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

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.

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.

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
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Presenters

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Module 2: Deforestation Risk Identification and Assessment

Part A: Preparatory Stage (29th Sep)
- Objective-setting and scoping
- Risk exposure
- Introduction to deforestation risk assessment

Part B: Assessing Deforestation Risks (4th Oct)
- Reputational Lens
- Legal lens
- Financial lens
Part A: Preparatory Stage

- Objective-setting and scoping
- Risk exposure
- Introduction to deforestation risk assessment
Section 1
Learning Objectives

❖ Understand what to include in scoping your risk identification and exposure assessment

Specifically, you will learn, how to:

❖ Set objectives for your assessment and its linkages to the criteria you will set for your assessment
❖ Matching internal and external context to priorities and output, to understand your assessment lens
Objective setting for your risk assessment

- Before you start your assessment, it is critical to set your objective.

- To help set your objective, it is important to understand internal and external context of the organisation. The defined objective should consider institutional needs and priorities of important stakeholders.

- Reflect on what the assessment wants to achieve and the expected outcome for the firm (this helps determine your approach, the data needed, and how you will apply the results)
Understand the external and internal context

Understanding **external** and **internal** context is important in risk management processes, because:

- Risk management takes place in the context of the objectives and activities of the organisation
- Organisational factors can be a source of risk
- The purpose and scope of the risk management process may be interrelated with the objectives of the organisation as a whole.

(Source: [ISO 31000: 2018](https://www.iso.org/standard/68004.html))

This can be done through the following iterative steps:

- Understand key deforestation risk and the bank’s priorities in addressing these risks (Framing)
- Understand where the bank has the greatest impact on these issues (Scoping)

(Adapted from: [COSO, 2018, Enterprise Risk Management](https://www.coso.org/assets/coso/195546235.pdf))
Deforestation risks – recap

Financial institutions risks

Soft commodity supply chain risks

Soft commodity supply chain

Non-performing loans
Clients may be unable to service debt

Asset values
Assets may become stranded if market conditions change

Revenue/profitability
Market value may deteriorate as revenue and profits are impacted

Operational
Resource scarcity, biodiversity loss and ecosystem degradation leading to decreased productivity and resilience

Legal and Regulatory
Environmental breaches and un-preparedness for compliance

Legal and Regulatory
Legal liabilities due to failure to manage environmental and social risks in activities

Markets
Change in consumption due to changes in societal preferences

Reputational
Companies might be targeted by campaigns due to their involvement in soft commodity value chains

Risk areas:
- Operational
- Legal and Regulatory
- Markets
- Reputational

Risks within soft commodity supply chains can affect standard financial metrics (e.g., revenue, asset valuation, or costs) which can affect credit worthiness of clients, or market value of debt, or equities of investee companies.

The soft commodity supply chain includes a diverse range of entities that have either direct or indirect impacts on forests.

The diagram illustrates the impacts of deforestation risks on various entities in the supply chain, highlighting how risks can be propagated throughout the chain, affecting financial institutions and individuals.
Gather internal context

Consider the organisation’s existing risk processes and institutional priorities. This supports thoughtfull deployment of resources and inhibits development of objectives that would exceed the bank’s risk appetite.

Use the **Operational Manual** of the bank to understand existing processes. Key aspects to see:

- The bank’s overall governance arrangements for risk management
- Processes for conducting credit and environmental risk identification and assessment
- The bank’s risk appetite

This will help make a more informed choice of objective for the assessment, and have a more holistic view when taking action following the assessment.

(Adapted from [NCFA, Integrating Natural Capital Risk Assessments, 2018](#) and [COSO, Enterprise Risk Management, 2018](#))
Linking priorities to the assessment lens

Your chosen priorities will determine your lens

- **Reputational**
- **Legal compliance (non-financial compliance)**
- **Financial compliance (capital adequacy, etc.)**

Other questions to help determine the priorities

- **Qualitative/semi-quantitative** (e.g. comparative scores, benchmarking)
- **Quantitative through deterministic methods (scenario analysis, stress test, reverse stress test) or probabilistic risk analysis (value at risk)**

- Is the bank assessment tied to specific target setting objectives?
- Is the bank going to be forward looking (e.g. scenarios, predictions) or backward looking (e.g. addressing the bank’s current business structure)?
- What aspect of risk management is the bank trying to tackle? (Day-to-day risk management, product development, capital allocation (economic capital) or stress testing?)
- Does the bank have evidence of actual deforestation-linked non performing loans or has the bank has been engaging with government on compliance-related issues?
Break Out Groups Exercise

Which aspect(s) of the deforestation issue do you find most important?

