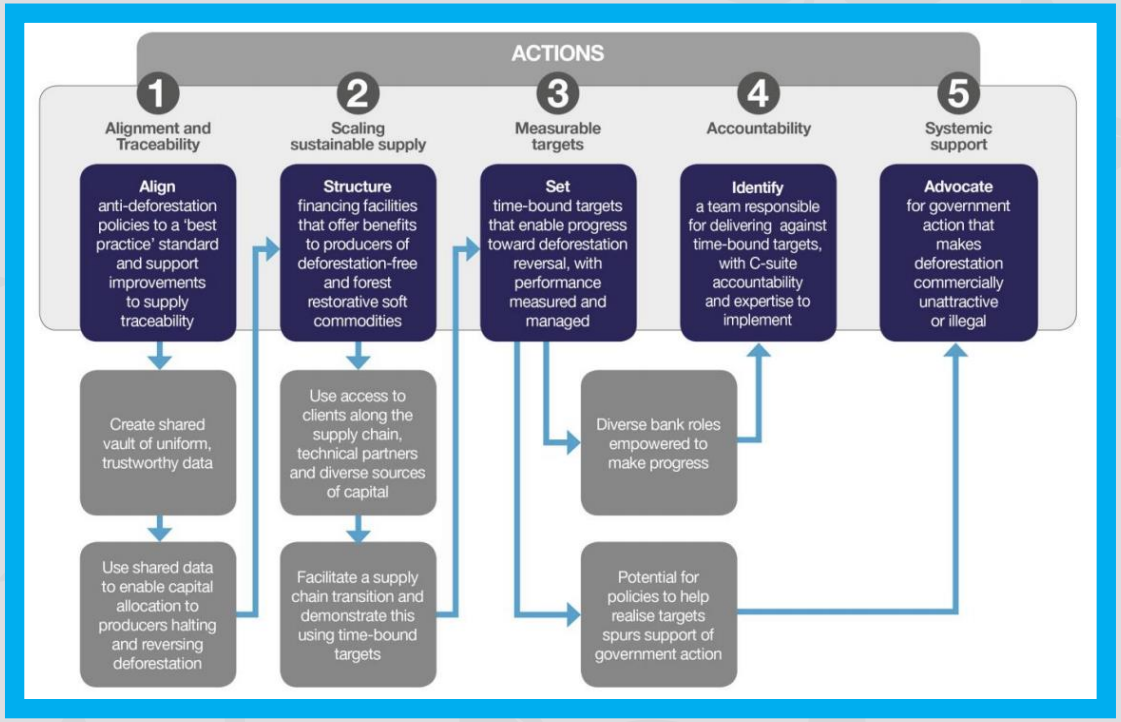
NGOs

*"**Collaboration is highlighted as indispensable to solving this complex challenge**; a broader range of banks, including local banks in commodity producing regions, which were not adopters of the Compact, as well as other stakeholders must come together to decouple soft commodity supply chains from deforestation. Banks cannot do this alone."*



Source: CISL, 2021

Five part Action Plan for banks to support the halting and reversal of deforestation



