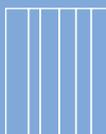




UNITED NATIONS ENVIRONMENT PROGRAMME

# BANK AND INVESTOR RISK POLICIES ON SOFT COMMODITIES

A framework to evaluate deforestation and forest degradation risk in the agricultural value chain



Natural Capital Declaration

Financial sector leadership on natural capital

Secretariat:



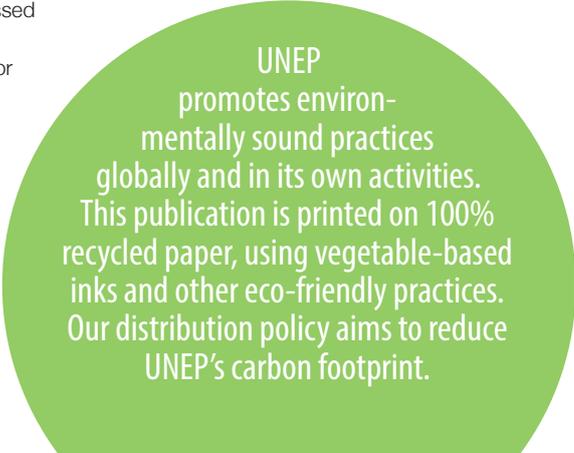
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# **BANK AND INVESTOR RISK POLICIES ON SOFT COMMODITIES**

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**A framework to evaluate  
deforestation and forest  
degradation risk in the  
agricultural value chain**

# ACKNOWLEDGEMENTS

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## About this Study

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## About the Natural Capital Declaration

The Natural Capital Declaration (NCD) was launched at the UN Conference on Sustainable Development (Rio+ 20 Earth Summit) in 2012 by UNEP FI and the UK-based non-governmental organization, Global Canopy Programme (GCP). It is a worldwide financed 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 endorsed by the CEOs of financial institutions. Signatory financial institutions are working towards implementing the commitments in the Declaration through NCD projects. These are overseen by a steering committee of signatories and supporters and supported by a secretariat formed of the UNEP FI and GCP.

## About The Global Canopy Programme (GCP)

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. GCP works through its 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. The Global Canopy Programme is a registered UK charity, number 1089110.

## 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 organizations 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 realize the adoption of best environmental and sustainability practice at all levels of financial institution operations.

## About Sustainalytics

Sustainalytics supports investors around the world with the development and implementation of responsible investment strategies. The firm partners with institutional investors that integrate environmental, social and governance information and assessments into their investment decisions. Headquartered in Amsterdam, Sustainalytics has offices in Boston, Bucharest, Frankfurt, London, New York City, Paris, Singapore, Timisoara and Toronto, and representatives in Bogotá, Brussels, Copenhagen and Washington D.C. The firm has 200 staff members, including more than 120 analysts with varied multidisciplinary expertise and thorough understanding of more than 40 industries. In 2012, 2013 and 2014, Sustainalytics was voted best independent sustainable and responsible investment research firm in the Extel IRRI survey.

This report was drafted in accordance with the agreed work to be performed and reflects the situation as on the date of the report. The information on which this report is based has – fully or partially – been derived from third parties and is therefore subject to continuous modification. Sustainalytics observes the greatest possible care in using information and drafting reports but cannot guarantee that the report is accurate and/or complete. Sustainalytics will not accept any liability for damage arising from the use of this report, other than liability for direct damage in cases of an intentional act or omission or gross negligence on the part of Sustainalytics.

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# FOREWORD

The continuing loss of the world's tropical rainforests represents a significant threat to the security of water, food, energy, health and climate for millions worldwide. To be involved in such wholesale erosion of natural capital<sup>1</sup> is simply bad business. Banks and investors can drive deforestation and land conversion through their lending and investment practices, exposing themselves to potentially significant risks. These include regulatory, reputational, legal, operational, biophysical and market risks, which in turn could affect the credit risk or market value of the underlying asset. Meanwhile, new opportunities are emerging to curb deforestation and produce sustainable value chains for commodities. Financial institutions can be part of the solution by adopting new products and services.

Addressing deforestation is high on the twenty-first century policy agenda, as seen at the Conference of the Parties to the UN Framework Convention on Climate Change (UNFCCC) and other high-level events such as the 2014 Climate Summit. A significant driver of tropical deforestation is the clearing of land to satisfy growing global demand for agricultural commodities, including beef, soy, and palm oil. With this in mind, many developing countries have committed to reduce emissions from agriculture and forestry activities as major foundations of their Nationally Appropriate Mitigation Actions, or NAMAs, under the UNFCCC. As such, they are reducing emissions from deforestation and forest degradation through conservation and enhancement of forest carbon stocks and sustainable management of forests.

For its part, the United Nations Environment Programme (UNEP) is actively supporting efforts to reduce deforestation and forest degradation in more than 50 partner countries through REDD+, a global initiative co-managed with the United Nations Development Programme (UNDP) and the Food and Agriculture Organization of the United Nations (FAO).<sup>2</sup>

The financial sector can play an equally important role to reduce deforestation and forest degradation. Key mechanisms include, but are not limited to, engaging with clients, restricting credit for the most harmful practices and incorporating risks from natural capital degradation into financial analysis. As a first step, banks and investors could have internal policies and procedures to strengthen monitoring and management of risks linked to the financing of companies that contribute to deforestation and forest degradation through their operations or supply chains.

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1. Natural capital comprises Earth's natural assets (soil, air, water, flora and fauna), and the ecosystem services resulting from them, which make human life possible.
  2. Reducing Emissions from Deforestation and Forest Degradation (REDD) is an effort to create a financial value for the carbon stored in forests, offering incentives for developing countries to reduce emissions from forested lands and invest in low-carbon paths to sustainable development. "REDD+" goes beyond deforestation and forest degradation, and includes the role of conservation, sustainable management of forests and enhancement of forest carbon stocks.

This study, commissioned by UNEP as part of the UN-REDD Programme, aims to provide greater clarity on policies that banks and investors can adopt to reduce deforestation and forest degradation from the production of soy, palm oil and beef. The study and the accompanying tool are produced by the Natural Capital Declaration (NCD). A unique global finance-led and CEO-endorsed initiative, NCD seeks to accelerate the integration of natural capital considerations into financial products and services such as loans, bonds and equities.

This study and the tool lay the foundation for linking financial sector decisions to deforestation and forest degradation. They will help financial institutions better understand the dependencies of soft commodity producers on forest ecosystems, and how their businesses affect these ecosystems. This, in turn, allows financial institutions to gain more insight into their own risks and opportunities. Ultimately, this more profound financial analysis would be included in accounting, disclosure and reporting.



**Achim Steiner**  
United Nations Under-Secretary-General  
Executive Director, United Nations Environment Programme



# EXECUTIVE SUMMARY

Palm oil, soy and beef are important soft commodities, but their production drives deforestation and forest degradation. Banks, investors and other institutions can be exposed to risks from deforestation by providing debt, equity and other forms of capital to companies in soft commodity production value chains. This report examines what types of risk policies on soft commodities banks and investors have developed to reduce or limit the chance of clients significantly impacting on tropical forests. It also provides recommendations for how financial institutions can strengthen approaches to manage these risks. An analytical framework was developed for that purpose titled Soft Commodity Forest-risk Assessment (SCFA) tool. It enables banks, investors and other financial institutions to take action by using the tool to develop, update or improve their soft commodity risk policies. Financial institutions are encouraged to identify how they can improve their own risk policies to systematically consider natural capital in the credit policies of specific sectors, including commodities, that may have a major impact on natural capital either directly or through the supply chain.<sup>3</sup>

## **Why are risks linked to soft commodity production relevant for financial institutions?**

1. Financial institutions are exposed to risks related to deforestation and forest degradation if companies they invest in or lend to are affected by biophysical, legal, market or regulatory risks linked to their impacts or dependencies on forest ecosystems. These risks can become material for a financial institution if one or a combination of these risks affects the costs, revenues or other financials of the company.
2. A rapidly emerging trend among consumer goods companies recognizing these risks is to aim to develop commodity value chains with minimal or no deforestation impacts. These corporate initiatives and international policy efforts to reduce deforestation and forest degradation – such as through the UN-REDD Programme – will increasingly place a spotlight on the role of the financial sector in financing activities that lead to deforestation, and its potential contribution to avoiding this.
3. Exposure to deforestation and forest degradation risk in soft commodity value chains is growing as companies and governments increasingly become proactive by taking measures to reduce deforestation and forest degradation, as well as stimulate conservation and enhancement of forest carbon stocks and sustainable management of forests (REDD+). This can create opportunities for financial institutions if they align their risk policies with emerging trends to incentivize the production of more sustainable commodities. Enhanced due diligence through more robust policy development and implementation can provide the foundation for innovation to develop products and services that support the collaborative efforts by agricultural and consumer goods companies to remove deforestation from their supply chains.

## **How can financial institutions contribute to the solution?**

1. Financial institutions that want to better understand and manage risks from deforestation and forest degradation can incorporate assessments of and responses to these risks in their operations. The Natural Capital Declaration

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3. See: [www.naturalcapitaldeclaration.org](http://www.naturalcapitaldeclaration.org) for an overview of financial institution signatories and to download the Declaration.

(NCD), a finance-led and CEO-endorsed initiative to mainstream the integration of natural capital in financial products and services, developed an internal policy framework that financial institutions can adopt in order to reduce the risks from deforestation and forest degradation in soft commodity value chains. An evaluation of 30 financial institutions' policies provides a representative picture of how financial institutions are already using these policies to address deforestation and forest degradation risks linked to these commodities, focusing on corporate lending, public equities, and advisory services.

2. The assessment is based on the application of a tool accompanying this report; the first NCD tool to build the capacity of financial institutions to integrate natural capital considerations into products and services. The Soft Commodity Forest-risk Assessment (SCFA) tool was developed to evaluate banks and fund managers' policies and processes to manage deforestation and forest degradation risk linked to the commodities. It is built on a framework comprised of weighted criteria for policy scope; policy strength; and implementation, monitoring and reporting.
3. Financial institutions can use the SCFA tool to evaluate how their policies compare to sector peers in addressing deforestation or forest degradation risks linked to these commodities. The tool is freely available on the NCD website, together with a guide on how to use it and how to interpret the results. The tool's framework criteria can be used to inform efforts to develop or update the soft commodity policies by banks or fund managers applicable to clients or companies that are active in the palm oil, soy or beef value chains. Meeting these criteria would strengthen the individual financial institution's performance in relation to the benchmark included in the SCFA tool.

## MINIMUM AND BEST PRACTICE RECOMMENDATIONS

Minimum and best practice recommendations have been developed for financial institutions based on the analysis of the policies of 30 financial institutions. The minimum standards can be used by financial institutions seeking a basic risk policy framework, whereas best practice standards can be used for more advanced institutions.

### **Minimum:**

- Disclose a general sustainability policy or detailed statement addressing environmental and social issues broadly.
- Reference relevant commodity roundtables and other credible sustainability certifications when assessing the performance of clients or investees.
- Outline some specific environmental and social requirements.
- Disclose implementation and monitoring efforts within the organization that are focused on environmental, social and governance (ESG) or sustainability issues.

### **Best practice:**

- Disclose a formal policy that addresses the environmental and social impacts associated with specific soft commodities. Apply the policy to all financial services offered by the financial institution, and to all stages of the value chain.
- Require (or strongly encourage) upstream companies to achieve or commit to a time-bound plan to achieve certification under the relevant commodity roundtables Roundtable on Sustainable Palm Oil (RSPO), Roundtable on Responsible Soy (RTRS) or other credible sustainability certifications.

- Disclose efforts to implement and monitor compliance with policies within companies that the institution provides financial services to or invests in, specifically in relation to soft commodities. Such activities may include the development of environment action plans with companies, engagement, screening, and audits/company visits.

## HOW THIS WORK IS LINKED TO FUTURE OUTPUTS

In order to build a stronger business case for financial institutions to evaluate ecosystem impacts it is necessary to develop and test practical and where possible quantitative tools, methods and frameworks that enable banks and other institutions to integrate natural capital factors, such as water scarcity, or risks related to deforestation and forest degradation, in the financial analysis of loans, bonds and equities. While the SCFA tool is qualitative, future work aims to integrate risks from degradation of natural capital into credit assessments, cash-flow analysis and other financial metrics used for everyday decisions in the financial sector. In this way, natural capital considerations could become a more integral part of financial sector decision-making.

## LIMITATIONS OF THE REPORT

The soft commodity risk policies of 40% of the 30 financial institutions that were reviewed for this study are considered best practice. However, there are three main caveats to this that need to be addressed. First, there is limited information available on what proportion of their loan and investment portfolios banks and investors apply such policies. Second, better evidence and causation is needed on whether risk policies by banks and investors can lead to a reduction in deforestation and forest degradation (especially in the absence of a level legal playing field provided through government regulation). Third, banks and investors require stronger evidence on how deforestation by clients or through the agricultural supply chain can lead to enhanced credit risk for the lender or investor.

## ADDITIONAL RESOURCES

The Soft Commodity Forest-risk Assessment tool, a guidance document and a summary version of the report is available from the NCD website: [www.naturalcapitaldeclaration.org/softcommoditytool](http://www.naturalcapitaldeclaration.org/softcommoditytool)

## KEY FINDINGS FROM THE ASSESSMENT OF FINANCIAL INSTITUTIONS

- There is broad awareness in the sample that the financial sector is exposed to risks from deforestation linked to the production and processing of soft commodities.
- Scores between financial institutions differed widely, ranging from 10 – for a bank that did not disclose sustainability information – to 93 (out of a total possible score of 100).
- On average, the 30 financial institutions reviewed scored 58 across the three categories. The average score could be seen as an initial benchmark against which financial institutions can assess and compare their own policies.
- A threshold score of 67/100 was established as a benchmark for best practice across all three categories analysed, with 12 top-scoring financial institutions grouped into this Tier 1. 15 financial institutions with scores between 33 and 67 are grouped in Tier 2, while three with limited policies or disclosure that score below 33 are grouped in Tier 3.
- Financial institutions that scored highly on the policy scope pillar also tended to do well on policy strength. Implementation, monitoring and reporting scores were positively correlated with policy scope and policy strength.
- Few if any financial institutions systematically quantify exposure to risks related to soy, palm oil and beef at the portfolio level. Challenges in doing so include access to information, limited resources, and the complexity of calculating and defining risk levels.
- Almost all financial institutions disclose some evidence of processes to implement their soft commodity or general sustainability policies, both internally and externally. However, many do not disclose evidence of specific activities to monitor clients' compliance with their policies, which is an important area for improvement.
- Almost half of the 30 financial institutions evaluated have policies in place to identify, manage and control or mitigate risks linked to loans or investments in companies involved in soft commodities. Almost all financial institutions disclose some evidence of processes to implement their soft commodity or general sustainability policies, both internally and externally. However, many do not disclose evidence of specific activities to monitor clients' compliance with their policies on an ongoing basis, which is an important area for improvement.
- 37% of financial institutions assessed refer to legal compliance in their policies. The majority of policies assessed do not explicitly require a client or investee to comply with applicable laws and regulations. Some financial institutions include this requirement in agreements with clients rather than in public documents. Publicly disclosing requirements for compliance in financial transactions can provide an important signal to companies, particularly in countries with weak regulatory enforcement.
- 13% of financial institutions assessed have developed financial products and services aimed at promoting the production and trade of sustainable commodities. There is appetite to develop further opportunities for sustainable finance.

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# PART I: RATIONALE

## WHY SHOULD FINANCIAL INSTITUTIONS DEVELOP SOFT COMMODITY POLICIES?

Increasing incidence of extreme weather due to climatic changes, natural resource scarcity, changing consumer preferences and demographics, and tighter regulations by governments to reduce impacts on forest ecosystems may affect the competitiveness and resilience of companies that have significant impacts or large dependencies on these ecosystems. This creates environmental risks, which become material if there is a probability that they affect standard financial metrics such as costs and revenue.

Financial institutions, especially those with a significant exposure to sectors with high direct or indirect impacts or dependencies on forest ecosystems, need to be aware of how this environmental risk may affect corporate lending, investment, advisory and other financial operations and transactions. For example, on the lending side it may impede a client's ability to service its debt and therefore impair the credit quality of the portfolio. On the investment side it may affect valuations. Banks, traders and investment managers have a considerable indirect natural capital footprint by lending to or investing in companies involved in unsustainable production, trade or sale of soft commodities. While it is at present difficult to calculate the value of risk to lenders and investors related to environmental issues such as water scarcity or deforestation impacts, developing soft commodity policies presents a way for banks and investors to better manage their lending to or investing in companies or projects that could have high deforestation impacts.

A rapidly emerging trend among companies is to develop commodity value chains that take into account sustainability concerns, including forest degradation and deforestation. This is driven by increasing consumer demand for products certified as deforestation free, pressure from non-government organizations, new or improved government regulations and other factors. For example, the board of the Consumer Goods Forum (CGF), an association of over 400 large retailers, manufacturers, service providers, and other stakeholders across 70 countries with combined sales of EUR 2.5 trillion (US\$ 2.7 trillion) recommends to its members that they adopt a policy of "no net deforestation" in their supply chains by 2020.<sup>4</sup> The Banking and Environment Initiative (BEI) set up by the Cambridge Institute for Sustainability Leadership, which currently consists of 10 banks, is in a process of seeking ways to align itself with the overall aim of the CGF to drive the creation of deforestation free value chains. Unilever, Wilmar, Cargill, Nestlé, Mars and a number of other major companies connected to soft commodity supply chains have made commitments to develop sustainable supply chains.

So far most attention has been centered on corporations that contribute to deforestation through their value chains. However, these and other international efforts will increasingly place a spotlight on the role of the financial sector in driving deforestation. The role that lenders and investors play by providing debt, equity and other forms of capital to companies that contribute to deforestation is increasingly gaining attention. A 2011 report by UNEP FI and the UN-backed Principles for Responsible Investment (PRI) found that environmental costs that are externalized to society equate to about one-third

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4. Consumer Goods Forum (n.d.)

of the profits of the 3,000 largest publicly listed companies. These costs can potentially rebound onto portfolio companies or corporate clients through inflated input prices, higher taxes, stricter insurance terms and the physical costs of environmental degradation and resource depletion that can affect the operating costs of portfolio companies.<sup>5</sup> The Norwegian Government Pension Fund (Global), one of the world's largest sovereign wealth funds, announced it was divesting from holdings following a review of its investment policies relating to deforestation.<sup>6</sup> Such actions may increasingly become a factor through which financial institutions can differentiate themselves from others, thereby reducing risk and increasing opportunities.

To respond to this trend, a growing number of banks, investment firms and other financial institutions have started to develop policies that describe under what conditions they engage with companies and clients in environmentally-sensitive sectors. These include producers of palm oil, soy and beef, which are among the most important soft commodities that drive deforestation. However, there is still limited understanding of how this risk can affect financial institutions and how financial institutions can best respond to the risk in order to measure and mitigate it. This report aims to close some of the gap by providing a clear understanding of risks from soft commodities for financial institutions, and offering a tool to help mitigate this risk.