What output(s) are you seeking from the assessment?

You will have 10 minutes to discuss, please assign a spokesperson to your group.
### Match context to priorities and output

#### Which aspect(s) of the deforestation issue do you find most important?

<table>
<thead>
<tr>
<th>Market</th>
<th>Improve market signaling (future-proofing investments according to market trends, alignment with competitors)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal</td>
<td>Increase compliance with existing and emerging/foreseen regulations</td>
</tr>
<tr>
<td>Reputation</td>
<td>Improve reputation and alignment with best practices/societal expectations</td>
</tr>
<tr>
<td>Assess financial loss</td>
<td>Improve allocation of capital and reduce risk of financial loss</td>
</tr>
<tr>
<td>Find opportunities</td>
<td>Better identification of opportunities for green finance</td>
</tr>
<tr>
<td>Others?</td>
<td>Others?</td>
</tr>
</tbody>
</table>

#### What output(s) are you seeking from the assessment?

| Improve market signaling (future-proofing investments according to market trends, alignment with competitors) |
| Increase compliance with existing and emerging/foreseen regulations                                           |
| Improve reputation and alignment with best practices/societal expectations                                    |
| Improve allocation of capital and reduce risk of financial loss                                               |
| Better identification of opportunities for green finance                                                   |
| Others?                                                                                                     |
Key messages

❖ To set your objectives you will need to reflect on the different type of deforestation risk you may be exposed to how the bank's appetite towards different risks varies.

❖ After understanding both the external and internal context, reflect on the following questions to help determine your objective:
  ❖ Which aspect of the deforestation issue are most important to the bank
  ❖ What outputs are sought as the result of the assessment process
  ❖ Is the need for the result a reactive or proactive approach?
  ❖ Is the bank assessment tied to specific target-setting objects?
  ❖ What aspects of risk management is the bank trying to tackle?

❖ Your objective will help determine the approach of your risk assessment (criteria, data needed, scope, etc.).
Defining the scope

- To set your objectives you will need to reflect on the different **type of deforestation risk** you may be exposed to and how the bank’s **appetite** towards different risks varies.

- The breadth (how much you want to include: certain geographies, sectors, etc.)
- The depth (the level of granularity: the institutional level, individual transactions, etc.)
- The lens of analysis (qualitative/semi-quantitative or quantitative approach)
Defining the breadth - geographies

- The geographical scope selected should match the bank's resources, timescale, priorities and appetite for granularity.
- The bank can conduct the assessment on its entire portfolio, but we recommend **starting with a few priority geographies** when conducting the assessment for the first time.

**Example:** If a bank has a global or multinational operations, it can select its top countries by portfolio value or countries where environmental risks tend to be more pronounced. If the bank is national or regional, it can focus on one country, or even on a specific region where its portfolio’s credit quality is lower.

Source: NCFA, *Integrating Natural Capital Risk Assessments, 2019*
Defining the breadth - sector

- In defining the sectors to include in the assessment, banks may wish to focus the analysis on a subset of priority sectors.
- For deforestation, it has been already identified which sectors are more exposed than others. Banks may wish to start with these sectors.

Example: A simple approach to filter sectors for analysis is to limit the analysis to the top 5 deforestation-related sectors/commodities by portfolio value/highest impact. This sector filter will help determine which transactions you wish to include in the risk identification step.

Source: The Investor Guide to Deforestation and Climate Change (Ceres, 2020)
In determining your geography and sector, recognize that deforestation risks vary significantly across the sector/geography/commodities categories.

Try to unpack the most important overlaps/levels for analysis (region/sector, country/sub-sector, clients across regions and sectors).

If choosing to assess indirect impacts, this will have implication on your assessment's spatial boundaries.

Source: The Investor Guide to Deforestation and Climate Change (Ceres, 2020)
Defining the depth

❖ Determine the level of granularity you wish to undertake for the assessment (institutional level, individual transactions, etc.).

❖ Decide if the analysis shall include subsidiaries, branches as well any equity stake that is reflected in accounting statements.

❖ If choosing portfolio-level: decide whether to include: all financial activities or a subset of products/services.

❖ There are temporal and spatial boundaries implications to the type of products you wish to include in the assessments (e.g. for longer-tenure loans, deforestation risks might be higher)

Source: NCFA, Integrating Natural Capital Risk Assessments, 2018
Portfolio assessment: which finance product should I start with?