Collaborate externally

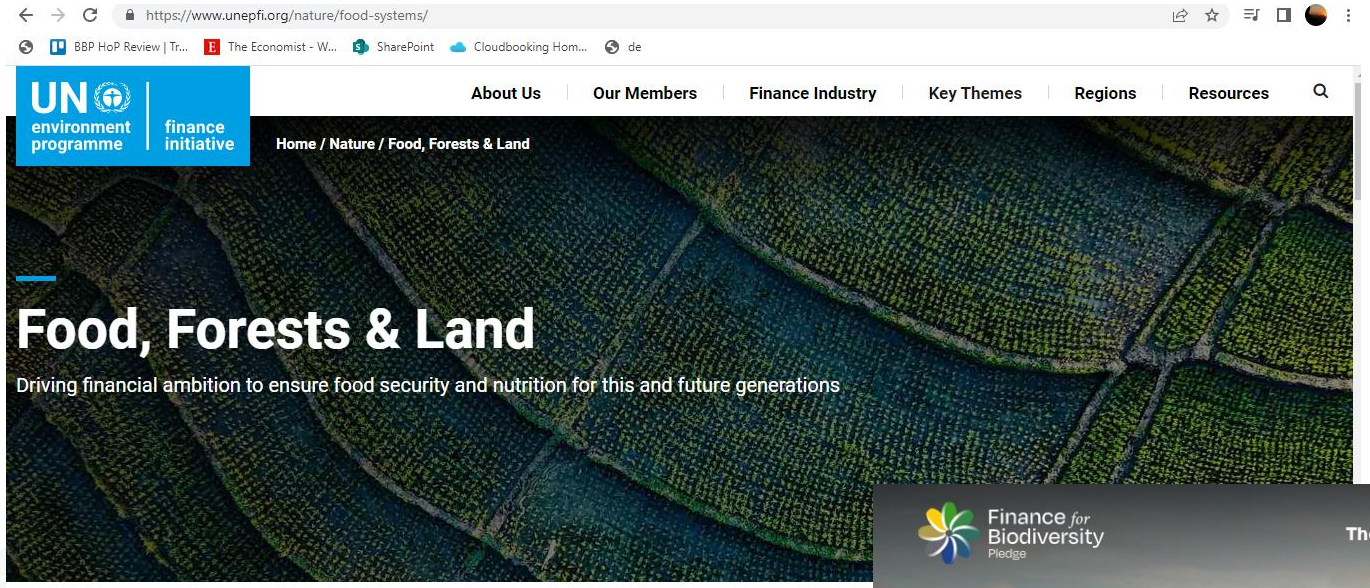
Peer engagement

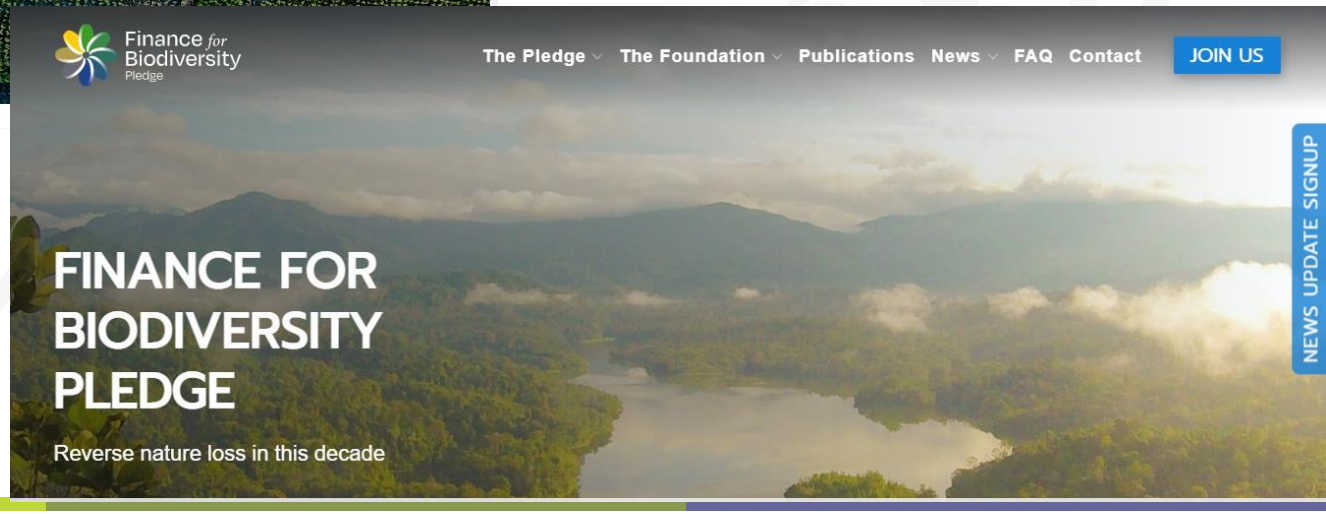
Multi-stakeholder initiatives

Enabling environment

Global Initiatives

NGOs





Collaborate externally

Peer engagement

Multi-stakeholder initiatives

Enabling environment

Global Initiatives

NGOs

Advantages of Joining RSPO

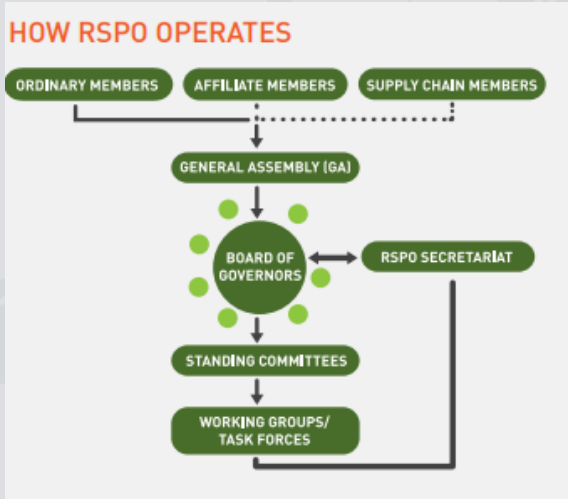
- Ability to have a direct stake in the shaping and growth of sustainable palm oil.
- Highlights a Financial Institution's commitment to financing sustainable business and reducing the reputational risk associated with the sector.
- Be part of a group of like minded Financial Institutions driving and supporting sustainability transformation in the palm oil sector.
- Meet investors and societies' demands for Financial Institutions to operate responsibly.
- Overall minimize environmental & social risks (ESR) for investments and reduce the administrative burden for ESR assessments and decision making.

What does RSPO require from Financial Institutions?

1. Abide by the RSPO Code of Conduct
2. Establish an internal policy, relevant to your business and to the RSPO Principles and Criteria (P&C).
3. Specify a time-bound plan for providing financial services and products to clients that are RSPO members, and/or are producing, trading or buying Certified Palm Oil and its derivatives, relevant to the scope of the members' operations.
4. Report progress annually as part of the mandatory progress report (Annual Communications of Progress – ACOP).
5. Encourage/Require your customers, where relevant, to be members of RSPO, and to promote the RSPO as the preferred certification standard.