To address this gap the project developed the following outputs:

- A **Soft Commodity Forest Risk Assessment (SCFA)** tool for financial institutions that want to develop or update their policies for clients that are active in the palm oil, soy or beef business on how to address the issues of natural capital, deforestation or forest degradation, focusing on corporate lending, public equities, and advisory services. The tool, based on an existing framework by WWF and developed further with input from financial institutions, experts and academics, is freely available on the NCD website, together with a guide on how to use it and how institutions can interpret the results to enable mainstreaming.
- The SCFA was used to **evaluate 30 financial institutions on policies and processes to manage deforestation and forest degradation risk**, based on publicly available information, associated with the three soft commodities: palm oil, soy and beef. In addition, Sustainalytics conducted interviews with ten financial institutions. This snapshot provides insight into the current state-of-play within the sector.
- Results of the evaluation were used to develop recommendations on **minimum standards** and **leading practice** in how banks and investors can develop risk policies and increase transparency and understanding of exposure to credit risk from deforestation.
- A preliminary attempt to describe **how deforestation impacts on footprints of financial institutions can be linked to material risks they may be exposed to**, to provide the rationale for adopting policy recommendations developed under the project.

A separate brief for the UN-REDD Programme has been written in parallel that identifies if and how soft commodity policies by financial institutions can potentially benefit countries seeking ways to achieve REDD+ results.

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5. PRI & UNEP FI (2011)  
6. NBIM (2015)

# PART II: UNPACKING DEFORESTATION RISK

## 1. THE SCALE OF THE CHALLENGE

Land-use conversion to produce agricultural commodities is the most significant driver of deforestation, accounting for an estimated 55 to 80% of global forest loss.<sup>7,8</sup> Soft commodities generally refers to commodities that are grown, rather than extracted such as metals and fossil fuels, and include coffee, palm oil, wheat, soy, etc. Palm oil, soy and beef are soft commodities that are grown or produced in the tropics on a large scale and are therefore major drivers of deforestation and forest degradation. In the agriculture sector, land clearance for livestock (mainly beef), soy, and palm oil resulted in around one-third of global deforestation between 1990 and 2008 (See figure 1).<sup>9</sup>

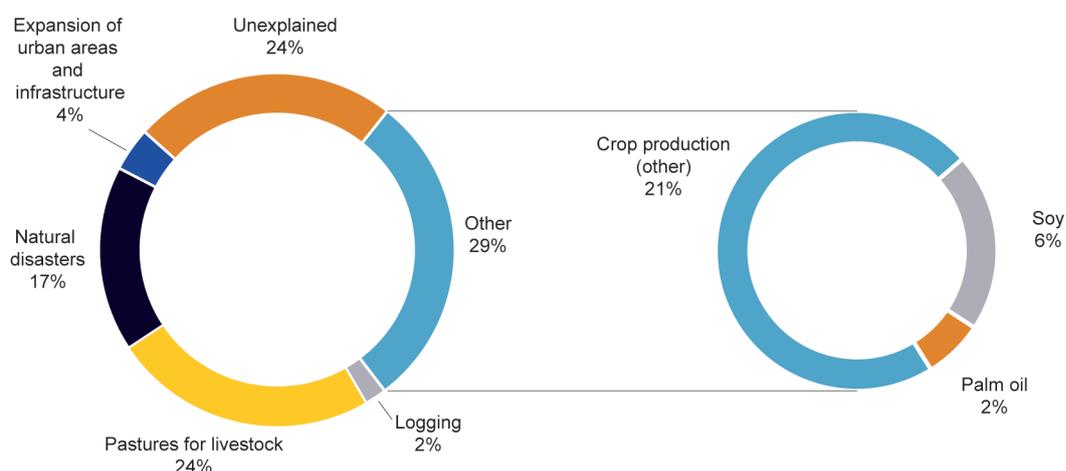


Figure 1: Global deforestation drivers (1990-2008)<sup>10</sup>

The countries that are the largest producers of these three soft commodities<sup>11</sup> are mainly located in the Amazon Basin, South-East Asia, and increasingly the Congo Basin, all of which contain the largest continuous expanses of tropical forests in the world. Tropical forests store 42% of all carbon contained in the world's forests, while covering only 33% of global forest area. They provide habitats for at least half of the earth's terrestrial biodiversity, facilitating vital ecosystem services such as freshwater supplies and climate regulation,<sup>12</sup> and support the food security and livelihoods of more than a billion people. Environmental and social impacts of deforestation and forest degradation include greenhouse gas (GHG) emissions that contribute to climate change, biodiversity loss, ecosystem degradation and the loss of livelihoods by communities that depend on forest resources. Forests are a renewable but

7. Brack, D., & Bailey, R. (2013)

8. Kissinger, G., Herold, M., & De Sy, V. (2012)

9. European Commission (2013)

10. Ibid

11. Soft commodities generally refers to commodities that are grown, rather than mined. In the context of this report, the term soft commodities is used exclusively to refer to palm oil, soy, and beef.

12. Rautner, M., Leggett, M. & Davis, F. (2013)

exhaustible natural resource that can be rendered finite by mismanagement and over-exploitation. The World Trade Organization (WTO) warns that trade may contribute to the exhaustion of resources by accelerating their depletion.<sup>13</sup> Demand for soft commodities is increasing due to population growth, and from increasing per capita real income that leads to dietary changes. As production increases to meet rising demand for food and non-food crops, the social, environmental and economic benefits that they support will continue to be threatened.

Shifting soft commodity producers to more sustainable business models, including increasing yields per hectare or planting on already degraded land, could help decouple increasing production from deforestation and forest degradation. More sustainable production and trade can help businesses and communities reduce greenhouse gas (GHG) emissions, preserve biodiversity and protect ecosystem services, while contributing to economic growth. Markets that incentivize and reward forest protection and the avoidance of deforestation and forest degradation resulting from the production of beef, soy, and palm oil are vital to a variety of economic sectors.

### **BOX I: Collaboration Catalyses Change**

Cargill, the largest palm oil importer in the U.S, one of the world's largest commodities traders and a palm oil producer, pledged to break the link between its palm oil and deforestation, peat destruction and social exploitation in response to pressure from Greenpeace, the Rainforest Action Network and other NGOs as well as many of its clients.<sup>14</sup> Cargill was among the companies to back a Sustainable Palm Oil Manifesto (SPOM), launched in July 2014.<sup>15</sup> In May 2013, Friends of The Earth and Profundo, a consultancy, criticized several financial institutions for investing in and/or providing financial services to Wilmar International, the world's largest palm oil company.<sup>16</sup> The company has been accused of clearing land in High Conservation Value (HCV) areas and of poor environmental performance, and was investigated by the Roundtable on Sustainable Palm Oil (RSPO). Collaboration between NGOs, financial institutions and customers demanding responsibly produced commodities contributed to Wilmar introducing a new policy in December 2013 to work towards zero deforestation.

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13. World Trade Organization (2010)  
14. Kropp, R. (2014)  
15. Greenpeace (2014a)  
16. Van Schaik (2014)

## 2. HOW DEFORESTATION IMPACTS CAN TRANSLATE INTO MATERIAL RISKS

Financial institutions may be exposed to a range of risks by lending to or investing in companies involved in soft commodities. Banks provide financing and advisory services for the production, processing and trade of soft commodities. In addition, many investors have a significant asset exposure to corporate bonds and stocks in the broader agricultural value chain such as food and beverage companies as well as consumer goods companies. Providers of debt (such as a bank engaged in trade finance of soft commodities or lending to infrastructure development in a rainforest) or equity capital to agri-businesses and their customers (such as an investor with shares in a palm oil production company or a company using palm oil derivatives in its products) need to better understand how to embed environmental factors in risk management, to control their exposure to the risks from deforestation. Banks, traders and investment managers have a considerable indirect natural capital footprint by lending to or investing in companies involved in the unsustainable production, trade or sale of soft commodities. Fund managers and banks can strengthen policies to incentivize a shift towards more sustainable soft commodities value chains, in turn contributing to a net reduction in deforestation and forest degradation.<sup>17</sup>

Throughout this study, *risk* refers to the financial risks linked to deforestation and forest degradation, and related environmental and social issues. By lending to or investing in companies involved in the upstream production or downstream consumption of soft commodities, financial institutions can be exposed to these risk factors, which are set to increase in the long term. Figure 2 below shows how financial institutions' decisions directly and indirectly affect the environment in and around forests. This influence leads to a variety of risks for financial institutions – both as a direct consequence of the financing decisions and indirectly through their affiliation with companies in the sector.

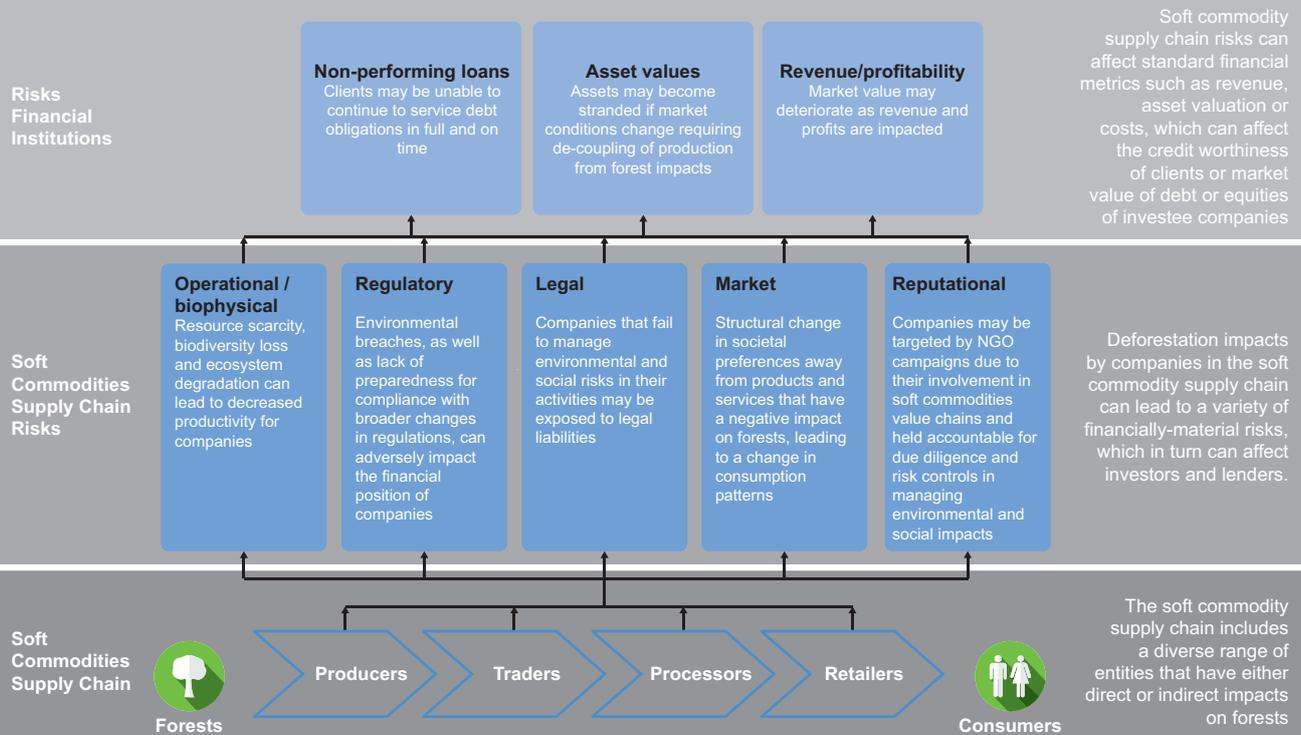


Figure 2: The impact of finance flows on forests and the risks created for financial institutions<sup>18</sup>

17. See also UNEP FI (2011)

18. See also Mulder, I. & Koellner, T. (2011)

The risks to financial institutions are often related to agricultural and consumer goods companies' conversion of tropical forest to agricultural land. Land-use change can reduce forest carbon stocks and damage biological diversity that supports agricultural productivity and sustains livelihoods. In Brazil, cattle ranching for beef and leather are the main cause of deforestation as forest land is cleared for pasture.<sup>19</sup> Crops such as soy and palm oil are predominantly rain fed and land intensive,<sup>20</sup> and while rain-fed agriculture can have some of the highest yields in tropical regions,<sup>21</sup> forest clearance can damage soil fertility and agricultural productivity in the long-term. Over two-thirds of the world's rainforests grow on extremely poor soils that are acidic and low in minerals and nutrients. Once the forests are cleared, land is temporarily arable but becomes less fertile and degraded, which leads to a decrease in agricultural productivity.

Forest assets that underpin climate, water, food and energy security as well as human health and livelihoods from local to global scales are largely unrecognized and unrewarded in international policy and financial frameworks. Nonetheless, forested land provides the largest area worldwide for potential rain-fed crop production. Expectations of growing global demand for agricultural commodities and rising rates of return in agriculture present a risk of increased land-use change for soft commodities production.<sup>22,23</sup> This is in stark contrast to commitments by many developing countries to implement Nationally Appropriate Mitigation Actions<sup>24</sup> (NAMAs), under the UN Framework Convention on Climate Change. 94% of proposed NAMAs by 43 countries aim to reduce emissions from forestry activities.<sup>25</sup>

Corporate impacts and dependencies on natural capital have been widely documented and analysed over the last years by organizations and initiatives including, but not limited to, the Natural Value Initiative (NVI), The Economics of Ecosystems and Biodiversity (UNEP TEEB), WWF, KPMG, PricewaterhouseCoopers (PwC), the Association of Chartered Certified Accountants (ACCA), and the United Nations Environment Programme Finance Initiative (UNEP FI). The Natural Value Initiative has developed a toolkit<sup>26</sup> to enable institutional investors to better understand risks and opportunities associated with the impacts and dependencies of the companies in which they invest in relation to biodiversity and ecosystem services, focused on the food, beverage and tobacco sectors.

The findings of these works serve as a starting point for understanding the risks and opportunities specific to the environmental and social impacts of soft commodity production. Figure 2 outlines the major direct and indirect risks associated with soft commodities and how they can impact financial institutions. Appendix 3 provides more detailed explanations of each type of risk and illustrative examples.

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19. UNEP, FAO, UNFF (2009)
  20. Alexandratos, N. & Bruinsma, J. (2012)
  21. World Bank Group (n.d.)
  22. Alexandratos, N. & Bruinsma, J. (2012)
  23. Johnson, T. (n.d.)
  24. UNFCCC (n.d.)
  25. FAO (2010)
  26. NVI (n.d.)

### 3. FACTORS THAT INFLUENCE LEVEL OF RISK EXPOSURE AND THE ABILITY TO HEDGE IT

A growing number of financial institutions such as diversified banks, asset managers, and development banks have begun to play an important role in accelerating the transition to more sustainable commodities by directing loans and investments towards companies that have adopted sustainable soft commodity production or purchasing practices, while encouraging further progress by companies that have yet to do so. It is in the interest of financial institutions to monitor and manage environmental and social impacts associated with soft commodity production and deforestation. This can also create business opportunities by financing the transition to sustainable production, for instance by providing advisory services and creating products and services that build capacity for and incentivize the production and consumption of commodities produced in accordance with relevant environmental and social standards. Lenders and investors with better environmental, social and governance (ESG) performance are better able to understand the environmental impacts of their activities, which in turn equips them to reduce financial risk. A study by Deutsche Bank in 2012 found overwhelming evidence that firms with high ratings for ESG have a lower cost of capital and have lower risk; with further evidence that ESG factors are correlated with corporate financial outperformance.<sup>27</sup> This was reinforced by findings in a publication by the Global Financial Institute in 2013 that firms with better ESG ratings tend to experience higher credit ratings and lower cost of debt.<sup>28</sup> A meta-study by Arabesque and the Smith School found that 90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital of companies.

This study identifies a number of factors that can affect financial institutions' level of exposure<sup>29</sup> to risks related to soft commodities, as well as their ability to manage them. These are outlined below based on desk-based research and interviews with financial institutions.

**4. The percentage, type, and tenure of loans or investments that are linked to soft commodities:** A financial institution with high level of involvement in soft commodities, either through loans or investments, will likely have a higher level of exposure to the risks related to these commodities. However, the level of exposure also depends on the type of financial activities that the financial institution is engaged in. Investors may be mainly exposed through the supply chains of companies in sectors such as food and beverage or consumer goods, which are users of soft commodities. A low level of financial involvement in soft commodities is not necessarily associated with a lower level of reputational risk, as significant reputational risks can arise from individual investments or loans.

A financial institution's ability to influence the actions of a company is also affected by the degree to which it provides loans to or invests in that company. An asset manager, or a group of asset managers, holding a relatively large stake in a company and with long-term ownership is more likely to be successful in an engagement effort than an asset manager holding a small or short-term stake in a company.<sup>30</sup> As lenders of capital, banks are able to directly impose requirements on borrowers, often over several years, and therefore arguably exhibit a greater degree of influence over companies than asset managers. However, banking clients may resist strict

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27. DB Climate Change Advisors (2012)

28. Global Financial Institute (2013)

29. Throughout this report, the term "level of exposure" refers to the degree to which a financial institution is exposed to risks related to soft commodities through factors such as the percentage and type of loans or investments that are linked to soft commodities, the geographic location of clients or investees, and the stage of the value chain that clients or investees are involved in.

30. Eurosif (2013)

environment-related disclosure or performance criteria in loan covenants. Types of financial transactions or advisory services will also affect the level of influence that financial institutions have. For example, structured or project finance have greater potential to address risks than trade services/transaction banking.

5. **The geographic location of clients or investees:** For example, legislation related to forest protection may be more stringent and better enforced in one location compared to another. One interviewee noted that in Paraguay violating the country's Zero Deforestation Law could result in severe financial penalties. The risk of controversies is more likely in countries with poor governance. In addition, one interviewee noted that less NGO scrutiny related to soft commodities in some places reduces reputational risk in those areas. The environmental and biological characteristics associated with different regions also greatly influence the environmental and social risks faced by companies. The UN-supported Principles for Responsible Investment (PRI) Working Group on soft commodities has seen cultural differences in different geographic regions leading to resistance to change in the context of collaborative investor engagement. Different approaches to determining, monitoring and protecting High Conservation Value (HCV) land also affects risk levels. For instance, the permitting system for concessions in Indonesia does not recognize HCV forest thereby incentivizing their conversion to plantations.<sup>31</sup>
6. **Types of commodities in client or investee company supply chains:** Differences in the characteristics of the supply chains of soy, palm oil and beef may contribute to differences in risk levels. Stricter risk management criteria may be required for commodities with less developed certification standards and where supply chains lack transparency. The strength of the chain of custody in place for different commodities affects the effectiveness of certification.<sup>32</sup>
7. **The level of involvement of clients or investees:** Level or type of risk exposure may differ based on the stage of the value chain in which a company operates. For example, producers may use loopholes in traceability under certification standards to expand production.<sup>33</sup> Retailers are more directly exposed to market risks related to consumer preferences, whereas producers are more directly exposed to operational as well as regulatory and legal risks. However, a risk at one stage of the value chain can have a ripple effect and impact other stages. For downstream companies that, for example, sell a small number of products containing soft commodities, the financial impact of related deforestation risks may be insignificant. However, lower level of involvement does not necessarily equate to lower reputational risks.
8. **The size of the financial institution:** The findings of this review indicate that the financial institutions that received the highest level of criticism from external stakeholders were also among the largest reviewed. This may be due to the fact that NGOs and the media often target larger financial institutions as they tend to have higher brand recognition, but they may also have the highest level of involvement in soft commodities, broader stakeholder interests and greater resources to address environmental issues.
9. **The availability of accurate and reliable environmental and social information:** Two interviewees noted that a challenge in assessing the environmental and social performance of companies is access to information. This is particularly true for the issue of soft commodities, due to lack of accountability in supply chains and limited coverage by ESG data providers. Although tools such as Global Forest Watch are providing increasingly granular field-level data, greater supply chain transparency is needed to connect

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31. Norton Rose Fulbright (2014)

32. Stanley, S., McNally, R., & Smit, H. (2013)

33. Worldwatch Institute (2009)

this data to clients or portfolio companies. Information available is largely based on company disclosure. This points to the need for banks and investors to have access to relevant information – resources and in-house expertise is crucial to know what to ask of companies. ESG research providers can help financial institutions understand companies’ preparedness to manage risks related to soft commodities, as well as their involvement in controversies and levels of public criticism. Banks and investors can also use data and tools from third parties, such as the World Resources Institute and Zoological Society of London, to support risk monitoring (see page 22 for more detail).