- Looking at loan book exposure would be a good place to start with portfolio level analysis.
- According to CDP, companies within Forest Risk Commodities supply chains in Southeast Asia rely primarily on bank lending for financing needs. (see figure)

Source: CDP, 2020, Transition to Sustainable Lending to the FRC Sector
Defining the assessment’s boundaries

Depending on the depth of your assessment (and later lens), multiple boundaries may need to be considered:

**Temporal/time horizon:** short-term, medium-term or long-term

**Spatial boundaries:**
- Depending on whether you would account for **indirect impacts**, value chain and where the clients sit within the value chain will need to be kept in consideration while assessing deforestation risk.
- This choice will affect the approach you take in the assessment. Will it be limited to direct client investments (i.e. **attributional approach**) or open to incorporate indirect impacts along the clients’ value chains (**contributory approach**, addressing possible upstream and downstream risks).

Source: *Capitals Coalition, Finance Supplement, 2018*
Key messages

- To define scope, you will need to determine **the breadth, depth and lens** of your assessment.
- You will need to consider the objective and scope of your assessment throughout your risk identification, risk assessment, and risk valuation stages.

Source: NCFA, *Natural Capital Credit Risk Assessment in Agricultural Lending, 2019*
Part A: Preparatory Stage

➢ Objective-setting and scoping
➢ Risk exposure
➢ Introduction to deforestation risk assessment
Things to consider

❖ Data can be a mix between internal client data and externally sourced data from third party providers.

❖ External sourced data is usually used to verify existing information or gather more granular data points for specific portfolio measurement exercises. External information sources may include, scores calculated from third party providers (ESG ratings) as well as raw data (geo-location of assets, etc.)

❖ Increasing the complexity of the analysis can give much better results but it is possible for the costs to outweigh the benefits, and so may not be suitable in all circumstances.

When choosing your data source think about how this relates to your objective and lens.

Source: BlackRock and European Commission, 2020
Determining forest-risk sector concentration

SELECT CLIENT BASE

Many companies operate in various commodities, decide how to ensure this is captured in results

DETERMINE SECTOR ADJUSTERS

From KYC, possibly relate them to their industry classifications (ISIC/GICS)

LINK TO SECTORS (INTERNAL DATA)

• Connecting GICS sector to FRC: CERES
• Connecting company with their FRC: Forest&Finance, CDP Forests Responses, DeforestationFreeFunds, ZSL SPOTT, BankTrack, RSPO, Forest500

LINK TO SECTORS (EXTERNAL DATA)

Concentration of finance and/or clients in forest-risk sectors/commodities:
• Beef/leather
• Palm Oil
• Soy
• Paper/Timber
• Rubber
• Cocoa
• Coffee

PRODUCE OUTPUT
Sector risk identification and exposure

Possible approach 1: Connect GICS sector to forest-risk commodities

Possible approach 2: Connect company to forest-risk commodities

Output: Forest-risk sector/commodities exposure

Source: The Investor Guide to Deforestation and Climate Change (Ceres, 2020)

Source: CDP Forests Responses
Determining forest-risk geographic concentration

Many companies operate in various countries/geographies, decide how to ensure this is captured in results.

For upstream companies, you may use the location of the company’s headquarters. For downstream companies, look into internal client data (e.g. 10-K filings/financial filings) to see operations/sourcing patterns.

- Connecting company with their operations/production facilities and sourcing: CDP Forests Responses/certification scheme annual reports
- Connecting company groups with their forest-risk operations: Forest&Finance
- Connecting commodity traders to sourcing region: Trase Finance and Trase Earth
- Determining forest-risk regions (country-level): CERES

Concentration of finance and clients across geographies. For geographic analysis, linking this to commodities exposure for that client will be crucial (can be taken from sector exposure results).
Geographic identification and exposure

STEP 1: Understand your forest-risk commodity exposure (from sector risk identification exercise)

STEP 2: Understand where your clients deforestation risk are

❖ Upstream companies: For country-level data, headquarter locations can be used. Traceability sourcing data is important when going beyond national-level analysis.

❖ Downstream companies: Need to unpack sourcing patterns from financial fillings or external data.

Example of trade linkages between countries, regions, and traders (using Trase platform)

OUTPUT: Concentration of finance and clients across geographies and forest-risk sectors

Source: Trase Earth
Other approaches: Unpacking value chains

Forest risk commodity supply chains are complex. Some actors cover multiple stages within specific supply chains and similarly act across supply chains for several different forest risk commodities.

The main major company types are:

- Producers
- Processors
- Trader/importer/exporters
- Manufacturers
- Retailers

Yet many companies transcend these categories and are represented in more than one segment.