RSPO

Roundtable on Sustainable Palm Oil



Source: RSPO, 2018

Collaborate externally

Peer engagement

Multi-stakeholder initiatives

Enabling environment

Global Initiatives

NGOs

https://grsbeef.org/members/

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Members

GRSB is a truly global organization, with member companies, corporations, associations, national roundtables, non-profits and private individuals from across five continents calling 24 countries home.

Personnel from member organisations include senior management and subject matter experts who commit to actively participate and represent their companies in advancing beef sustainability.

GRSB membership is organized into six constituencies: Producers and producer associations, Allied services and Industries, Processing, Retail companies, Civil Societies, and National Roundtables. Observing and Consulting memberships may also be available.

GTPS

Brazilian roundtable on sustainable livestock

Collaborate externally

Peer engagement

Multi-stakeholder initiatives

Enabling environment

Global Initiatives

NGOs

UN CLIMATE CHANGE CONFERENCE UK 2021 | RACE TO ZERO

COP26 Call for Climate Action Announcements from Private Finance Institutions

The COP26 Presidency, Mark Carney's COP26 Private Finance Hub and the High Level Climate Action Champions are calling for private financial institutions to announce new ambitious actions at COP26.

The commitments, strategies and initiatives unveiled by financial institutions at Glasgow can be decisive in turning the tide on climate change. We are now onl few weeks out from the summit, and the world is looking for concrete actions t put a zero-carbon world within reach.

Leadership in the private financial sector comes at a critical juncture. The IPCC' Sixth Assessment Report[1] is a stark and sober reflection of the insufficient pace climate action to date. Without rapid and drastic reductions in emissions this decade, we will fail to deliver the promise of the Paris Agreement, putting capit communities and future generations at risk. The International Energy Agency's (IEA) *Net Zero by 2050*, highlights the need for a total transformation of the energy systems that underpin our economies[2]. **The COP Presidency, Mark Carney's COP26 Private Finance Hub and the High Level Climate Action Champions are therefore calling for private finance institutions to make cle commitments for COP**.

https://racetozero.unfccc.int/system/nature-and-tackling-deforestation/

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CAMPAIGNS THEMES MEDIA ABOUT CAREERS

RACE TO RESILIENCE | RACE TO ZERO

Commitment on Eliminating Agricultural Commodity-Driven Deforestation

Over 30 financial institutions with more than **(US)$8.7 trillion** in assets under management are committed to work on eliminating agricultural commodity-driven deforestation risks in their investment and lending portfolios by 2025. To read the commitment letter, please click here.

This investor-led initiative is supported by a collaborative effort from leading organizations and individuals at the intersection of finance and conservation (Nature4Climate Secretariat, Conservation International, Global Canopy, Global Optimism, High-Level Climate Champions team, WEF Tropical Forest Alliance).

Together, they are working to drive ambition and enable action towards achieving key components of the Call for Climate Action Announcements from Private Finance Institutions issued by the COP26 Presidency, Mark Carney's COP26 Private Finance Hub and the High Level Climate Action Champions.

The signatory financial institutions commit to using "best efforts to eliminate forest-risk agricultural commodity-driven deforestation activities at the companies in our investment portfolios and in our financing activities by 2025".

To strengthen this collective effort new Financial Institutions can access and sign up to the Financial Sector Commitment on Eliminating Agricultural Commodity-Driven Deforestation initiative by accessing this form now.

Section 3 Summary and Key Messages

- External collaboration may be appropriate to eliminate some of the risks to individual banks when deforestation risks are considered to be too large or complex for one bank to manage.
- There are different ways to collaborate based on the on the type of stakeholder involved:
  - Peer engagement (e.g. Soft Commodities Compact), multi-stakeholder initiatives (e.g. RSPO, RTRS, GRSB), enabling environment (engagement with policy makers/regulators), global initiatives (e.g. Race to Zero), NGOs (e.g. Nestle and The Forest Trust)

Overall Summary and Key Messages

- **Module 1:** introduced the global deforestation issue within the broader sustainability agenda. Key message that nature loss equals economic loss and is thus a financial risk.
- **Module 2**: considered deforestation risk identification and assessment. The module covered how deforestation-related risks fits within the traditional risk management framework, as well as outlining important deforestation-related assessment tools.
- **Module 3:** explored how we can take action to mitigate deforestation risk.
  - Risk governance: setting a strategy, building internal capacity, ensuring effective implementation (IIA's Three Lines of Defense)
  - Risk responses: monitoring, avoiding (eligibility criteria, blacklisting and divesting), and reducing (client engagement, contractual & financial responses, exploring opportunities)
  - External collaboration: Peers, Multi-stakeholder initiatives, Regulators, Global initiatives, NGOs
- **Next steps:** We value your feedback to help us build future versions of this training.