10. **Exposure to companies in sectors that internalize the costs of damages:** Risks can manifest through the impacts of deforestation on companies that banks service in the agricultural/ forestry sectors, as well as through the indirect impacts of forest loss on companies in other sectors that are located in the proximity of soft commodities producers. Deforestation can undermine water cycles and lead to drought and flooding, disrupting energy and water supplies and transportation. For instance, extreme drought in the Amazon Basin damaged 13% of oilseed crops in 2005. Drought in 2010 made waterways too shallow for barges to reach export terminals, causing soy exporters such as Cargill to pay higher transport costs. The worst drought in more than a century in Brazil has strained hydropower generation in 2014 and low river water levels have led to cargo deliveries being suspended to the port of Santos. The equivalent of 10,000 lorry-loads of cargo had been transferred by road by August 2014. Many industries have suspended activities because of water shortages, and the drought has caused lower coffee, sugar cane and wheat crop production in one of Brazil’s main agricultural states.<sup>34</sup> Deforestation in the Amazon rainforest could have wider regional impacts, reducing rain and snowfall in the western United States, affecting water and food supplies in the U.S. state of California.<sup>35,36</sup>

## BOX II: CASE STUDY: Deforestation puts revenue at risk

Companies involved in soft commodities production linked to deforestation can lose market share. In Brazil, links between cattle rearing and deforestation led to NGO campaigns including Greenpeace’s ‘Slaughtering the Amazon’ in 2009 and the Amigos da Terra Amazônia Brasileira’s ‘Time to Pay the Bill’ in 2012.<sup>37</sup> This was followed by legal action by the Public Prosecutor’s Office in the Amazon state of Pará which led to four key meatpackers that together controlled one-third of Amazon slaughter (JBS, Bertin, Marfrig and Minerva) signing an agreement with Greenpeace to adopt a timeline for purchasing only from ranches that can demonstrate zero deforestation. Meanwhile, seven international customers, Adidas, IKEA, Clarks, Princes, Sainsbury’s, Asda and Sligro Food Group cancelled their business with JBS.<sup>38</sup> As well as shifting to sustainable sources, consumer goods companies can switch to alternative products. For instance, the sportswear brand Puma has announced that it will stop using leather in the future because it is damaging to the environment.<sup>39</sup>

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34. Climate News Network (2014)  
35. Medvigy, D., Walko, R., Otte, M., & Avissar, R. (2013)  
36. Gonzales, G. (2014)  
37. CDP (n.d.)  
38. Greenpeace (2012)  
39. Financial Times (2012)

## TOOLS ON DEFORESTATION RELATED RISK

### **The World Resources Institute's Global Forest Watch Application:**

In February 2014, the World Resources Institute (WRI) launched its Global Forest Watch application, which uses satellite technology, open data, and crowd sourcing to map and monitor forest use and change globally. While this innovative tool allows financial institutions, governments, and NGOs to track and analyse deforestation trends at a regional or company level, it also exposes poorly performing companies to greater reputational risks. The WRI has also released a Land Suitability Mapper that enables users to identify potentially suitable sites for sustainable palm oil production.<sup>40</sup>

### **Zoological Society of London (ZSL) Sustainable Palm Oil Transparency Toolkit (SPOTT):**

Launched November 2014, ZSL's Sustainable Palm Oil Transparency Toolkit (SPOTT) is a free, regularly updated, interactive resource, designed for stakeholders in the palm oil sector, to assess oil palm growers on the information that they make publicly available about the sustainability of their operations.

ZSL is working with organisations such as the Roundtable on Sustainable Palm Oil (RSPO) to constructively engage companies and rebuild trust in sustainable palm oil by making operations more transparent, in order to reduce negative environmental impacts.

Launched as part of ZSL's industry information website, the Sustainable Palm Oil Platform (SPOP), the Toolkit combines satellite mapping technology with in-depth performance assessments on 25 of the largest publicly listed companies that grow oil palm – 21 of which are RSPO members and four of which are non-RSPO members. A privately owned Brazilian grower, Agropalma Group, has also volunteered to join SPOTT.

The assessment framework is comprised of 48 indicators – framed as direct questions about best practice and its disclosure – across seven categories. These include a mixture of both transparency and performance-related indicators specific to the Roundtable on Sustainable Palm Oil's (RSPO) reporting requirements, zero burning, deforestation, environmental management, GHG emissions, traceability and fragile, marginal and peat soils.

Rather than a static scorecard, ZSL SPOTT is a dynamic, interactive system that updates users on changes to company policies reflected in their quarterly assessment scores, to ensure that information on the Toolkit is maintained and to reward growers for becoming more transparent.

Each company assessed on SPOTT receive a percentage score for every indicator category and a combined score for their overall performance, to assist with the identification of key areas for improvement, and to measure how transparent they currently are.

Stakeholders can monitor the activities of oil palm growers using the Google-based mapping tool with data layers for company concession plantation boundaries, protected areas, forest cover and loss, and NASA active fire alerts from the World Resources Institute's Global Forest Watch.

Future iterations of the Toolkit will expand on the number of growers and the indicators to include more detailed assessment and verification of best practice implementation. By working with growers to explore the integration of site-level indicators – such as those generated by ZSL's RSPO-endorsed Impact Monitoring System – ZSL intends to revolutionize data availability so that it is more reliable and monitors actual implementation of best practice. For more information, please visit: <http://www.sustainablepalmoil.org/spott/>

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40. See: WRI Suitability Mapper. Available: <http://www.wri.org/resources/maps/suitability-mapper>

## 4. QUANTIFYING EXPOSURE TO RISK

**None of the financial institutions that were interviewed and/or reviewed have a process in place to quantify the overall percentage of their loan book or investment portfolios related to soft commodities and the risks that are associated with it.** For example, when asked what percentage of loans or investments is related to specific soft commodities, one interviewee stated “I cannot provide these exact numbers – frankly we have not compiled those numbers and maybe we should.” Three other financial institutions stated that they have limited ability to quantify their exposure to soft commodities. While no financial institutions evaluated disclose their specific exposure to palm oil, soy, or beef, some financial institutions do disclose the total value or percentage of loans or investments related to agriculture in general. Two financial institutions with asset management activities said their exposure to palm oil producers is limited as there are only a few publicly-listed producers. However, several conglomerates derive revenue from palm oil, and indices may not capture this if palm oil is not the major source of company revenue.

**Several financial institutions highlighted the challenges associated with analysing and quantifying risks related to soft commodities, including access to information, lack of resources, and defining risk.**

Access to information was specifically highlighted as a challenge when assessing the degree to which a downstream company is involved in a soft commodity. Some financial institutions lack the resources, expertise and time to conduct this type of analysis, and one interviewee emphasized that this needs to be prioritized. HSBC has a global team of 50 sustainability risk managers who are responsible for providing guidance to HSBC’s relationship managers on its sustainability policies. The relationship managers are responsible for ensuring that customers are in compliance with HSBC’s policies, and analyse potential transactions using a four-scale Sustainability Risk Rating framework. Both a fund manager and a bank highlighted the difficulty in defining risk, suggesting that to understand exposure to risks related to soft commodities, a number of factors (such as those listed under Factors that Influence Level of Exposure) must be analysed in addition to the portion of loans or investments active in soft commodity value chains. One of these interviewees stated that a risk multiplier would have to be applied to each commodity (e.g., palm oil may be twice as risky as soy), but argued that, given the difficulty in doing so, it is better to analyse risk on a company-by-company basis, focusing on those that attract negative attention. Organizations including CDP, the Zoological Society of London, World Resources Institute, WWF and Global Canopy Programme are working on initiatives to improve access to information.

One interviewee stated “Unfortunately, for some of the banks it’s still viewed as a reputational issue, but this has been viewed as a reputational issue for 10 years; the pioneers in this area have all moved beyond that.” However, this interviewee added that there is still a need to better prove the materiality of these risks, since developing a clear case around the financial impact of these risks will lead to more financial institutions addressing them. Olaf Brugman, Teamleader of Sustainability Policies, Risk and Reporting for Rabobank, stated that it is difficult to “filter out” sustainability risk from other types of risks, but noted that “increasingly, sustainability or reputation risks directly transform into credit risk.”

# PART III METHODOLOGY

## 1. A POLICY FRAMEWORK TO BENCHMARK FINANCIAL INSTITUTIONS

The Soft Commodity Forest-risk Assessment (SCFA) tool is designed to evaluate the degree to which banks and asset managers (collectively referred to in this report as financial institutions) have adopted and implemented risk policies and processes on three soft commodities: palm oil, soy, and beef. The overall weightings of indicators are shown in Figure 3 below. Financial institutions can download a free spreadsheet-based tool in order to conduct a self-assessment and benchmark their existing or proposed policies against sector peers worldwide. While this report focuses on three soft commodities, the tool can also be extended to other commodities that cause risk from deforestation and forest degradation.

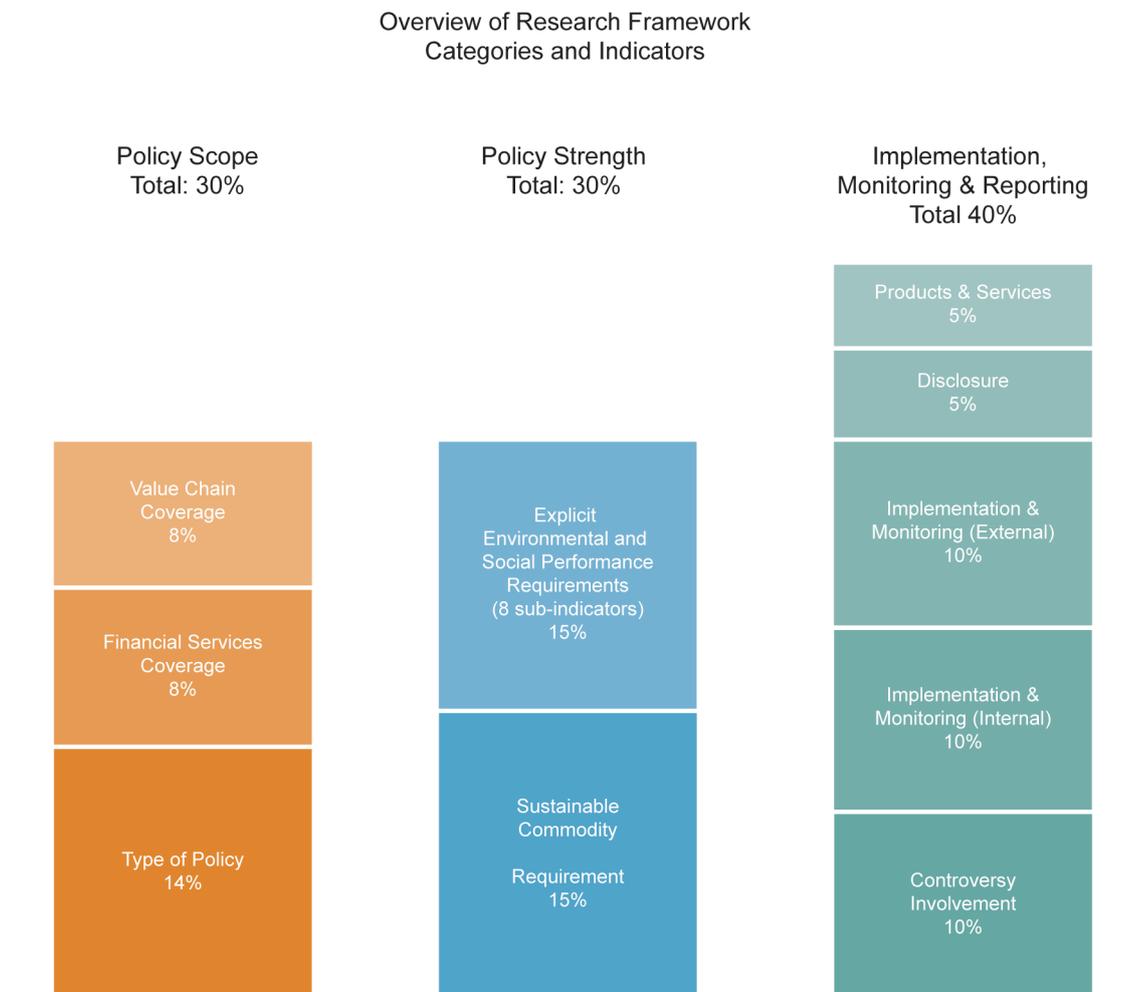


Figure 3: Framework for the Soft Commodity Forest-risk Assessment (SCFA) tool: Indicator categories and weighting

The framework builds on previous work by WWF, including key performance indicators used in a Bank Policy Benchmarking Tool developed in 2012 to anonymously assess banks' environmental and social policies for high-risk sectors.<sup>41</sup> The WWF tool was adapted to specifically address risk in soft commodities by the NCD in collaboration with Sustainalytics and experts in the field. The framework for the Soft Commodity Forest-risk Assessment Tool is comprised of three categories with 18 individually-weighted<sup>42</sup> indicators (see Table 1). The column on the right indicates each indicator's weighting in the overall score.

Table 1 – Policy Framework to evaluate and inform policy development

<b>1.0 Policy Scope</b>			
<b>To be meaningful and credible, financial institutions should adopt a formal policy statement that explicitly addresses soft commodities. This category considers the scope of a policy and how it applies to the various activities of the organization, irrespective of geographic location, and to the various stages of the soft commodity value chain.</b>			
<b>1.1</b>	<b>Type of policy</b>	This indicator assesses whether or not the financial institution has a policy on providing financial services to or investing in companies that are involved in palm oil, soy and/or beef. A formal policy can be: i) a stand-alone policy document which demonstrates that the financial institution has gone through a formal process to establish the policy, ii) integrated into a formal company document that requires compliance (e.g., a code of conduct), or iii) a formal statement contained within a broader policy. The indicator also considered if a financial institution had a broader policy approach to sustainability or ESG.	<b>14%</b>
<b>1.2</b>	<b>Financial services coverage of policy</b>	This indicator assesses the degree to which a policy (or statement) applies to all financial services (e.g., corporate lending, project finance, asset management, advisory services, etc.). The indicator also captures information on the proportion of activities covered by the policy, and whether the policy applies based on a certain monetary threshold.	<b>8%</b>
<b>1.3</b>	<b>Value chain coverage of policy</b>	This indicator assesses the degree to which the financial institution's policy applies to the entire value chain of the soft commodity it addressed.	<b>8%</b>

41. See also WWF (2008) and WWF (2012a)

42. The default weightings are based priorities informed by previous work by WWF in consultation with NCD signatories and supporters, including WWF. In the tool the user is able to change the default weightings.

## 2.0 Policy Strength

To ensure effectiveness, both in terms of risk management as well as positive change, financial institutions should ensure that policies include detailed sustainability criteria that promote and align with best practice standards. This category considers the strength of the policy in terms of the sustainability requirements outlined and alignment with best practice standards.

2.1	<b>Requires sustainable commodity certification</b>	This indicator assesses the degree to which the financial institution requires (or strongly encourages) clients or investees to achieve credible certification. If the financial institution's policy applies to downstream companies, this indicator assesses whether or not these companies are required (or strongly encouraged) to commit to increasing the share of soft commodities that are sourced from certified sources. Some financial institutions have historically required their clients to be members of roundtables but not certified by them.	<b>15%</b>
2.2	<b>Environmental and social performance requirements</b>	This indicator uses a checklist approach as opposed to a tiered-scoring approach, and assesses the degree to which the policy or statement addresses eight specific environmental and social performance requirements:	<b>15%</b>
	<b>Criterion 1</b>	The client or investee is required to identify, manage and monitor High Conservation Value (HCV) land and avoid land-use conversion in HCV areas, primary forests, and/or native forests.	
	<b>Criterion 2</b>	The client or investee is required to identify, manage and monitor High Carbon Stock (HCS) land and avoid land-use conversion in these areas, including peatlands and forests, in order to prevent greenhouse gas emissions resulting from land-use change.	
	<b>Criterion 3</b>	The client or investee is required to avoid the use of fire to clear land.	
	<b>Criterion 4</b>	The client or investee is required to conduct independent social and environmental impact assessments prior to developing new plantations or operations, and/or implement a mitigation plan to address potential environmental and social impacts.	
	<b>Criterion 5</b>	The client or investee is required to respect the rights of local communities, including land-use rights, the right to Free, Prior and Informed Consent (FPIC), and other human rights outlined in the Universal Declaration of Human Rights.	
	<b>Criterion 6</b>	The client or investee is required to comply with all applicable local, national, and ratified international laws and regulations, in line with Principle 2 of the RSPO. <sup>43</sup>	
	<b>Criterion 7</b>	Downstream clients or investees are required to commit to increasing the share of soft commodities that are sourced from certified sources.	
<b>Criterion 8</b>	Downstream clients or investees are required to take steps to improve transparency and traceability throughout their value chains, including at the smallholder level, to ensure the integrity of their claims regarding sourcing certified sustainable commodities.		

43. RSPO (2013)

### 3.0 Implementation, Monitoring and Reporting

To ensure results, financial institutions should have processes to implement policies effectively. This category considers what processes are in place to ensure that internally, employees apply the policy and externally, that companies comply with the financial institution's policy requirements. It also considers whether financial institutions report on activities undertaken to ensure the policy is implemented, to demonstrate accountability. Finally, it considers how financial institutions are addressing soft commodities through products and services and whether or not they have been criticized for involvement in controversies.