Unpacking these value chains could be important to determine the level of influence to deforestation risk and selecting the most appropriate mitigation strategy.

Source: Forest500, 2020; Climate Advisers, 2021
Banks focus on upstream clients with direct impacts on nature

It can be seen from the disclosures that while banks recognize their clients can have an impact on nature, they are currently concentrating on clients operating upstream in FRC supply chains which have a direct impact on nature. There is less attention given to clients operating further downstream that may have indirect impacts on nature through their supply chain. In reality, both direct and indirect effects are important, and both have the capability to present risks to the bank.

Source: (CDP, 2021, Lending Forests a Hand)
## Deforestation heat map throughout supply chain

<table>
<thead>
<tr>
<th></th>
<th>Upstream</th>
<th>Midstream</th>
<th>Downstream</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Physical risks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acute</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td>Chronic</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Transition risks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy and legal</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Market</td>
<td>High</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Reputational</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Technology</td>
<td>Medium</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Deforestation-free opportunities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market</td>
<td>High</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Resilience</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Resource efficiency</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

*Source: Chain Reaction Research, 2021*
Other approaches

By financial products (e.g. shareholdings, loans, all taken from internal data)

By company (proportion of financing to certain companies)

Or a combination of various approaches

Source: Climate Advisers, 2021; Climate Advisers, 2021
Key messages

❖ The first step in identifying risk is to determine the concentration of forest risk exposure and unpack this depending on your objective and priority.

❖ This can be done through various approaches most relevant to deforestation risk: sector, geographic, value chain, financial product, list of high-risk companies, or a combination of these.

❖ The complexity of agri-supply chains could make it difficult to separate them into different sectors/geography/value chain, therefore determining your adjusters beforehand will be important.

❖ This first step however, does not yet determine the level of risk, but could indicate where more efforts are needed to further identify and assess the severity of risk.
Part A: Preparatory Stage

- Objective-setting and scoping
- Risk exposure
- Introduction to deforestation risk assessment
Identify and assess risks through the lenses

Banks could examine their risk base through a reputational, legal, and/or financial lens. A lens view looks at the various threats in risk register that could be significantly amplified through additional reputational/legal/financial damage.

**REPUTATIONAL**
Examining risks related to negative publicity and reputational damage in financing forest-risk companies targeted by NGOs, clients, media, and the wider public.

**LEGAL**
Examining risks related to current and future regulations (which are likely to be more stringent) in financing forest-related activities.

**FINANCIAL**
Examining risks that can ultimately affect portfolio companies revenue and profitability (e.g. default on debt obligation, declining equity value, and asset stranding).

Adapted from: *Tropical Forest Alliance, 2018*
### Defining the lens

**Approach**
- **Qualitative/semi-quantitative** (e.g. comparative scores, benchmarking)
- **Quantitative** through deterministic methods (scenario analysis, stress test, reverse stress test) or probabilistic risk analysis (value at risk)

**Advantages**
- Useful when time, resources, data are less available
- Provides information beyond financial impact and likelihood (vulnerability, speed of onset and non-financial impacts (e.g. reputation)
- Helpful for deforestation risks that have a strong moral/ethical dimension
- Useful when prioritisation requires consistency with other risk severity assessments
- Support decision-making for trade-offs
- Helps compute capital requirements to maintain solvency under extreme conditions
- Enables risk based capital allocation to businesses with optimal risk return

**Disadvantages**
- Cannot numerically aggregate or address risk interactions and correlations (disparate risk cannot be compared)
- Less precise (greater possibility of bias)
- Time consuming and costly
- Deforestation models still under development
- Qualitative impacts overlooked
- Use of numbers may imply greater precision than the uncertainty of input warrants (assumption and calculations can be complex)

How much time and cost is needed (next slide)

Source: Deloitte, Risk Assessment in Practice and COSO, 2018, Enterprise Risk Management
### Costs considerations