3.1	<b>Implementation and monitoring (Internal)</b>	This indicator assesses the degree to which the financial institution has processes in place to implement and monitor compliance with its policies by employees <u>across the financial institution</u> , for example, when assessing risks of potential transactions. The indicator considers aspects such as a clear governance structure with managerial oversight, employee training, and regular reviews of the policy.	10%
3.2	<b>Implementation and monitoring (External)</b>	This indicator assesses the degree to which the financial institution has processes in place to implement and monitor compliance with its policies and guidelines <u>within the companies it provides financial services to or invests in</u> , throughout the life of the relationship. The indicator considers aspects such as due diligence processes, development of action plans with companies allowing a phased-approach, assessment of companies for natural capital risks, monitoring of company performance over time, and company engagement on natural capital issues.	10%
3.3	<b>Disclosure on performance</b>	This indicator assesses the degree to which the financial institution tracks and reports on the implementation of its policies and its performance with respect to the commitments made in its policies on a regular basis. Such reporting could address: the number of transactions, clients, etc., to which the policies have been applied; the number of employees that have been trained on the policies; and progress on policy commitments.	5%
3.4	<b>Sustainable commodity products and services</b>	This indicator reviews whether or not the fund manager or bank has developed any innovative products and/or services designed to help address environmental or social issues related to forest commodities. For example, HSBC has developed a discounted finance product for RSPO-certified palm oil that is designed to incentivize trade in sustainable palm oil, and to encourage clients to achieve RSPO certification more rapidly.	5%
3.5	<b>Controversy involvement</b>	The scope and strength of a policy should be considered in the context of real-world performance. This indicator considers financial institutions' involvement in controversies or the existence of criticism of a financial institution by other stakeholders, which may indicate a disconnect between a policy and the effectiveness of its implementation. This indicator assesses the degree to which a financial institution has been involved in controversies in the past five years related to forest commodities. For example, a controversy may include findings that a financial institution financed (either knowing or unknowingly) illegal activity, or an activity that violates the company's own internal policies. The indicator considers the frequency and severity of stakeholder criticism. This indicator relied largely on external sources, including media and NGO reports. Allegations were not verified for this analysis. However, for each individual controversy, Sustainalytics sought to identify several independent sources in order to corroborate allegations and/or facts.	10%

The framework also takes account of criteria used in key sustainable commodity certification standards (see Table 2). Banks and investors' policies can adopt additional environmental and social criteria to address weaknesses in the certification schemes that do not guarantee sustainable commodities production. For instance, audits required under RSPO can leave gaps in consistency, uniformity and honesty in surveillance.<sup>44</sup> Further, coverage of certification schemes for soy and beef is limited at present with only up to three percent of the world's soy supply being responsibly certified.<sup>45</sup> A study by KPMG recommends greater demand from banks for certification as a pre-condition to providing finance to companies in the soy supply chain to help increase uptake.<sup>46</sup>

44. PANAP (2013)

45. KPMG (2013)

46. Ibid

Table 2 - Overview of sustainable commodity certification standards

Leading Standard	Description	Market Uptake	Other Certification Standards
<b>Roundtable on Sustainable Palm Oil (RSPO)</b>	RSPO is a not-for-profit association that unites stakeholders from seven sectors of the palm oil industry - oil palm producers, palm oil processors or traders, consumer goods manufacturers, retailers, banks and investors, environmental or nature conservation non-governmental organizations (NGOs) and social or developmental NGOs - to develop and implement global standards for sustainable palm oil.	18% <sup>47</sup>	Rainforest Alliance Certified Palm Oil, The Roundtable on Sustainable Biofuels (RSB), Indonesian Sustainable Palm Oil (ISPO) <sup>48</sup>
<b>Roundtable on Responsible Soy (RTRS)</b>	RTRS is a civil organization that promotes responsible production, processing and trading of soy on a global level. It has developed a standard for responsible soy production.	2-3% <sup>49</sup>	The Roundtable on Sustainable Biofuels (RSB), ProTerra Standards, Sustainable Agriculture Network (SAN) Standards
<b>The Sustainable Agriculture Network (SAN) Standard for Sustainable Cattle Production Systems</b>	The SAN Standard for Sustainable Cattle Production Systems was launched by the SAN Secretariat and partners, together with CATIE (Centro Agronómico Tropical de Investigación y Enseñanza), in 2010. This standard includes 5 principles and 36 additional criteria around integrated cattle management systems, sustainable range and pasture management, animal welfare, reducing the carbon footprint and additional environmental requirements.	n/a	Global Roundtable on Sustainable Beef (GRSB) National Grasslands Certification Program

For the evaluation, data collected from a sample of 30 financial institutions was used to create a benchmark derived from scores compiled and evaluated by Sustainalytics. For each of the 30 financial institutions included in the study, indicators were scored on a scale of 0 to 100, and a final weighted score was aggregated. The results are presented anonymously in this report. The research framework is designed to be replicable and repeatable.

## 2. SELECTION OF FINANCIAL INSTITUTIONS TO EVALUATE

The framework was used to evaluate 30 financial institutions, including some of the largest banks and fund managers globally, based on their value of assets under management. Different types of financial institutions were included in the study – 20 commercial banks, three development banks and seven fund managers. A mix of types was selected in an effort to paint a representative picture of what financial institutions worldwide are currently doing with regards to soft commodities, while recognizing that this is merely a snapshot of the entire sector. Including both fund managers and banks also enabled the analysis to identify potential areas for sharing knowledge and good practice across different types of financial products and services. Many of the large banks and asset managers are likely to be indirectly exposed to soft commodities through loans, diversified investments or advisory services to consumer goods companies. See Appendix 1 for a full list of institutions.

The assessment includes 12 financial institutions operating at a national or regional level in UN-REDD Programme partner countries. The UN-REDD Programme supports national REDD+ readiness efforts in 60 partner countries, spanning Africa, Asia-Pacific and Latin America. Approximately 50 such financial institutions were initially reviewed in order to include more national or regional financial institutions in UN-REDD Programme partner countries

47. RSPO (2014)  
 48. Mandatory in Indonesia  
 49. KPMG (2013)

in the research. The initial sample of financial institutions had operations in UN-REDD Programme partner countries that were also top producers of palm oil, soy, or beef, and that had some degree of (English language) disclosure on natural capital or environmental and social issues more broadly. However, the assessment was challenged by the limited level of disclosure on even a high-level approach to sustainability of many national or regional financial institutions. Only those with some publicly disclosed information on policies were assessed, and many of these did not respond to interview requests. Six financial institutions that are domiciled in UN-REDD countries and a further six that are based elsewhere but operate in these countries were included in the study. Ten NCD Signatories actively participated in this project, providing additional information and participating in interviews.

### 3. RESEARCH AND ANALYSIS PROCESS

Data was gathered through primary and secondary sources, predominantly through desk-based research. Public reporting by the financial institutions constituted the starting point for research, with key sources including sustainability reports, policy documents, financial reports and corporate websites.

Telephone interviews were conducted with 11 financial institution representatives, as well as with experts from the PRI and BEI. Insight from interviews informed the assessment and recommendations, and has been incorporated throughout the report. The information collected in this process was critical for gaining a deep understanding of context and approach. With the exception of the interviews, financial institutions were not contacted to verify or expand on publicly available information.

Each financial institution was assessed according to each indicator scored on a scale of 0 to 100, and received a final weighted aggregate score. Stronger disclosure may lead to better performance scores as companies that do not disclose information are scored 0 for any given indicator based on lack of evidence. The results are presented anonymously in this report, with examples of strong policies and practices highlighted.

Limitations to the research include lack of public information for financial institutions' policies, language barriers and sample selection bias. The tool also does not take into account all the possible responses to risk by financial institutions (management of identified risk). For example, one institution, which scored poorly on the policy assessment, has already excluded these sectors from their investible universe due to unacceptably high risk.

# PART IV: DETAILED RESULTS

The average overall score for the financial institutions reviewed was 58 out of 100, which can be regarded as an initial benchmark against which to evaluate individual financial institutions (see Figure 4). Many of the financial institutions evaluated have strong policies and processes relative to the benchmark to address sustainability risks in soft commodities. Scores cover a wide range, with the highest score being 93 out of 100 and the lowest score being 10 out of 100. Nine financial institutions achieved scores above 80, and eight scored between 30 and 39.

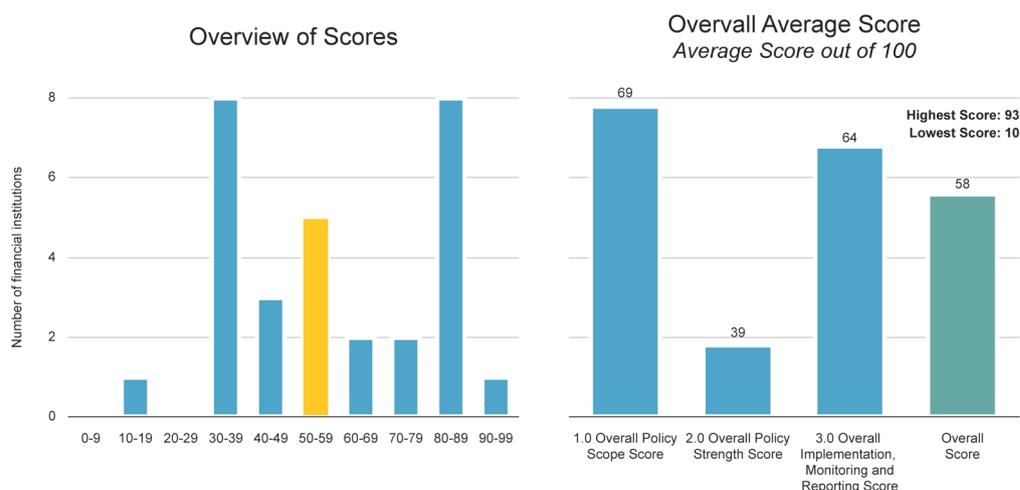


Figure 4: Breakdown of the scores of 30 financial institutions by quintile (A) and category (B)

Looking at the three pillars of the assessment, while policies or statements on either soft commodities or sustainability more broadly are prevalent (only one financial institution was found to disclose nothing at all), the strength of the policies varies, with an average score of 39, the lowest for the three categories in the research framework. This means that, on average, financial institutions do disclose policies, but these policies lack detailed criteria and requirements for companies to adhere to. In other words the ‘strength’ of the risk policies is not in line with the ‘scope’ of the policies. Also, institutions that generally score well on ‘scope’ and ‘strength’ also score well on ‘implementation, monitoring and reporting’. See Figure 5 for an overview of the benchmark results.

Many of the financial institutions display strong policies and implementation approaches. For example, IFC, FMO, the African Development Bank (AfDB), Standard Chartered, Sumitomo Mitsui Trust Bank, and Rabobank have clearly invested resources in understanding, and addressing, risks related to soft commodities. Examples of strong practice, from these and other financial institutions, are highlighted throughout the report.

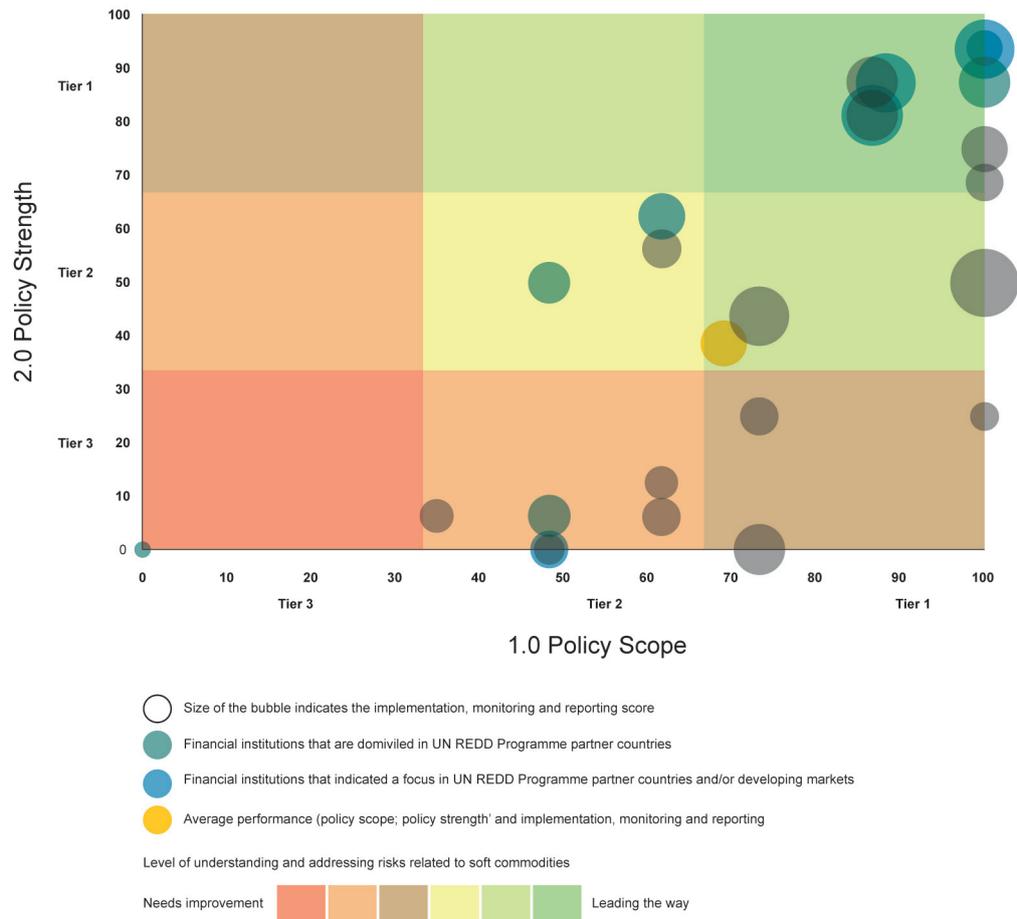


Figure 5: Benchmark results: how the risk policies on soft commodities of 30 financial institutions score on scope, strength and implementation, monitoring and reporting

## 1. POLICY SCOPE

The financial institutions reviewed were found to have strong performance on policy scope, with an overall weighted average score of 69 out of 100 (see Figure 6). Seven financial institutions received scores of 100, indicating standalone policies that explicitly address at least one soft commodity that apply to all financial activities of the organization, and that apply both upstream and downstream of the soft commodity value chain. One financial institution received a zero, indicating no evidence of a sustainability policy of any kind. Fifteen of the financial institutions scored above 67.

Overall Policy Scope Performance  
Average Score out of 100

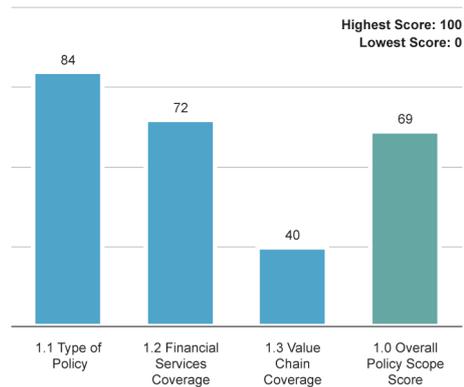


Figure 6: Scores for ‘policy scope’ aggregated across the 30 financial institutions reviewed

### Indicator 1.1: Type of Policy

The result of the indicator ‘type of policy’ is shown in Figure 7. It assessed whether financial institutions have developed a specific, standalone policy addressing one or more soft commodities, or at minimum, a general sustainability policy or statement.

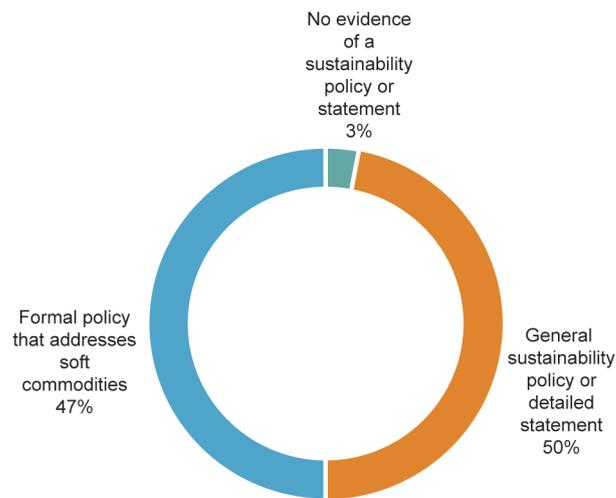


Figure 7: Type of policy aggregated across 30 financial institutions reviewed

Nearly half (14 out of 30) of the financial institutions reviewed have a formal policy that explicitly addresses at least one soft commodity, while 50% have a general policy that addresses sustainability more broadly (Figure 7). Only four financial institutions explicitly address all three soft commodities, including Rabobank (see spotlight) and HSBC. HSBC has a Statement on Forestry and Palm Oil, which was updated in March 2014. This policy evolved from a more general Forest Land and Forest Products Sector Risk Policy established in 2004, potentially reflecting growing attention in the palm oil sector. In addition, HSBC has an Agricultural Commodities Policy that addresses soy and cattle ranching.

## POLICIES IN INDONESIA

The Indonesian Government has developed a strategy to participate in the UN-REDD Programme. In May 2013, it extended a forest moratorium, which bans the approval of licenses to cut primary forests. The moratorium encourages palm oil producers to increase production volume by improving yields through better management, rather than by expanding plantations onto forested land. Under the moratorium, companies that have not adapted their production techniques to improve yields and allow for plantation development on degraded lands will be unable to realize production growth at the same rates as their peers. Several international banks operating in Indonesia appear to be better positioned for the changing regulatory environment than some of the banks domiciled in the country. For instance, PT Bank Mandiri (Persero) Tbk and PT Bank Negara Indonesia (Persero) Tbk had limited disclosure related to deforestation and soft commodities compared with the international banks assessed that provide products and services in Indonesia. Of the two, PT Bank Negara was stronger - it advises clients to obtain ISPO and RSPO certification and reports on the number of its clients that have achieved certification. However both banks scored below the average of 58, mainly due to room for improvement against criteria used to assess policy strength. **Stronger enforcement** and changes to permitting systems are needed to send a stronger signal to local banks that the government will uphold the moratorium.

Rabobank, HSBC and Standard Chartered, which all provide finance for agribusiness in Indonesia, were among banks with the strongest policies. Rabobank has established standalone policies for 12 commodities, including palm oil, soy and livestock. The palm oil supply chain policy outlines Rabobank's long-term objective, its general approach (e.g., client assessment and client engagement), and the specific requirements expected of clients with respect to palm oil. Standalone policies enable Rabobank to outline specific criteria that reflect the key issues associated with a specific sector or commodity. The specific policies are applied only when the topic represents a main activity of a company, and in some cases, more than one is applied. In an interview, Rabobank expressed the importance of having standalone policies on topics for which multi-stakeholder initiatives or standards have not matured sufficiently, such as beef.

Standard Chartered has adopted a robust programme to implement and monitor compliance with its palm oil and agribusiness position statements within the organization. The financial institution trains its employees on sustainable finance, and assigns direct responsibility for implementing and monitoring compliance with its policies to relationship managers. Standard Chartered states that "our relationship managers (or an independent technical specialist where necessary) will work closely with clients who do not currently meet these standards, to develop a time-bound action plan for compliance and to monitor the client's progress against that plan." Standard Chartered's board-level Brand and Values Committee oversees sustainability management within the financial institution.

HSBC's Corporate Sustainability team provides guidance on policies and is responsible for reviewing and updating them, overseen by the Risk Management Meeting of the Group Management Board. In 2011, HSBC launched an e-training programme to strengthen specific employees' knowledge of its sustainability policies. HSBC regularly reviews and updates its sustainability policies, and engages with NGOs when doing so.

**National or regional banks operating in UN-REDD Programme partner countries demonstrate environmental and social risk frameworks of varying levels of sophistication and, in some cases, disclosure is limited.**<sup>50</sup> Ecobank, a pan-African bank, demonstrates an understanding of sustainability risks in the summary of its Environmental and Social Policy and Procedure Manual (ESPPM). However, the full manual is not publicly available. Banorte, the third largest bank in Mexico, has implemented a Social and Environmental Management System (SEMS) for Corporate Banking projects valued at more than US\$1 million. Sudameris, which operates as a commercial bank in Paraguay, has an environmental and social questionnaire that clients are expected to complete, but a more formal, detailed policy is not disclosed. In December 2013, the African Development Bank (AfDB) adopted its Integrated Safeguards System (ISS), which is a tool used to identify and assess the environmental and social risks and impacts associated with projects that the bank finances. Under the ISS, the bank has adopted Operational Safeguards (OSs), which outline environmental and social requirements for clients or investees, including those involved in the production of agricultural commodities.

**One financial institution located in a UN-REDD Programme partner country noted that a challenge in developing and implementing a soft commodity policy is the risk of losing existing and potential clients.** The interviewee noted that financial institutions must remain competitive with those that have not developed soft commodity and sustainability policies, and there is an underlying concern that they may risk losing business by adopting a soft commodity policy. This interviewee also mentioned that environmental and social risk analysis can delay the overall credit risk analysis process, which can also lead to lost business. This may indicate a lack of understanding among certain banks as to the risks of not having a policy and to not undertaking environmental and social due diligence. Financial institutions in UN-REDD countries may have limited awareness of rising sustainability and ESG standards and processes globally among companies and financial institutions.

More than half of the diversified banks reviewed disclose sector-specific policies on soft commodities. In contrast, asset managers tend to outline how sustainability issues in general are considered in investment processes, and none disclose in more detail how they consider specific sustainability risks associated with soft commodities. Goldman Sachs and BlackRock, both asset managers, disclose an investment approach that incorporates sustainability issues broadly. Some asset managers may keep policies relatively broad in order to have the flexibility to add or remove issues, as well as limiting specific criteria so that companies do not avoid addressing substantial issues that are not yet specified. This difference in approach between asset managers and banks is indicative of the level of direct risk exposure through loans upstream in supply chains (see Exposure to Risks Related to Soft Commodities). Investors are more likely to be exposed to risk through stakes in companies that purchase soft commodities and are generally less prepared for responsible procurement standards and changes in consumer demand.

## Indicator 1.2: Financial Services Coverage

**This indicator considers whether a policy or statement is applied to all financial activities or to a subset of activities.**

**Half of the financial institutions reviewed apply their policy to all of their financial activities, and 47% apply it to a subset of activities (Figure 8).** BNP Paribas, Rabobank, Standard Chartered, Sumitomo Mitsui Trust Bank, and Credit Suisse all clearly state that their soft commodity policy

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50. It is important to note that it is typical of national and regional banks to only make information available in the local language, which was a constraint for this study.

(or statement) applies to all of their financial activities. Rabobank states that its position statements on palm oil and soy apply to “all commercial banking services” and Credit Suisse states that its Sector Policies and Guidelines apply to “all business activities relating directly to companies operating in those sectors, regardless of whether the company is in a direct contractual relationship with Credit Suisse or the object or target of a Credit Suisse client”. Six financial institutions evaluated explicitly state that their policies cover advisory services.

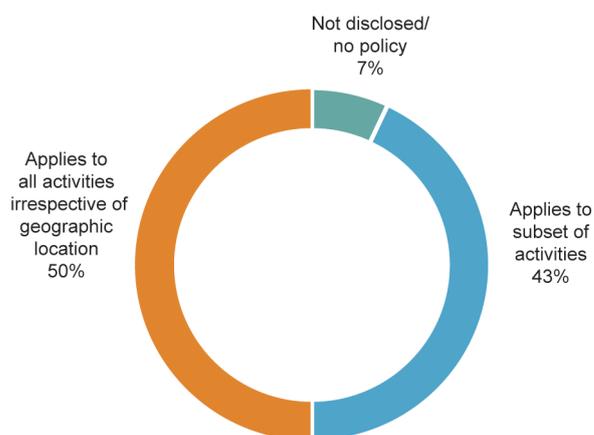


Figure 8: Coverage of risk policies on soft commodities across financial products and services

There is a clear difference in approach between banks and asset managers, even within the same organization. This may reflect that lending and investment activities are structured to operate in silos and operate under different policies and mandates. For example, HSBC has a strong palm oil policy that applies to its Commercial Banking and Global Banking and Markets line of businesses. HSBC states that the policy does not apply directly to its asset management business, as “there is a lower degree of influence over the investment itself”. However, HSBC is a signatory to the PRI and has established a broader responsible investment policy that addresses sustainability issues, yet it is unclear whether environmental and social issues related to soft commodities may be incorporated into investment decisions. BNP Paribas specifies that its sector policy on palm oil applies to all entities managing proprietary assets, and that entities managing third-party assets are to reflect the policy and develop standards adapted to their businesses which will exclude any stock or issuer that does not comply with their standards. Financial institutions should clearly define a firm-level perspective on managing soft commodity risks and describe how this is to be implemented across all financial activities.

### Indicator 1.3: Value Chain Coverage

**This indicator considers whether a policy or statement is applied to all companies operating along soft commodity value chains, or to a subset.**

**Only 30% (9 out of 30) of the financial institutions apply their soft commodity or sustainability policy to the entire value chain, and 20% (6 out of 30) apply it to a subset (Figure 9).** IFC, NBIM, BNP Paribas, HSBC, Rabobank, Sumitomo Mitsui Trust Bank, UBS, AfDB, and FMO all apply some form of soft commodity approach to the broader supply chain. For example, IFC’s policy covers “primary suppliers” which “provide the majority of living natural resources, goods, and materials essential for the core business process of the project”. IFC Performance Standard 6, “Biodiversity Conservation

and Sustainable Management of Living Natural Resources,” requires clients to manage supply chain risks when purchasing primary production, including food and fiber commodities, and where possible to shift commodity procurement to those suppliers that can demonstrate that they are not significantly impacting areas of natural and / or critical habitats. Rabobank’s various soft commodity policies explicitly address both upstream companies (defined by the bank as palm oil growers and mills) and downstream companies (defined by the bank as traders, processors, manufacturers, wholesalers and retailers).

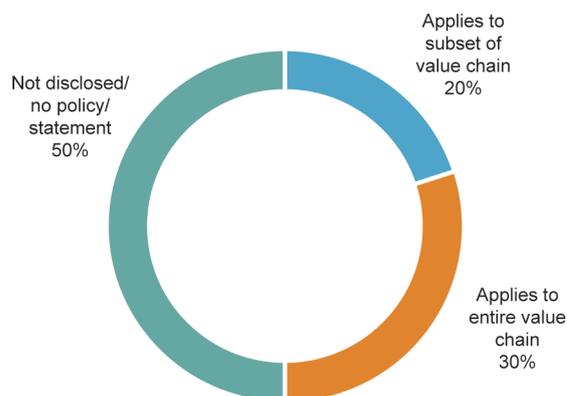


Figure 9: How risk policies on soft commodities cover the agricultural value chain

**Several financial institutions recognize that a uniform set of requirements cannot be applied to an entire value chain, and therefore specify how their policies apply to companies operating at different points.** For example, UBS applies an enhanced due diligence process to palm oil producers only, but states that prior to any new or renewed contract being awarded, standardized checks are completed to assess supplier- and commodity-specific environmental, labor and human rights risks. Therefore, through the supplier check, it is presumed that UBS captures environmental and social risks across the value chain to some degree. Another example of this is Credit Suisse (see Spotlight).

## SPOTLIGHT: CREDIT SUISSE’S SPECIFIC DEFINITION OF VALUE CHAIN COVERAGE

Credit Suisse publicly discloses a summary of its Palm Oil Guidelines. The guidelines only apply to a subset of the soft commodity value chain, but Credit Suisse provides a detailed statement on this coverage, and its approach to the stages of the value chain that are not directly covered. Credit Suisse states that the use of palm oil in the production of products such as food and soaps, as well as the trading of palm oil or palm oil products are “in principle considered outside of the core scope of these guidelines.” The bank states that it exercises discretion in deciding whether to apply the guidelines to transactions that only have an indirect connection to palm oil production and trade, or to the provision of financial services to a company that has only marginal involvement in the palm oil sector, and that it will make such decisions on a case-by-case basis after assessing the materiality of risk.

## 2. POLICY STRENGTH

Figure 10 shows that financial institutions were found to have lower performance on policy strength, with an overall weighted average score of only 39 out of 100. While a relatively large portion of financial institutions require or encourage sustainability certification of soft commodities, few outline specific environmental and social requirements for companies. Ten financial institutions had policies that were strong in scope but limited in strength, meaning they lack specific environmental and social requirements.

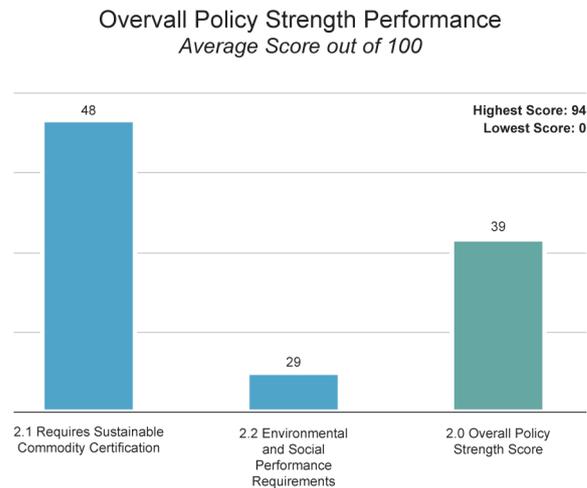


Figure 10: Scores for 'policy strength' aggregated across the 30 financial institutions reviewed

Banks and lenders may be in a stronger position to require companies to meet certain criteria than asset managers. Banks, bond investors and private equity investors may have more scope to set conditions than investors in public equities. While investors can screen out companies or sectors and use shareholder ownership rights to engage companies, they do not have the power to require companies to meet certain criteria. More detailed reporting by companies would make it easier for funds to include a criterion that investees should, for instance, avoid land clearance in High Carbon Stock (HCS) areas.

As noted under indicator 2.2, four requirements in particular are not widely implemented: avoid HCS areas, avoid the use of fire to clear land, conduct impact assessments, and improve supply chain transparency. HCS is a relatively new term in the private sector and the Palm Oil Innovation Group is currently working to more clearly define HCS. Cargill became one of the first companies to commit to implementing the HCS approach in July 2014.

### Indicator 2.1: Sustainable Soft Commodity Certification

**This indicator considers whether a financial institution requires (or strongly encourages) companies to obtain credible certification and/or source commodities from certified sources (Table 2).**

Credible globally, regionally, or nationally recognized standards are objective and achievable; are founded on a multi-stakeholder consultative process; encourage step-wise and continual improvements; and provide for independent verification or certification through appropriate accredited bodies for such standards.<sup>51</sup>

51. See for example IFC (2012a)

**43% (13 out of 30) of the financial institutions require (or strongly encourage) companies to obtain certification and/or source commodities from certified sources, while 10% (3 out of 30) only reference sustainability certifications when assessing client or investee performance (Figure 12). Half of the financial institutions do not refer to certification. See Figure 11.**

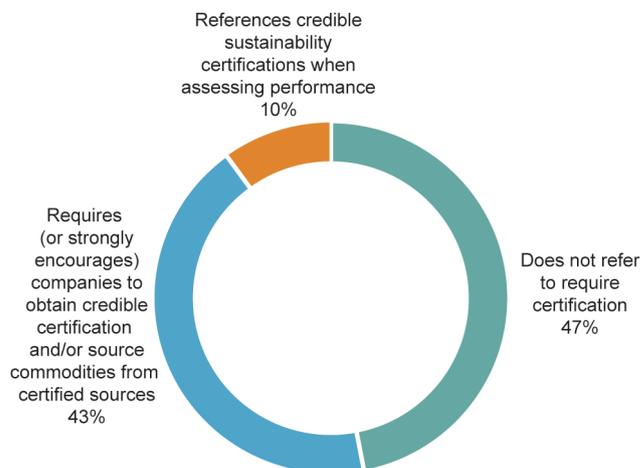


Figure 11: Whether financial institutions require clients to have soft commodities certification

**Of the 13 financial institutions that require or encourage certification, the majority of which are banks, five explicitly require companies to achieve or commit to a time-bound plan to achieve certification.** Setting time-bound action plans enables companies to address challenges in shifting to sustainable practices, while ensuring progress is monitored. Credit Suisse, for example, explicitly requires that its clients achieve certification under the RSPO or commit to a time-bound plan to achieve certification. HSBC, Rabobank and UBS disclose similar requirements. The remaining financial institutions encourage, but do not require, certification. For example, among the financial institutions operating in UN-REDD Programme partner countries, BNI recommends that palm oil companies, which have applied for or secured loans from the organization, obtain ISPO or RSPO certification.

**Of the 13 financial institutions that require or encourage certification, seven stipulate requirements for downstream companies regarding sourcing certified sustainable commodities.** For example, in relation to downstream agribusiness companies, the IFC Performance Standards Guidance Note 6 states that “where there are appropriate certification and verification systems in place for sustainable natural resource management in the country of origin, clients are encouraged to consider the procurement of certified product and demonstrated certification or verification under a credible chain-of-custody scheme relevant to the commodity or product in question.”<sup>52</sup> Both Rabobank and Credit Suisse encourage buyers to source palm oil from certified sources.

**One of the challenges in requiring certification at all levels of the supply chain is access to certification.** Currently, certification is not attainable in all geographies or at all scales, as some countries lack the auditing infrastructure required to support certification schemes. In addition, certification can be cost-prohibitive for many companies. When certification

52. IFC (2012b)

requirements are in place, there is a perception that this can lead to a loss of business and can prevent banks from achieving their mandate. While some financial institutions provide a pricing incentive for certified companies (see Indicator 3.4: Sustainable Commodity Products and Services), others such as IFC work with clients to help them achieve certification.

**Among the financial institutions reviewed, there is recognition that beef sustainability standards need to be strengthened.** One financial institution interviewed noted that there is “no robust international standard for beef” at the moment. Another interviewee emphasized that in the absence of a globally-accepted standard for beef, financial institutions that are active in the sector need to develop their own policies and opinions. A third interviewee stated that, as beef certification schemes are strengthened and the sector attracts greater stakeholder attention, the bank would update their policy statements to address beef.

## SPOTLIGHT: HSBC SETS TARGET FOR CERTIFICATION BY 2018

Under its Agricultural Commodities Policy, HSBC requires growers, mills, refiners, and traders to achieve 100% certification (of either management units, or owned facilities) under RSPO by December 2018. In addition, HSBC requires customers operating in these segments of the palm oil value chain to meet certain requirements in the lead up to certification, such as developing a time-bound plan to achieve 100% certification. HSBC also requires refiners and traders to develop a plan to “exclude palm oil from controversial sources, by providing traceability, within a set timeline”. By adopting a phased approach, HSBC allows customers time to complete the complex and costly process of achieving RSPO certification.

### Indicator 2.2: Environmental and Social Performance Requirements

**This indicator is comprised of eight sub-indicators that consider whether or not a financial institution has established specific environmental and social performance requirements<sup>53</sup> that govern its approach to working with companies involved in soft commodities.**

**Almost half (47%, 14 out of 30) of the financial institutions encourage or require companies to avoid High Conservation Value (HCV) areas, and to respect the rights of local communities, making these criteria the most frequent to appear in financial institutions’ policies.** This reflects the maturity of the concept of HCV areas, and the concept has been integrated into sustainable commodity certification standards, including RSPO and RTRS, as well as the policies of commodity producers. The process of identifying and managing HCVs should follow the guidelines of the HCV Resource Network.<sup>54</sup> Regarding local communities, unjust displacement for the development of plantations and pastures can lead to violations of locals’ rights to Free, Prior and Informed Consent (FPIC). The framework used to evaluate policies

53. These requirements were derived based on a review of best practice soft commodity policies (of both companies and financial institutions), sustainable commodity standards, and NGO research, and were chosen based on their relevance to forest use. Note: these requirements do not address some important environmental and social issues associated with soft commodities, such as water management, chemical use, and labour rights.

54. See: HCV Resource Network. <http://www.hcvnetwork.org/>

examines whether they require businesses to “respect” all internationally recognized human rights, but does not specify what those rights are. Instead, it refers to the Universal Declaration of Human Rights (in addition to other sources). The UN Guiding Principles on Business and Human Rights (the Ruggie framework) explain the role of business and governments in managing human rights issues. Essentially, the framework states that: i) governments should “protect” against human rights abuses, and ii) businesses should respect human rights. With respect to palm oil, the importance of respecting the rights of local communities is growing increasingly important, as palm oil companies are making large-scale land acquisitions in west and central African countries, which, in some cases, lack sufficient governance mechanisms to protect land rights.

Environmental and Social Performance Requirements Imposed by Financial Institutions  
8 sub-indicators

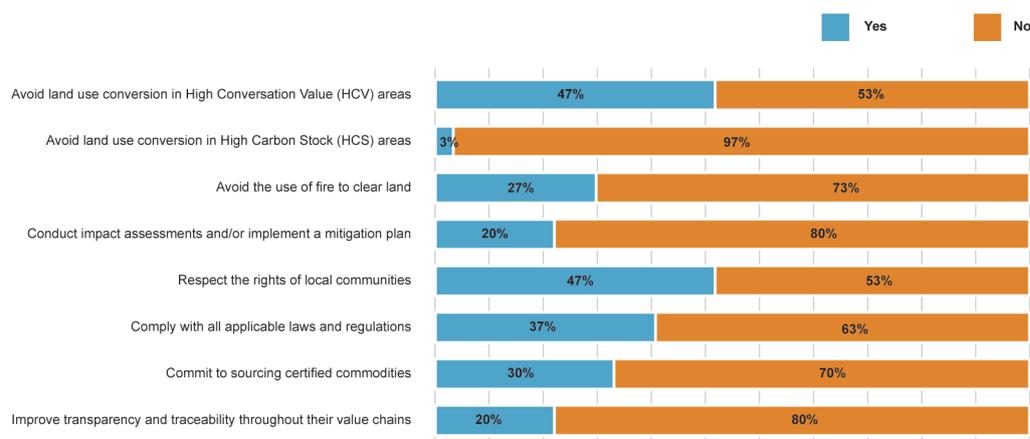


Figure 12: Environmental and social performance requirements imposed by financial institutions

**IFC is the only financial institution reviewed that addresses the protection of High Carbon Stock<sup>55</sup> (HCS) areas.** IFC has considered this concept within its strategic approach to investments in the palm oil sector, as outlined in the World Bank Group Framework and IFC Strategy for Engagement in the Palm Oil Sector, which states that “Palm oil plantations that result in significant conversion or degradation of high carbon stock or high conservation value habitats will be avoided.” The fact that so few financial institutions have integrated this concept into their soft commodity policies reveals a disconnection between those institutions and national and international commitments by governments to address the significant contribution of deforestation to global GHG emissions. However, in contrast to HCV, HCS is a relatively new concept. Some historically controversial soft commodity producers, including Golden Agri-Resources Limited and Wilmar International, recently adopted policies addressing the protection of HCS areas. In addition, PepsiCo and Colgate-Palmolive adopted policies addressing impacts on HCS areas in their supply chains in 2014. These developments suggest that financial institutions are lagging behind producers and retailers with respect to HCS. One interviewee noted that financial institutions may begin to incorporate HCS into their policies if it was better defined, and tools were developed to implement it. Unilever is leading a process to define HCS in partnership with NGOs through the POIG.

55. The HCS approach involves calculating the total tonnes of carbon per hectare (tC/ha) stored in a forest and using this information to make land-use decisions that support mitigation of GHG emissions from deforestation.

**37% (11 out of 30) of financial institutions require companies to comply with all applicable local, national, and/or ratified international laws and regulations.** Some financial institutions view compliance with applicable laws and regulations as a minimum requirement for clients and investees involved in soft commodities, but explicitly state this in agreements with clients rather than in public documents. Publicly disclosing requirements for compliance in financial transactions can provide an important signal to companies, particularly in countries where regulatory enforcement is weak. The IFC Performance Standards require that “the client ...establish an overarching policy defining the environmental and social objectives and principles that guide the project to achieve sound environmental and social performance. The policy provides a framework for the environmental and social assessment and management process, and specifies that the project (or business activities, as appropriate) will comply with the applicable laws and regulations of the jurisdictions in which it is being undertaken, including those laws implementing host country obligations under international law.” BNP Paribas “expects that upstream palm oil companies comply with existing social and environmental laws, at a local or state/provincial level, as well as with international regulations ratified by their operating countries. Evaluation criteria for investments in palm oil companies cover the Convention on International Trade in Endangered Species of Wild Fauna and Flora, Convention on Biological Diversity, International Labour Organization Convention 169 Concerning Indigenous & Tribal Peoples in Independent Countries, ILO Conventions on Forced Labour and Worst Forms of Child Labour.” The criteria provide a framework for analysis and dialogue with companies.<sup>56</sup>

**One third of financial institutions reviewed require or encourage downstream companies to commit to sourcing certified commodities, while 20% (6 out of 30) require or encourage downstream companies to improve transparency and traceability throughout their value chains.** IFC, BNP, HSBC, Rabobank and Credit Suisse all disclose strong requirements regarding sourcing certified commodities. While AfDB does not explicitly require downstream companies to source commodities from certified sources, it does state that clients or investees are required to develop and implement a sustainable resources procurement plan. This represents a strong example of a financial institution not requiring, but at least promoting transparency and traceability throughout supply chains.