<table>
<thead>
<tr>
<th>Approach</th>
<th>Allocation</th>
<th>Deforestation-related considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualitative/semi-quantitative</td>
<td>The complexity of the assessment increases the allocation for:</td>
<td>Increased complexity increases the costs of assessment:</td>
</tr>
</tbody>
</table>
|                        | ❖ Human resources/skills  
❖ Data required  
❖ Time  
❖ Costs  
❖ Physical infrastructure (e.g. certain software) | On data, you might need to consider:                                                                    |
|                        |                                                                           | ❖ Data access costs (some platforms are paid)                                                            |
|                        |                                                                           | ❖ Availability of accurate and reliable environmental information for soft commodities (the need to find reliable proxies) |
|                        |                                                                           | On skills, you might need to consider:                                                                  |
|                        |                                                                           | ❖ Whether it would require an understanding of soft commodities supply chains and how to relate/interpret deforestation-related data to clients or portfolio companies. |
|                        |                                                                           | ❖ GIS/spatial data knowledge                                                                             |
|                        |                                                                           | ❖ Whether multiple teams across the banks is needed                                                     |
|                        |                                                                           | ❖ Possibility of hiring experts/outsourcing (increasing costs)                                          |
|                        |                                                                           | ❖ That there no specific models to quantify deforestation risk (investment needed to build this)          |

#### Quantitative

- Deforestation-related considerations

- Increased complexity increases the costs of assessment:
  - On data, you might need to consider:
    - Data access costs (some platforms are paid)
    - Availability of accurate and reliable environmental information for soft commodities (the need to find reliable proxies)
  - On skills, you might need to consider:
    - Whether it would require an understanding of soft commodities supply chains and how to relate/interpret deforestation-related data to clients or portfolio companies.
    - GIS/spatial data knowledge
    - Whether multiple teams across the banks is needed
    - Possibility of hiring experts/outsourcing (increasing costs)
    - That there no specific models to quantify deforestation risk (investment needed to build this)
## Comparison on costs

<table>
<thead>
<tr>
<th>Lens</th>
<th>Approach Examples</th>
<th>Allocation</th>
</tr>
</thead>
</table>
| Reputational                | **Simple Qualitative**: Assessing whether a forest-risk company is member of a voluntary certification standard (e.g. RSPO member)** | **Resources**: can be done by a single staff member  
**Skill level**: easy (no background required, only guidance)  
**Data**: can be acquired through due diligence questions or quick online check  
**Time**: minutes/days (depending on how quickly responses are received)  
**Costs**: low |
| Financial compliance (capital adequacy, etc.) | **Complex Quantitative**: Stress testing to model deforestation impacts on credit risk | **Resources**: requires multiple resources and cooperation across teams (risk analysts, ESG, others)  
**Skills**: highly specialised (e.g. the need to develop a methodology, interpret data, design/select scenarios)  
**Data**: complex (e.g. data of physical and transition risks related to deforestation, connecting deforestation data to cash flows)  
**Time**: substantial  
**Costs**: high |
## Further considerations

**Increasing the complexity** of the analysis can give much better results but it is possible for the costs to outweigh the benefits, and so may not be suitable in all circumstances.

While the initial costs of doing an assessment may be high, the **unit cost should fall over time**, as assessment processes become streamlined.

## How do I start?

It might make sense to **start with the largest loans in the highest-impact sectors/commodities**.

Before extending the analysis to a sub-level lens, this should be weighed against the additional cost and general complexity it creates.

A lower-level analysis should only be undertaken in situation where the upper-level analysis has too much variability (i.e. clients, sectors, geographies).

---

*Source: NCFA, Natural Capital Credit Risk Assessment in Agricultural Lending, 2019*
## Risk identification & assessment sample output

<table>
<thead>
<tr>
<th>RISK IDENTIFICATION</th>
<th>RISK ASSESSMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(sample output)</strong></td>
<td><strong>(sample output)</strong></td>
</tr>
<tr>
<td><strong>Reputational</strong></td>
<td></td>
</tr>
<tr>
<td>Screening indicated that there are many</td>
<td>Measuring risk severity of low-performing clients</td>
</tr>
<tr>
<td>clients operating in Southeast Asia that</td>
<td>through reputationally-relevant datapoints (e.g.</td>
</tr>
<tr>
<td>are low performers in NGO rankings.</td>
<td>deforestation rates, fires, certification)</td>
</tr>
<tr>
<td><strong>Legal</strong></td>
<td></td>
</tr>
<tr>
<td>Portfolio screening indicated concentration of loans where compliance to forest regulation is a known issue.</td>
<td>Measuring risk severity of low-performing clients through legally-relevant datapoints (e.g. protected areas, tenure risk, overlap of concessions)</td>
</tr>
<tr>
<td><strong>Financial</strong></td>
<td></td>
</tr>
<tr>
<td>Screening indicated larger rate of defaults in agricultural loans in regions experiencing higher temperature fluctuations.</td>
<td>Estimating present/future financial value or loss related specific deforestation-related risk (e.g. forest moratorium leading to stranded assets)</td>
</tr>
</tbody>
</table>