**Challenges in financial institutions requiring downstream companies to procure commodities from certified sources include the cost of and access to certified sources.** PAX mentioned that, while it is easy to determine the primary business activities of a company, it can be difficult to determine the extent to which soft commodities are used in its products and supply chain. An oversupply of certified sustainable palm oil (CSPO) since 2012 has resulted in a negligible premium being paid for CSPO by downstream companies disincentivising further production. However, financial institutions can play an important role in increasing demand for CSPO among buyers by promoting increased production of CSPO. For instance, Credit Suisse encourages clients producing products containing palm oil to source their raw materials from RSPO-certified providers. Both Calvert and MN Services encourage investees to source palm oil from certified sources through their engagement activities. Around half of the asset managers evaluated disclose explicit environmental and social performance requirements related to soft commodities.

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56. BNPP IP (2014)

## SPOTLIGHT: BNP PARIBAS – ENVIRONMENTAL AND SOCIAL PERFORMANCE REQUIREMENTS

BNP Paribas has developed a Palm Oil Policy, in which it outlines specific environmental and social criteria that clients or investees must comply with. The criteria address six out of the eight requirements assessed under this indicator and align with industry best practices. Specifically, BNP Paribas requires or encourages that:

- Upstream companies “do not convert existing High Conservation Value forests (HCVF) into new plantations.”
- Upstream companies “have a no-burn policy, in line with the recommendations of the ASEAN policy on zero burning or other regional best practice.”
- Upstream companies “will not develop a new plantation on lands previously owned or occupied by local communities without having (and in line with the RSPO principles and criteria): conducted a proper consultation process, achieved an acceptable compensation arrangement, and implemented an acceptable grievance mechanism.”
- “Upstream palm oil companies comply with existing social and environmental laws, at a local or state/provincial level, as well as with international regulations ratified by their operating countries.”
- “Palm oil mills, traders and refiners, to set up policies requiring that their suppliers (i) become RSPO certified by the end of 2015 as well as (ii) encourage the traceability of sources of palm oil supply.”

## ADDRESSING DEFORESTATION RISKS LINKED TO SOFT COMMODITIES RISK THROUGH THE EQUATOR PRINCIPLES

The Equator Principles form an environmental and social risk management framework for project finance-related activities. Of the financial institutions reviewed, 43% are Equator Principle members. However, the relevance of the Equator Principles to soft commodity production depends on the prevalence of project finance in this sector. According to WWF, project finance now plays a limited role in the palm oil industry. Project finance also typically represents a small portion of financial institutions’ activities. For example, HSBC states “The Equator Principles work well for project finance but this is a small proportion of HSBC’s business. This is why we believe it is particularly important to have our own policies.” Nevertheless, some financial institutions that have adopted the Equator Principles have made a choice to extend the application of the principles to financial services beyond project finance-related activities. For example, FMO adopted the Equator Principles in 2006 and applies the principles to all financing activities.

### 3. IMPLEMENTATION, MONITORING, AND REPORTING

Figure 13 shows that financial institutions were found to have relatively strong performance on ‘implementation, monitoring, and reporting’, with an overall weighted average score of 58 out of 100. Scores ranged from zero for one regional bank to 100. Performance on implementation, both internally and externally, and disclosure was aligned, with average overall scores of 63, 70 and 65 respectively. However, many financial institutions have not yet begun to develop soft commodity financial products and services, with an average overall score of only 13 out of 100 for this indicator.

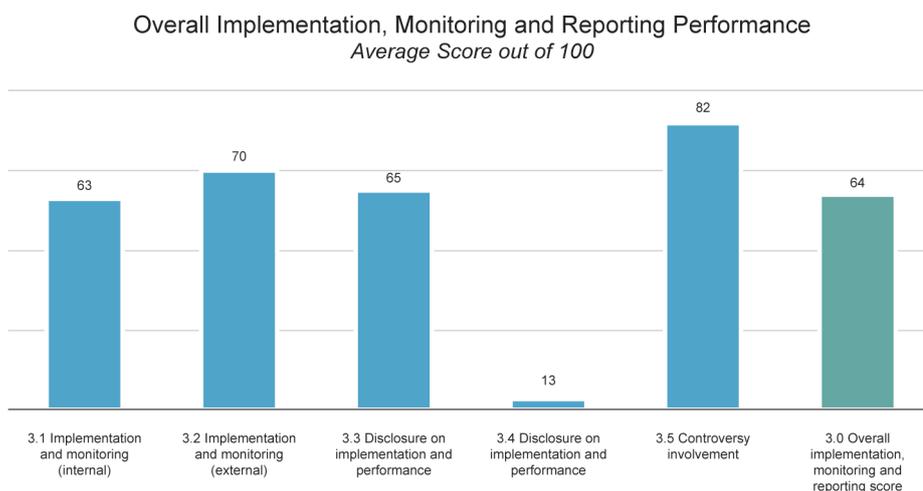


Figure 13: Scores for ‘implementation, monitoring and reporting’ aggregated across the 30 financial institutions reviewed

#### Indicator 3.1: Implementation and Monitoring (Internal)

**This indicator considers the degree to which a financial institution has processes in place to implement and monitor compliance with its policies within the organization.**

Nearly all (28 out of 30) financial institutions reviewed have established implementation and monitoring procedures to ensure that their sustainability or soft commodity policy has been implemented effectively. 33% (10 out of 30) of financial institutions report on having internal implementation and monitoring practices specifically in relation to soft commodity policies.

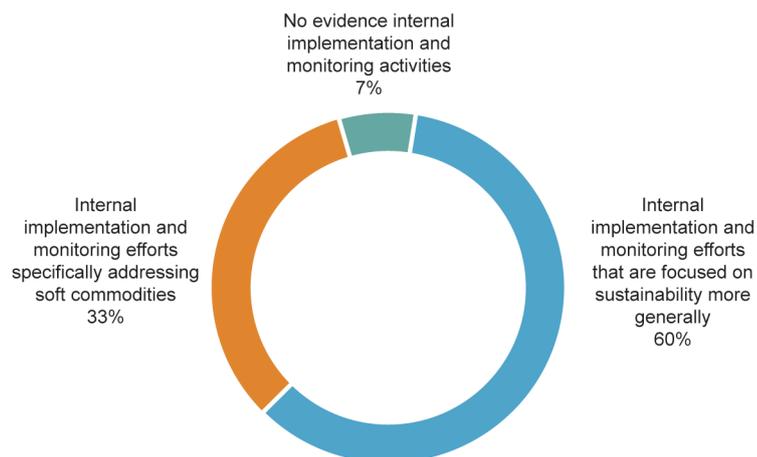


Figure 14: Internal procedures by financial institutions to ensure implementation and monitoring of risk policies

**Financial institutions have established high-level management accountability for soft commodity or sustainability policies.** For example, any review or change to HSBC’s agricultural commodities policy must be approved by the Risk Management Meeting of the Group Management Board. Sumitomo has established an ESG Monitoring Committee, which is chaired by an executive officer and is responsible for informing all departments across the company on specific issues set out under the ESG Engagement Policy.

### BOX III

#### Top tip: Identify links between financial risk and forest-risk commodities

Map credit risk ratings and where relevant, facility risk ratings, by exposure to forest-risk commodity supply chains. Project/loan-level risks on such a register can be aggregated up to allow consideration of material risks at an institutional/corporate level. Information gathering can form part of due diligence and relevant risks could be escalated to board level for inclusion in a risk register for ongoing monitoring and management

**Financial institutions have established designated teams to ensure day-to-day implementation, which are also tasked with liaising with other teams.** Rabobank has established an internal network of sustainability co-ordinators and specialists, and highlights that close co-operation between sustainability co-ordinators and sales teams is vital for further integration of sustainability into the operations of the firm globally. FMO even has a double pair of eyes approach: environmental and social analysts in its credit department provide a review of the environmental and social requirements as identified by the front office E&S officers in the due diligence process prior to a recommendation being made to the investment committee. This system aims to ensure that environmental and social factors are fully integrated in the credit process. Investors, including Calvert, PAX, and MN, have also established in-house ESG teams. In addition, several interviewees noted that regular

interaction between sustainability and financial teams is a key catalyst for effective implementation.

**Several financial institutions highlighted the challenges of implementing a soft commodity or sustainability policy within an organisation, including a lack of resources and the complexity of relevant issues.** As a legal responsibility, risk management requires adequate resources. However, one interviewee noted that banks often lack the resources to conduct environmental and social due diligence. This interviewee also said that there is often a gap between a CEO and CFO, where, for example, the CEO wants to address deforestation risks, but the CFO does not know how to operationalize it. Another financial institution highlighted the challenges of conducting employee training on deforestation-related issues, stating that the main challenge is to present the complexity of this topic in a way that can be easily understood. It is important for asset managers and banks to have access to expertise and resources enabling them to assess information related to the environmental and social requirements. Investment teams need access to adequate information to reduce risk and unlock business opportunities.

**Several financial institutions have established employee training programmes.** Some financial institutions have established training focused on soft commodities, for example, IFC states that all staff involved in the palm oil sector undergo a training course.<sup>57</sup> Other training approaches are focused on improving sustainability integration, for example, MN held interactive trainings between the internal equity team and the socially responsible investment (SRI) team in order to ensure a “greater balance between financial and strategic aspects and ESG aspects.”

#### **BOX IV**

##### **Top Tip: Target policies**

Banks could distinguish between policies that apply to lending activities for commodities where finance is known to contribute directly to deforestation such as finance for specific divisions, activities, projects or regions versus general purpose working capital that may indirectly support these activities. Corporates can also offer debt that is specifically used for sustainable activities.

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57. IFC (2011)

## CDP FORESTS PROGRAM

CDP's forests program operates a global disclosure system on behalf of 240 signatory investors with US\$15 trillion in assets who wish to understand how companies are addressing their exposure to deforestation risks. Information is collected annually from the world's largest companies through the lens of the agricultural commodities responsible for most deforestation including palm oil, soy and beef.

The information collected from companies aims to enable investors, as well as other stakeholders, to address the following key questions:

- Are any of the company's operations or critical suppliers exposed to deforestation risks – regulatory, operational or reputational?
- What systems do they have in place to manage their supply chain and to ensure traceability of products?
- How confident are they that they will have access to the quantity and quality of commodities required to operate now and in the future?

Disclosure plays an important role in encouraging and monitoring more responsible production and sourcing of commodities by companies. An increasing number of investor signatories are filing shareholder resolutions against companies to develop sustainable sourcing policies, to set targets for moving to certified sustainable commodities and to disclose their progress publicly. Publicly-available responses can be analysed by civil society, while scoring and shareholder pressure can drive performance improvement and publicize best practice. The process of disclosing information to CDP incentivizes companies to measure, manage and reduce their impact on the environment and build resilience. See [www.cdp.net](http://www.cdp.net)

## THE PRI SUSTAINABLE PALM OIL INVESTOR WORKING GROUP

The Principles for Responsible Investment Sustainable Palm Oil Investor Working Group (IWG) is a group of 45 investment organizations (as of August 2014). All are members of the UN-supported Principles for Responsible Investment and support the development of a sustainable palm oil industry through the RSPO. IWG aims to attract more investor interest and provide a coherent and unified investor perspective to support the palm oil industry's development. The IWG also aims to engage directly with investee companies across the palm oil value chain to encourage the production and purchase of sustainable palm oil.

### Indicator 3.2: Implementation and Monitoring (External)

**This indicator assesses the degree to which a financial institution has processes in place to implement and monitor compliance with its policies throughout the life of a client or investee relationship.**

**44% of financial institutions reviewed disclose evidence of external implementation and monitoring activities specifically related to soft commodities, while 53% disclose evidence of external implementation and monitoring activities addressing sustainability issues more broadly (Figure 15). Only 3% do not disclose, or disclose very little evidence of efforts to implement and monitor compliance externally.**

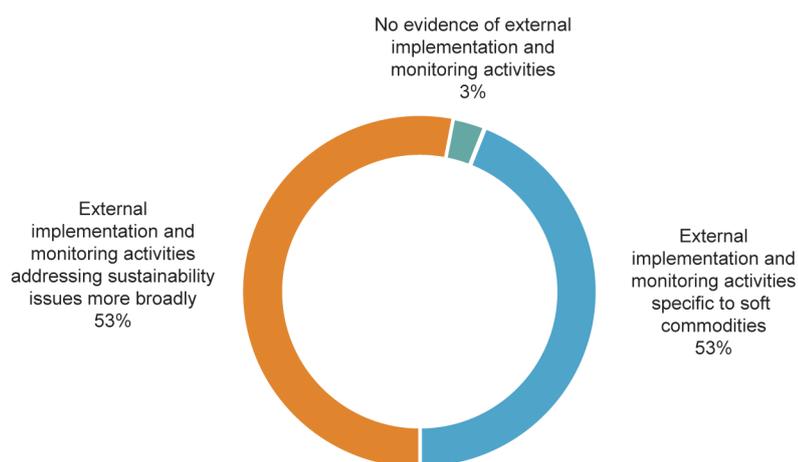


Figure 15: How financial institutions disclose external implementation and monitoring of risk policies

**Of the 13 financial institutions that disclose external implementation and monitoring activities specifically related to soft commodities, seven allow for “full compliance over time” and commit to working with clients to achieve compliance.** For example, Standard Chartered states that “as part of [our] commitment to help our clients towards higher standards of sustainable development, our relationship managers (or an independent technical specialist where necessary) will work closely with clients who do not currently meet these standards, to develop a time-bound action plan for compliance and to monitor the client’s progress against that plan.” BNP Paribas recognizes that implementing its palm oil policy may be challenging for companies and takes time. The financial institution therefore allows clients and investees to meet requirements over a specified timeframe and engages with clients to encourage them to improve their environmental performance.

**Varying approaches are employed among the financial institutions that report in detail on activities to monitor compliance with their policies.** For example, IFC monitors whether or not existing clients are complying with its policies in two ways: i) by conducting site visits; and ii) by reviewing clients’ annual submissions on their progress in meeting the environmental and social terms of an investment agreement. ADB has a Compliance and Safeguards team in place, which conducts audits or appoints an independent monitoring team to a project if there is a high risk of non-compliance with its Operational Safeguards. Other financial institutions, including Rabobank, MN Services and PAX World Management, use ESG research providers, in addition to other tools, to monitor compliance with their policies and investment strategies. Although these financial institutions report in detail

on activities to monitor compliance with their policies, in addition to other implementation activities, many do not.

**The asset managers reviewed implement their policies in different ways: through engagement, divestment, exclusion, or a combination of these approaches.** For example, ASN Bank seeks to avoid investing in palm oil, soy and beef producers because these activities do not comply with its Special Investment Criteria on Biodiversity and are viewed as too risky with regard to biodiversity, human rights and climate for the organization to be involved in. Conversely, MN Services invests in and engages with palm oil producers and encourages these companies to join the RSPO. While NBIM engages with its investments on a regular basis to improve sustainability performance, the asset manager also employs a divestment approach.

**Very few financial institutions disclose actions to be taken in the event of policy non-compliance,** undermining the credibility and enforceability of policies. Financial institutions should establish clear guidelines on actions to be taken if a company is found to be in violation of their policy to support its credibility and enforceability. For example, HSBC states “if customers are unable or unwilling to improve to meet our standards over a reasonable timeframe, the relationship is ended as soon as is contractually possible.” One bank noted that it might take legal action against a client that does not comply with its policy. Clear guidelines on actions to be taken in the event of non-compliance support the credibility and enforceability of a policy.

## SPOTLIGHT: FMO - ASSESSING, IMPLEMENTING, AND MONITORING ESG PRACTICES

FMO has a strong programme in place to implement and monitor compliance with its environmental and social policy. FMO’s investment approach involves assessing, implementing, and monitoring ESG practices within its clients’ operations. To do this, FMO conducts an ESG risk assessment against IFC Performance Standards and ESG risk categorization process prior to working with a client, includes ESG clauses in contracts, and develops ESG action plans. The ESG action plans outline specific requirements that clients must comply with over a period of time, typically three years. In addition, to monitor clients’ compliance with its ESG standards, FMO conducts periodic site visits and annual client reviews. FMO has also developed ESG training toolkits to help its clients improve their ESG performance.

## SPOTLIGHT: IFC - ROBUST PROGRAMME TO IMPLEMENT AND MONITOR COMPLIANCE

The application of IFC’s Performance Standards in IFC’s investments is led by their environmental and social specialists who are responsible for identifying and assessing potential projects’ environmental and social risks and impacts. The environmental and social due diligence process involves assessing company performance in comparison to the Performance Standards. This includes meeting with the company, governments and local stakeholders to discuss the environmental and social aspects of a project. As part of its project due diligence process, IFC develops Environmental and Social Action Plans (ESAPs) for clients, which outline requirements that clients must meet in order to comply with the IFC Performance Standards and include a timeline for their implementation. IFC commits to working with clients to help them improve their performance over time. In addition, a mechanism has been established through the Compliance Advisor Ombudsman (CAO) to enable individuals and communities affected by IFC-supported business activities to raise their concerns to an independent oversight authority.

### Indicator 3.3: Disclosure on Implementation and Performance

This indicator assesses the extent to which financial institutions disclose meaningful information on the application of their policies, such as the number of transactions, clients, etc., to which the policies have been applied; the number of employees that have been trained on the policies; and progress on policy commitments.

**46% of financial institutions reviewed report in detail on the implementation of their policies and their performance with respect to the commitments made in these policies, specifically in relation to soft commodities (Figure 16).** 37% provide limited disclosure or do not address soft commodities in their disclosure, and 17% do not report on the implementation of their policies or on their performance with respect to these policies.

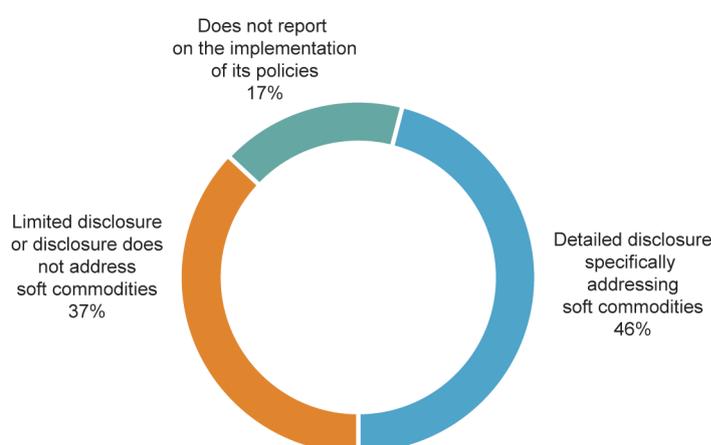


Figure 16: How financial institutions report on implementation and performance of their risk policies

**A number of financial institutions use quantitative metrics to demonstrate their progress in implementing their policies.** For example, BNP Paribas discloses that in 2012, more than 1,500 employees were trained on analysing transactions in sensitive sectors, including palm oil. BNP Paribas also discloses details on its engagement efforts with palm oil companies, stating that since March 2011, it has maintained dialogue with eight palm oil companies in Southeast Asia. HSBC discloses the percentage of its customers that fall under each of its four sustainability risk classifications: Leader, Compliant, Near-compliant, and Non-compliant. BNI, an Indonesian bank, discloses the number of its clients that have achieved ISPO and RSPO certification and the total value of loans made to these clients.

**Of the financial institutions reviewed, IFC, HSBC and AfDB make explicit commitments to report on the application of their policies.** For example, AfDB has a Disclosure and Access to Information Policy, in which it commits to disclosing environmental and social impact assessments for all projects.

**IFC, AfDB, and FMO, all development banks, have implemented systems to quantify and disclose their contribution to sustainable development.** IFC has implemented a Development Outcome Tracking System (DOTS), which is used to measure the development effectiveness of its investment and advisory activities. For investment projects the DOTS rating is based on, among other criteria, the degree to which a project meets the IFC

Performance Standards. In its 2013 Annual Report, IFC discloses the DOTS score of its investments by industry and region. FMO publishes an annual evaluation report, in which it assesses the development outcome of the projects that it has invested in. The development outcome is measured based on three indicators: a project's business success, its contribution to economic growth and environmental and social outcomes.

### **BOX V: ASN Bank applies criteria to avoid land-use change linked to the soft commodities value chain**

ASN Bank has an operational target to become climate neutral by 2030 with all investments, and aims to develop a similar long-term measurable target with regard to biodiversity in the coming years. It avoids direct investment in soft commodities. In the value chain, the bank applies specific criteria to changes in land use and expects companies to avoid large-scale land-use change or activities that contribute to the loss of natural habitat and biodiversity. Examples of relevant sectors are agriculture and forestry. Criteria include:

- Insufficient: The company has no policy.
- Poor: The company has no policy but does have the intention of joining a certified standard including RSPO and RTRS.
- Sufficient: The company has a policy and aims to meet the requirements of one these standards.
- Good: The company has policy and a management system that, depending on its operating activities, is based on guidelines from the International Union for the Conservation of Nature (IUCN) for the management of various categories of protected areas (Protected Area Management Categories), and/or FSC certification if the company uses wood from old-growth forests; and/or the company respects the High Conservation Value Areas (HCVAs) by only growing palm oil and soy according to the criteria of, for example, the Brazilian Soy Platform and the RSPO; and/or only using second-generation biomass. The company reports in accordance with the Global Reporting Initiative biodiversity guidelines.

### **Indicator 3.4: Sustainable Soft Commodity Products and Services**

**This indicator assesses whether or not a financial institution has developed financial products and services aimed at promoting the production and trade of sustainable commodities.**

Only 13% (4 out of 30) of financial institutions reviewed have developed financial products and services aimed at promoting the production and trade of sustainable commodities (see Figure 17). In the interview process, a number of financial institutions expressed an interest in developing financial products and services aimed at promoting sustainable commodity production, but do not believe the business case is clear or has been sufficiently researched. One interviewee noted that their organization wishes to promote financial products and services that support the production of sustainable commodities, but they face the challenge of demonstrating the link to a high-level of profitability. This interviewee stated that if you can create differential lending products, borrowers are incentivized to implement sustainable practices in order to benefit from a lower cost of capital. Another interviewee discussed applying Green Bonds, financial instruments that enable capital raising for projects with environmental benefits, to palm oil. This interviewee noted that the application

of Green Bonds to palm oil could allow the organization to develop a positive relationship with a company that is not a lending client.

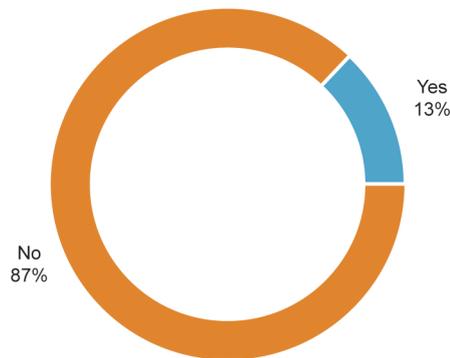


Figure 17: Number of financial institutions that have developed financial products aimed at promoting production and trade of sustainable commodities

**Two financial institutions, FMO and IFC, are analysing and developing the business case for sustainable commodity production.** In 2012, FMO collaborated with WWF and the UK development finance institution CDC Group to assess the financial costs and benefits of producing palm oil under the RSPO guidelines. The study found a causal relationship between sustainable production practices and profitability. Also in 2012, the Sustainable Trade Initiative (IDH),<sup>58</sup> in partnership with FMO, IFC and WWF, commissioned KPMG to conduct a cost/benefit analysis on RTRS certification in Argentina and Brazil, which demonstrated a three-year payback period for certification and outlined other business benefits. Based on responses from the interviewees, further developing the business case for implementing sustainable commodity standards will allow for and accelerate the adoption of financial products and services that promote sustainable commodities production.

**Two financial institutions with asset management activities expressed a desire to develop investment products aimed at promoting sustainable agricultural development.** One interviewee noted that it plans to become a leading impact investor by 2020 and as part of this strategy, is seeking to invest in projects that result in reduced emissions from deforestation and forest degradation (REDD). Another interviewee stated that they have been speaking with several banks, traders and brokers that think their organization should develop investment products related to certified commodities, and noted that they are looking into this.

**Two financial institutions, HSBC and IFC, have developed innovative financial products aimed at promoting the production and trade of certified sustainable commodities.** HSBC has developed a product – discounted finance for RSPO-certified palm oil – offered to customers since July 2014 to incentivize trade in sustainable palm oil and catalyse the achievement of RSPO certification. Any such rate would need to be competitive relative to other international and domestic banks in order to provide a lever for the transition to sustainable practice, which may require additional government interventions. In 2013, HSBC published a report predicting an increasing link between sustainability and financial performance in the palm oil sector. Under its Global Trade Finance Program (GTFP), IFC is working with the Banking Environment Initiative (BEI) to incentivize growth in the

58. See: IDH The Sustainable Trade Initiative. <http://www.idhsustainabletrade.com/sustainable-lab>

trade of sustainably produced commodities. Through the use of Sustainable Shipment Letters of Credit (LCs), IFC offers preferential terms to shipments originating from certified sustainable sources. At the time of writing this report, RSPO certified palm oil is the only commodity eligible for this programme.<sup>59</sup> However, IFC expects to include more commodities in the future. For investors, impact, thematic or sustainable investment products can be developed, along with “zero deforestation” indices against which to benchmark funds.

## SPOTLIGHT: SUMITOMO MITSUI TRUST BANK - PREFERENTIAL LENDING TERMS FOR NATURAL CAPITAL PRESERVATION

Sumitomo Mitsui Trust Holdings (Sumitomo) has developed unique financial products that are aimed at promoting the preservation of natural capital. These serve as best practice examples for developing differentiated lending and investment products based on sustainability criteria. In April 2013, Sumitomo launched a lending product that offers preferential terms to companies that are managing their impact on natural capital, as it considers these companies to have a lower credit risk. In addition, under its asset management business, Sumitomo has developed a Biodiversity Support Fund, through which it seeks to invest in companies that are either actively managing their impact on biodiversity or providing technology and services that preserve biodiversity.

### BOX VI: Top tip: Offer sustainable financing

Banks can provide financial products and services aimed at financing the production and trade of sustainable commodities. Lenders can consider offering preferential financing terms to companies involved in the production and trade of sustainable commodities in order to accelerate and enable the adoption of more sustainable business models. For example, banks may consider developing discounted finance products aimed at encouraging more rapid achievement of Roundtable on Sustainable Palm Oil (RSPO) certification. Opportunities may include forward contracts, insurance, certification or forest-friendly pricing structures.

59. See: IFC Sustainable Shipments LCs. [http://www.ifc.org/wps/wcm/connect/industry\\_ext\\_content/ifc\\_external\\_corporate\\_site/industries/financial+markets/trade+and+supply+chain/gtfp/gfm-tsc-gtfp-sustainablelc](http://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/financial+markets/trade+and+supply+chain/gtfp/gfm-tsc-gtfp-sustainablelc)

### Indicator 3.5: Controversy Involvement

This indicator considers the degree to which a financial institution has received criticism from external stakeholders such as the media, NGOs, government reports and civil society groups, as a result of lending to or investing in companies involved in environmental and social controversies related to soft commodities. The analysis relied on credible international media sources and NGOs where possible.

For most financial institutions evaluated, little or no evidence of external stakeholder criticism was found, resulting in an average overall score of 82 out of 100 (see Figure 18). For a slim majority (53%) of financial institutions reviewed, no evidence of criticism was found. These include several asset managers, such as Calvert, MN Services, and PAX. Most of the financial institutions with activities in UN-REDD Programme partner countries, including Ecobank, Banorte, BNI, AfDB, Sudameris, and Financiera Rural, have not been the subject of public scrutiny. A low level of NGO activity in the country in which a bank operates might influence the level of criticism that a financial institution receives.

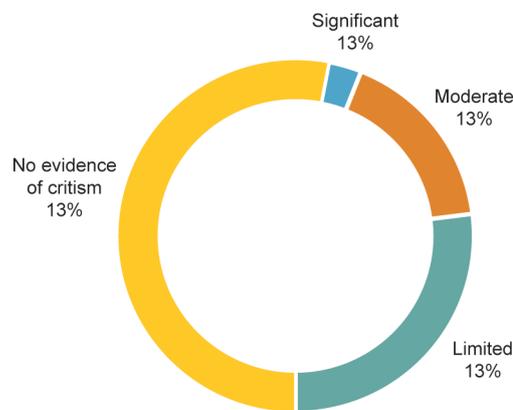


Figure 18: Level of external criticism from 3<sup>rd</sup> parties on risk policies by 30 financial institutions reviewed

**The financial institutions that received the highest level of criticism from external stakeholders were also among those with the highest level of preparedness to manage the environmental and social risks associated with soft commodities.** Frontrunner banks or fund managers that are well known may be targeted by NGOs because of their influential position in the marketplace. Criticism aimed at signalling areas for improvement can lead to stronger policies where valid and relevant. It is possible that recurrent criticism from external stakeholders over a number of years spurred financial institutions to adopt stronger policies to manage activities in these sectors and/or to strengthen existing policies. Criticism from external stakeholders can be subjective and may target an institution because of its size or the scale of its involvement in soft commodities, even if it has a higher level of preparedness to manage environmental impacts than smaller competitors.

Generally, the financial institutions that were most criticized by external stakeholders were also larger financial institutions that typically have more resources to dedicate to developing and implementing policies. In addition, NGO campaigns often target large organizations in order to attract significant attention and have greater impact. However, some financial institutions that have attracted criticism may have inadequately implemented and enforced theoretically strong policies and management systems.

**Most incidents of criticism related to loans to and/or investments in palm oil companies in Indonesia and, to a lesser degree, Malaysia.** 90% of global palm oil production occurs in these two countries.<sup>60</sup> Loans to and/or investments in Wilmar, Bumitama, and Golden Agri-Resources were frequently criticized due to the allegedly poor environmental and social track record of these companies. In some cases, major financial institutions held large amounts of shares and/or provided significant loan financing to these companies over several years, and therefore were repeatedly criticized by NGOs, particularly Friends of the Earth.

Some financial institutions responded to criticism and took action against the companies involved in controversies. NBIM divested from 23 palm oil companies, including Wilmar and Golden Agri-Resources. Although NBIM still held investments in palm oil companies, it addressed concerns about unsustainable practices. In January 2014, IFC announced that it would not continue to fund Corporación Dinant until the company strengthened its community engagement and environmental and social standards. In response, the company pledged to follow IFC's performance standards.

### **BOX VII: Top tip: Enhance disclosure**

Financial institutions can raise awareness of expectations and risk by publicly reporting on the implementation of soft commodity or sustainability policies and performance against criteria included in these policies. Fund managers could strengthen disclosure by reporting on issues engaged on, types of companies engaged with, whether or not engagement focuses on activities in UN-REDD countries, and the outcome of engagement and proxy voting activities. Reporting on risk controls could include engagement with internal and external stakeholders to rate impacts of soft commodities financing and inform a risk matrix to assess potential materiality.

### **BOX VIII: Watch the rankings**

Financial institutions can monitor the policies of 500 investors, companies and jurisdictions through the Forest 500 rankings. Based on a methodology developed by Global Canopy Programme, this website publishes information on the key powerbrokers in the deforestation-linked economy worldwide. [www.forest500.org](http://www.forest500.org)

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60. WWF (2012a)

# PART V: FRAMEWORK AND RECOMMENDATIONS

The table below outlines the framework used in the **Soft Commodity Forest-risk Assessment (SCFA)** tool, with expectations and characteristics of financial institutions evaluated against the framework criteria and scored in each of the three tiers:

*Tier 1: Best practice:* leading the way

*Tier 2: Minimum standards:* on track relative to average benchmark performance

*Tier 3: Starting grid:* needs improvement

The criteria used in the framework and SCFA tool can inform policy development by financial institutions wishing to establish or strengthen policies for soft commodities to address risks linked to deforestation and forest degradation. Expectations for average performance in Tier 2 can be considered the minimum recommendations for policies to address deforestation and forest degradation risk linked to soft commodities in line with industry norms. By meeting the expectations outlined for Tier 1, financial institutions can develop leading policies or good practice based on this framework. Financial institutions starting to develop policies should consider implementing the minimum recommendations as immediate elements of a roadmap, with a greater focus on best practice demonstrated by leaders over time. See Appendix 2 for guidance on using the tool.

Financial institutions are encouraged to see what improvements they can make in their own company as these recommendations relate directly to one of the NCD commitments, namely to “*systematically consider and value natural capital in the credit policies of specific sectors, including commodities, that may have a major impact on natural capital either directly or through the supply chain.*”

## Best practice: leading the way

	Policy Scope Expectations	Policy Strength Expectations	Implementation, Monitoring, and Reporting Expectations
<p><b>Tier 1</b>  <b>“Leading the Way”</b>  <b>(financial institutions with category scores of 66.6 - 100)</b></p>	<ul style="list-style-type: none"> <li>■ The financial institution discloses a formal policy in which it addresses the environmental and social (ES) impacts associated with specific soft commodities.</li> <li>■ The policy applies to all financial services offered by the financial institution</li> <li>■ The policy/statement applies to all stages of the value chain</li> </ul>	<ul style="list-style-type: none"> <li>■ The financial institution requires (or strongly encourages) upstream companies to achieve or commit to a time-bound plan to achieve certification under the relevant commodity roundtables — Roundtable on Sustainable Palm Oil (RSPO), Roundtable on Responsible Soy (RTRS), and Global Roundtable for Sustainable Beef (GRSB) or other credible sustainability certifications. If the financial institution’s policy applies to downstream companies, these companies are required (or strongly encouraged) to commit to increasing the share of forest risk commodities that are sourced from certified sources.</li> <li>■ The financial institution outlines several, specific environmental and social requirements.</li> </ul>	<ul style="list-style-type: none"> <li>■ The financial institution discloses implementation and monitoring efforts within the organization that are specific to soft commodities, including, for example, employee training procedures, management oversight, or regular reviews of the soft commodity policy.</li> <li>■ The financial institution discloses efforts to implement and monitor compliance with its policies within companies that it provides financial services to or invests in, specifically in relation to soft commodities. Such activities may include the development of environment action plans with companies (allowing a phased approach), engagement, screening, and audits/company visits.</li> <li>■ The financial institution, on a regular basis, tracks and reports on the implementation of its policy(ies) and its performance with respect to the commitments made in its policy(ies). Such reporting should be specific to soft commodities and address: the number of transactions, clients, etc., for which the policy(ies) has been applied; the number of employees that have been trained on the policy(ies); and reviews of policy commitments.</li> <li>■ The financial institution has developed financial products and services aimed at promoting the production and trade of sustainable commodities.</li> <li>■ The financial institution has received limited or no criticism for involvement in environmental and social controversies through investments in or services provided to companies involved in palm oil, soy and/or beef, over the last five years.</li> </ul>

Minimum recommendations: on track  
relative to average benchmark performance

	Policy Scope Expectations	Policy Strength Expectations	Implementation, Monitoring, and Reporting Expectations
<p><b>Tier 2</b> <b>“On Track”</b> <b>(financial institutions with category scores of 33.3 – 66.5)</b></p>	<ul style="list-style-type: none"> <li>▪ The financial institution discloses a general sustainability policy or detailed statement addressing ES issues broadly.</li> <li>▪ The policy applies to a subset of financial services offered by the financial institution</li> <li>▪ The policy/statement applies to a subset of the value chain</li> </ul>	<ul style="list-style-type: none"> <li>▪ The financial institution references relevant commodity roundtables and other credible sustainability certifications when assessing the performance of clients or investees, but does not require or encourage certification.</li> <li>▪ The financial institution outlines some specific environmental and social requirements</li> </ul>	<ul style="list-style-type: none"> <li>▪ The financial institution discloses implementation and monitoring efforts within the organization that are focused on ESG or sustainability more generally, including, for example, employee training procedures, management oversight, or regular reviews of the ESG policy.</li> <li>▪ The financial institution discloses efforts to implement and monitor compliance with its policies within the companies it provides financial services to or invests in, addressing sustainability more broadly. Such activities may include the development of environment and social action plans with companies (allowing a phased approach), engagement, screening, and audits/company visits.</li> <li>▪ The financial institution refers to the implementation of its policy(ies) in public company documents or on its website, but disclosure is limited and metrics are not used to demonstrate implementation, and/or disclosure does not address soft commodities.</li> <li>▪ The financial institution has not developed financial products and services aimed at promoting the production and trade of sustainable commodities.</li> <li>▪ The financial institution has received moderate criticism for involvement in environmental and social controversies through investments in or services provided to companies involved in palm oil, soy and/or beef, over the last five years.</li> </ul>

## Starting grid: needs improvement

	Policy Scope criteria	Policy Strength criteria	Implementation, Monitoring, and Reporting criteria
<b>Tier 3</b> <b>“Needs improvement”</b> <b>(financial institutions with category scores of 0 - 33.2)</b>	<ul style="list-style-type: none"> <li>■ Financial institutions in Tier 3 do not disclose:</li> <li>■ Information regarding approaches to soft commodities or sustainability more broadly.</li> <li>■ The financial services covered by the financial institution’s policy.</li> <li>■ The stages of the value chain that the policy applies to.</li> </ul>	<ul style="list-style-type: none"> <li>■ The financial institution does not refer to, require, or encourage clients or investees to achieve or commit to achieving certification under relevant commodity roundtables or other credible sustainability certifications, or there is no evidence of a policy.</li> <li>■ The financial institution does not outline specific environmental and social requirements.</li> </ul>	<ul style="list-style-type: none"> <li>■ The financial institution does not disclose any, or discloses very little evidence of implementation and monitoring efforts.</li> <li>■ The financial institution does not disclose any, or discloses very little, evidence of efforts to implement and monitor compliance with its policies within the companies that it provides financial services to or invests in.</li> <li>■ The financial institution does not report on the implementation of its policies and its performance with respect to the commitments made in its policies, or there is no evidence of relevant policies.</li> <li>■ The financial institution has not developed financial products and services aimed at promoting the production and trade of sustainable commodities.</li> <li>■ The financial institution has received significant criticism for involvement in environmental and social controversies through investments in or services provided to companies involved in palm oil, soy and/or beef, over the last five years.</li> </ul>

## FURTHER RECOMMENDATIONS TO CONSIDER

In addition to implementing measures to achieve policies that would enable a financial institution to achieve Tier 1 or Tier 2 in the above framework, further recommendations are outlined below to support innovation. These are based on suggestions from practitioners and independent experts who commented on a draft version of this study during a consultation period.

### Policy scope

- Apply policies to both upstream companies (e.g., those directly involved in growing and processing soft commodities) and downstream companies (e.g., those involved in refining, trading, manufacturing, marketing, or selling products containing soft commodities). As the requirements for upstream production units will need to be different from those applicable to downstream operations, this should be clearly defined by the financial institution.
- Policies should cover small-to-medium-sized enterprises (SMEs) to ensure systems address risk throughout supply chain, including from smallholders.
- Clearly indicate which financial activities policies apply to and how this application differs depending on the activity (e.g. investment, lending, advisory) and the geographic region.
- Fund managers can apply policies at each stage of the investment process: 1) pre-investment; 2) investment decision making; and 3) investment monitoring.

### Policy strength

- Address each soft commodity explicitly, including a description of how each represents unique environmental and social risks. The policy should cover environmental and social risks and impacts associated with forest-risk commodities.
- Identify the proportion of corporate assets that are comprised of High Conservation Value (HCV) or High Carbon Stock (HCS) forests to inform the provision of asset-backed/collateralized loans and valuations.
- Set expectations for companies to commit to a time-bound plan to achieve certification under recognized schemes where available, particularly for high-risk sectors and geographies. However, given that existing schemes are evolving, certification should be viewed as a minimum standard when assessing the environmental and social performance of companies. Where adequate national, regional or international schemes are not available, specify that commodities must be sourced via third-party verification. Advocate expansion of internationally-recognized certification schemes in specific production countries.
- Require loan terms for soft commodities producers to specify whether tenures cover a growing cycle or can be used for capital expenditure.
- Commit to achieving zero deforestation in loans and investments in UN-REDD countries by 2020.

### Implementation, monitoring and reporting

- Put in place governance structures, employee training, resources and expertise on deforestation issues, guidance documents, and policy review processes to ensure the policy is operationalized effectively and reviewed on a regular basis.
  - Monitor compliance with soft commodity policies internally and externally, and establish time-bound action plans. These may allow for “full

compliance over time” and adopt a phased implementation approach. Requirements should be included as covenants within legally-binding loan documentation. Outline clear guidelines on actions to be taken in the event of non-compliance.

- Implement a system to quantify and assess exposure to financial risks related to soft commodities. To evaluate exposure to risk and target the application of risk policies, internally capture information on the proportion of loans/investments for clients directly involved in forest-risk commodities supply chains and covered by relevant policies to address deforestation risk. This can include producers, processors, traders, buyers and retailers of goods containing forest-risk commodities.
- Allocate adequate resources to manage forest-risk commodities risk.
- Develop and externally communicate the expectation for clients to comply with all applicable local and national laws and regulations.
- Monitor client/investee uptake of internationally-recognized sustainability certification schemes.
- Explore use of geospatial information that can enable greater due diligence in identifying and assessing corporate exposure to deforestation risk.
- Banks can put processes in place to implement soft commodity policies within client or investee operations, and to monitor compliance with these policies on an ongoing basis.
  - Banks can strengthen due diligence in soft commodities to better understand customer risk policies and controls, as well as integrating forest-risk expectations in on-boarding processes.
  - Banks can implement processes to work with clients to help them comply with their soft commodity policies and fund managers can use engagement and proxy voting to highlight areas for improvement.
  - Fund managers and banks can share knowledge and learn from one another to define explicit requirements that go beyond evolving standards and are aligned with industry best practice and public policy developments. This can be based on input from multiple stakeholders, such as clients or investees, UN-REDD country governments, and NGOs.
  - Develop products and services to facilitate REDD+. For example, by strengthening environmental and social criteria and developing public-private partnerships to generate returns from the protection of HCV and HCS forested areas. Financial products such as concessional credit lines and guarantees could include environmental criteria targeting reductions in deforestation, conversion of peatlands and forest fire management. “Deforestation free” funds and indices can also be developed. Explore opportunities to develop mechanisms that support forest rehabilitation/restoration.
  - International and local financial institutions operating in UN-REDD countries could collaborate to build capacity in policy development and implementation to strengthen risk management across capital allocations to create a level playing field in preventing deforestation and forest degradation.

## Next Steps

In order to build a stronger business case for financial institutions to evaluate ecosystem impacts it is necessary to develop and test practical and where possible quantitative tools, methods and frameworks that enable banks and other institutions to integrate risks related to deforestation and forest degradation in the financial analysis of loans, bonds and equities. While the SCFA tool is qualitative, future work aims to integrate risks from degradation of natural capital into credit assessments, cash-flow analysis and other financial metrics used for everyday decisions in the financial sector. In this way, natural capital considerations may become a more integral part of financial sector decision-making.

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# APPENDIX 1: LIST OF FINANCIAL INSTITUTIONS INCLUDED

Financial Institution (in alphabetical order)	GICS Sub-industry	Market Capitalisation as of March 2014 (MM USD)	Assets Under Management as of March 2014 (MM USD)	Country of domicile	Domiciled in UN- REDD Programme Partner Country	Indicated a focus in UN-REDD Programme Partner Countries or developing markets in general	NCD Signatory	Soft Commodity Scheme Memberships (RSPO, RTRS, GRSB)
<b>African Development Bank (AfDB)</b>	Multilateral Development Bank	8,963	32,353	Ivory Coast	X	X		
<b>ASN Bank NV</b>	Asset Management and Custody Banks	543	14,549	The Netherlands			X	
<b>Banco Bilbao Vizcaya Argentaria, S.A.</b>	Diversified Banks	71,299	131,855	Spain			X	
<b>Banco Sudameris SAECA</b>	Diversified Banks	N/A	N/A	Paraguay	X	X		
<b>Bank of America Corporation</b>	Diversified Banks	184,308	821,449	United States				
<b>Banorte – Ixe</b>	Diversified Banks	20,215	80,321	Mexico	X	X	X	
<b>BlackRock, Inc.</b>	Asset Management and Custody Banks	50,347	4,324,088	United States				
	Diversified Banks	96,672	1,225, 856	France				RSPO

Financial Institution (in alphabetical order)	GICS Sub-industry	Market Capitalisation as of March 2014 (MM USD)	Assets Under Management as of March 2014 (MM USD)	Country of domicile	Domiciled in UN- REDD Programme Partner Country	Indicated a focus in UN-REDD Programme Partner Countries or developing markets in general	NCD Signatory	Soft Commodity Scheme Memberships (RSPO, RTRS, GRSB)
<b>Calvert Group, Ltd.</b>	Asset Management and Custody Banks	N/A	13 bn USD as of 2Q 2014 (Source: www. calvert.com)	United States			X	
<b>Credit Suisse Group AG</b>	Diversified Capital Markets	49,635	1,407,523	Switzerland				RSPO
<b>Ecobank</b>	Diversified Banks	1,396	22,354	Togo		X		
<b>Financiera Rural</b>	Rural government agency	N/A	N/A	Mexico	X	X	X	
<b>FMO</b>	Development Bank	2,659	8,378	Netherlands		X	X	
<b>HSBC Holdings plc</b>	Diversified Banks	183,134	921,000	United Kingdom				RSPO
<b>Industrial and Commercial Bank of China Ltd.</b>	Diversified Banks	187,868	3,162,508	China				
<b>International Finance Corporation</b>	Multilateral Development Bank	23,348	84,544	United States		X	X	RSPO, RTRS
<b>JP Morgan Chase &amp; Co.</b>	Diversified Banks	218,953	1,598,000	United States				
<b>MN Services NV</b>	Asset Management and Custody Banks	N/A	174	The Netherlands		X	X	
<b>National Australia Bank Limited</b>	Diversified Banks	71,588	161,640	Australia			X	
<b>Norges Bank Investment Management (NBIM)</b>	Asset Management and Custody Banks	N/A	5,110 bn NOK as of 1Q 2014 (Source: www. nbim.com)	Norway				

<b>PAX World Management Corporation</b>	Asset Management and Custody Banks	N/A	3.3 bn USD as of 1Q 2014 (Source: www.paxworld.com)	United States			X	
<b>PT Bank Mandiri (Persero) Tbk</b>	Diversified Banks	19,633	61,700	Indonesia	X	X		
<b>PT Bank Negara Indonesia (Persero) Tbk (BNI)</b>	Diversified Banks	7,676	31,418	Indonesia	X	X		
<b>Rabobank Group</b>	Diversified Banks	54,239	912,169	Netherlands		X	X	RSPO, RTRS, GRSB
<b>Standard Chartered PLC</b>	Diversified Banks	47,222	10,000,000	United Kingdom		X	X	RSPO
<b>State Street Corporation</b>	Asset Management and Custody Banks	28,552	2,345,000	United States				
<b>Sumitomo Mitsui Trust Bank</b>	Diversified Banks	23,845	408,478	Japan			Yes	
<b>The Goldman Sachs Group, Inc.</b>	Investment Banking and Brokerage	76,259	919,000	United States				
<b>UBS AG</b>	Diversified Capital Markets	78,270	2,508,702	Switzerland				RSPO
<b>Wells Fargo &amp; Company</b>	Diversified Banks	251,081	862,000	United States				

# APPENDIX 2: GUIDANCE FOR USING THE SOFT COMMODITY FOREST-RISK ASSESSMENT (SCFA) TOOL

## About The SCFA Tool

This flexible Excel-based tool draws from the Natural Capital Declaration (NCD) policy framework and research to assess financial institutions' policies and processes to manage exposure to deforestation and forest degradation risks associated with three soft commodities: palm oil, soy, and beef. The NCD contracted Sustainalytics to develop a research framework to create the tool. Sustainalytics conducted desk-based research and interviewed 11 financial institutions to inform the tool's development.

## This tool can be used to:

Assess your financial institution's policies and processes to manage exposure to deforestation and forest degradation risks associated with palm oil, soy, and beef, across three research categories: 1.0 Policy Scope; 2.0 Policy Strength; 3.0 Implementation, Monitoring and Reporting

Compare the results of your assessment to 30 financial institutions, which have been researched by Sustainalytics and are presented anonymously.

## How to Use This Tool

The tool and a summary version of this report is available from the NCD website: [www.naturalcapitaldeclaration.org/softcommoditytool](http://www.naturalcapitaldeclaration.org/softcommoditytool)

**Step 1:** Review the 2.0 Assessment Framework Overview and 3.0 Assessment Framework tabs. These tabs provide an overview of the individual research indicators under each of the four research categories. The 3.0 Assessment Framework tab outlines the answer categories associated with each indicator, as well as the weights and scores associated with each indicator. (Note: the indicator weights can be changed in the 3.0 Assessment Framework tab; however, the total indicator weight (cell G37) must add up to 100%.)

**Step 2:** In the 4.0 Assessment Inputs tab, under each indicator listed in row 2, choose the answer category that is best suited to your financial institution's current policies or processes. This information should be filled out across row 4, title [Your Financial Institution], using the dropdown menus that appear in the Answer Category cells. When an answer category is selected under a research indicator, the score associated with that answer category will automatically appear. The Comment Text and Source cells under each indicator heading can be used to document your work.

**Step 3:** Once the 4.0 Assessment Inputs tab has been filled out, the results can be viewed in three different formats in the following tabs: 5.0 Assessment Results – Table, 6.0 Assessment Results – Matrix, 7.0 Assessment Results – Bar Chart.

**Interpreting results:** The scores indicate areas of strengths and, where relevant, weaknesses in your institution's policies. By referring to the criteria /expectations used for each category, you can identify areas for improvement to achieve the industry benchmark (Tier 2) or leading policies (Tier 1).

# APPENDIX 3: DEFORESTATION AND FOREST DEGRADATION RISKS RELATED TO SOFT COM-MODITY VALUE CHAIN

Description of Risk <sup>61</sup>	Rationale/Example
<p><b>Legal</b></p> <p>Financial institutions that fail to manage environmental and social risks in their lending and investment activities may be exposed to legal liabilities.</p>	<p>The Freshfields Report, published by UNEP FI in 2005, concluded “integrating [environmental and social] considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.” In addition, the follow up to this report, known as Fiduciary II, found that asset managers have a duty to raise environmental and social considerations with clients, and the failure to do so presents “a very real risk that they will be sued for negligence on the ground that they failed to discharge their professional duty of care to the client.”</p> <p>In most countries, weak management of environmental or social risk by a financial institution is not illegal. Governments and central banks are increasingly introducing policy instruments and requiring credit restrictions to strengthen environmental risk management in the financial sector. Central Bank of Brazil introduced a new resolution requiring over 2,000 Brazilian financial institutions that it regulates to implement environmental and social risk policies. By 2015, they must put in place governance structures so that environmental and social factors become a core component of overall risk management.<sup>62</sup></p> <p>Banco do Brasil was sued for allegedly funding deforestation in the Amazon in 2011. Prosecutors in the state of Para said that the bank had approved 55 loans worth nearly US\$5 million to farms that had broken environmental and employment laws.<sup>63</sup> Banco da Amazonia was also sued for giving 37 loans worth US\$11 million to farms with similar violations. Prosecutors at the Public Ministry said the loans violated Brazil’s constitution, environmental laws, banking regulations and international agreements signed by Brazil. Prosecutors called for closer regulation and control of how loans are granted.</p>
<p>Regulatory and legal actions in response to environmental breaches, as well as lack of preparedness for compliance with broader changes in regulations, can adversely impact the financial position of companies involved in soft commodities. In addition, if soft commodity sectors are constrained by changes in government regulations, financial institutions may have fewer opportunities to invest in or lend to companies involved in soft commodities.</p>	<p>Several governments are developing strategies, action plans, policies and measures to build capacity to reduce emissions from deforestation and forest degradation, including vital restrictions such as moratoria on forest clearance in parts of Indonesia and Brazil.</p> <p>In January 2014, PT Kallista Alam, an Indonesian palm oil company, was fined US\$9.5 million and ordered to pay US\$21 million in compensation to the Indonesian Ministry of Environment after being found guilty of illegally clearing and burning protected swamp forests within the Leuser Ecosystem of Sumatra island.</p>

61. Risk categories developed by Sustainalytics, with the aggregation of the types of risks based on the following documents: ACCA, Fauna & Flora International, KPMG (2012); Mulder, I. & Clements-Hunt, P. (2010); Mulder, et al. (2013); PricewaterhouseCoopers (2010)

62. Robins, N. & Zadek, S. (2014)

63. BBC News (2011)

Financial institutions may be directly targeted by NGO campaigns due to their provision of financial services to companies involved in soft commodities value chains and held accountable for due diligence and risk controls in managing environmental and social impacts, including deforestation and forest degradation.

Companies that are directly involved in environmental and social controversies resulting from the production, trade or sale of soft commodities face negative impacts on share price, brand value, and social license to operate as they are held accountable for damages to third parties by media and civil society. Financial institutions may be exposed to lower returns and higher default risks as a result.

Risks for banks include potential loss of deal flow, while asset managers linked to deforestation may be disadvantaged in tendering for investment mandates with sustainability criteria. In 2013, Green Century Capital Management, the US-based investment advisory firm, coordinated a campaign with more than 40 global institutional investors with combined assets of US\$270bn, calling on the palm oil industry – and those that finance it – to adopt policies to ensure it does not contribute to deforestation, development on peatlands, or human rights violations.

In May 2014, Genting Plantations, which is involved in the development of palm oil plantations in Malaysia and Indonesia, had its membership in the Roundtable of Sustainable Palm Oil (RSPO) suspended. This followed a complaint from an NGO that accused the company of violating the RSPO Principles and Criteria.

Over the last year, Herakles Farms has repeatedly been targeted by Greenpeace due to its development of a palm oil plantation in Cameroon, and exited the RSPO process following complaints. Greenpeace has stated that the project violates local laws, and that the company has been involved in illegal deforestation. The project, which lies within the Congo Basin, has also faced significant community opposition based on concerns that it will deprive locals of their livelihoods, and was temporarily suspended in May 2013.

Fund managers and indices may exclude companies linked to the unsustainable production or trade of soft commodities. In 2012, Norges Bank Investment Management (NBIM), which manages the Norwegian Government Pension Fund – Global, divested from 23 palm oil companies. NBIM withdrew US\$314 million in investments on the grounds that “these companies’ business model is not considered sustainable in the longer term”.<sup>64</sup> NBIM stated: We sold our stakes in 23 companies that by our reckoning produced palm oil unsustainably. Before reaching this decision, we reviewed a number of companies contributing to tropical deforestation through their involvement in the palm oil industry in Malaysia and Indonesia. We contacted several of the companies to obtain information on how they managed deforestation and we placed weight on whether the companies had committed to the Roundtable on Sustainable Palm Oil.<sup>65</sup>

Criteria for Financial Services companies in indices such as the FTSE4Good Index include evaluation of their approach to environmental considerations in investments and lending. Stock Exchanges in Brazil and Colombia have joined the UN-backed Sustainable Stock Exchanges Initiative, which aims to enhance corporate transparency – and ultimately performance – on environmental, social and corporate governance issues and encourage sustainable investment.

64. NBIM (2013)

65. NBIM (2012)

Resource scarcity, biodiversity loss and ecosystem degradation can lead to decreased productivity for companies involved in the production of soft commodities.

Deforestation can contribute to land degradation. Agricultural production and overgrazing accelerate soil erosion and nutrient loss, degrading land and agricultural productivity.<sup>66</sup> Plants such as palm oil and soybean can increase soil erosion beyond the soil's ability to maintain itself. When an area is deforested for farming and vegetation is burned, this "slash-and-burn" deforestation removes nutrients and increases flooding and erosion rates. Soils often become unable to support crops in just a few years. If the area is then turned into cattle pasture, the ground may become compacted as well, slowing or preventing forest recovery.<sup>67</sup>

Deforestation costs an estimated US\$23 million a year in the UN REDD partner country Ethiopia, where crops include oilseeds.<sup>68</sup> In Mexico, another UN REDD country, agricultural expansion contributes to deforestation, which is an important driver land degradation, with costs of up to \$0.5 billion a year.<sup>69</sup>

Climate change, which is linked to greenhouse gas (GHG) emissions from deforestation, poses significant physical risks to agricultural production, including water scarcity and droughts, extreme weather and shifts in seasons.

66. See: WWF, Soil erosion and degradation. <http://www.worldwildlife.org/threats/soil-erosion-and-degradation>  
 67. Lindsey, R. (2007)  
 68. Berry, L., Olson, J. & Campbell, D. (2003)  
 69. Ibid

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***The continuing loss of the world's tropical rainforests and the resulting contribution to climate change, biodiversity loss and ecosystem degradation represents a significant threat to the security of water, food, energy, health and climate for millions worldwide. Banks and investors indirectly contribute to this when financing companies that drive deforestation and land conversion in their operations or supply chains. This can create both material risks for financial institutions, as well as business opportunities to be part of the move to curb deforestation by stimulating the creation of sustainable value chains for soft commodities. This study provides a) greater clarity on policies that banks and investors can adopt to reduce forest impacts from the production of soy, palm oil and beef; b) an Excel-based tool allowing financial institutions to assess their own policies; c) a benchmark for financial institutions by evaluating the policies of 30 financial institutions. The study and tool are produced by the Natural Capital Declaration (NCD), a unique finance-led initiative that seeks to accelerate the integration of natural capital considerations into the finance sector. The tool and more information is available from: [www.naturalcapitaldeclaration.org/softcommoditytool](http://www.naturalcapitaldeclaration.org/softcommoditytool)***