global canopy

Linking deforestation risks to investment value

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globalcanopy.org

Overview

There is growing evidence that loans to, and investments in, companies linked to deforestation can pose significant risks to financial institutions.

In this briefing, we explain the different kinds of risks that financial institutions are exposed to, how these can translate into lower loan and investment values, and how financial institutions can mitigate these risks.

Every year over nine million hectares of tropical forest are cleared[1] to make way, principally, for the production of palm oil, soya, cattle, and timber.

Growing awareness of the environmental and social costs of these activities is leading to increased governmental, consumer and other stakeholder pressure to reduce deforestation.

For financial institutions, this means there is an urgent need to more carefully identify and mitigate deforestation risks in their portfolios.

5 key risk categories for companies linked to tropical deforestation

MARKET ACCESS RISKS

POLICY RISKS

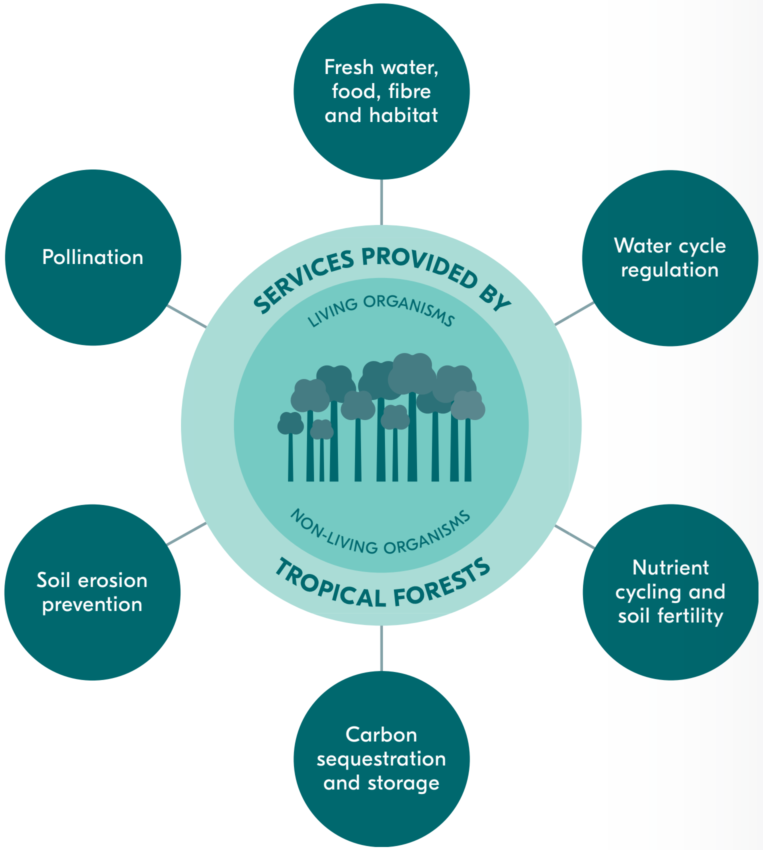
REGULATORY RISKS

REPUTATIONAL RISKS

PHYSICAL RISKS

Deforestation risks

Tropical forest services are worth an annual $4tn to the global economy[2]. Government, company and consumer actions to preserve this value lead to *transition* risks for companies connected to deforestation.



Preservation priorities: *Key tropical forest services*

1. Transition risks:

Transition risks arise from the capital reallocation decisions associated with the shift to a low-carbon and deforestation-free economy.

Market access risks

Changes in consumer and retailer choices towards more sustainably-sourced goods can quickly reduce market access for less sustainably sourced goods.

A number of companies have made zero deforestation commitments, for example through the Consumer Goods Forum and the New York Declaration on Forests. Implementation of these commitments may result in reduced access to markets for upstream companies operating unsustainably.

Rising demand for sustainable food and increasing consumer awareness of sustainability issues also pose market access risks for retailers. In the UK, 81% of consumers said they were more likely to buy from a brand with a positive approach to sustainability[3].

JBS, a major global meatpacking company operating in Brazil, lost buyers after Greenpeace showed that the company was sourcing cattle from pastures on illegally deforested land in 2012. Several retailers including Tesco, Sainsbury's and Asda dropped the company over concerns that it was not meeting deforestation-specific sourcing criteria[4].

Policy risks

Productivity and extent of land assets is a key element when valuing soft commodity producers. The introduction of more stringent deforestation policies by producers may restrict their business practices and strand existing land assets.

When Peru’s largest producer, refiner and exporter of palm oil (Grupo Palmas) published a No Deforestation, No Peat, No Exploitation (NDPE) policy in 2017, four planned projects with a total land bank of 25,000 hectares were halted. This land is now considered a stranded asset[5].

Regulatory risks

By ratifying the Paris Climate Agreement and adopting the UN Sustainable Development Goals, governments have signalled a commitment to act against unsustainable business practices.

Companies could face higher costs or fines, reduced market access and reputational damage from the stronger enforcement of existing regulation, or from new laws.

The Lacey Act and the EU Timber Regulation (EUTR) block illegal timber from being sold in US and EU markets respectively. In 2016 an injunction was filed against Fibois BV, a Dutch operator importing timber from a Cameroonian exporter identified as dealing in illegally harvested timber. The company was fined €1800 per m^3 of timber placed on the market until correct due diligence could be undertaken.

Going forward, EU operators importing from high risk countries will face regulatory and financial risks if they are unable to supply documentary proof of EUTR compliance throughout the whole supply chain[6].

New legislation and greater legislative enforcement are expected to further restrict market access for unsustainable soft commodities.

Reputational risks

Many of the companies making and selling consumer goods that contain palm oil, soy, cattle and timber have made commitments to achieve zero net deforestation by 2020. Yet huge quantities of these soft commodities are still unsustainably sourced.

In 2016, Archer Daniels Midland and Wilmar International acknowledged that consumer-demand ‘for sustainable, deforestation-free products’ posed a reputational risk to their companies[7].

Unilever suspended sourcing from Sawit Sumbermas Sarana (SSMS), an Indonesian-based palm oil supplier found to be linked to illegal deforestation. This was due to fears that links to SSMS could damage its reputation for sustainability[8].

TRANSITION RISKS

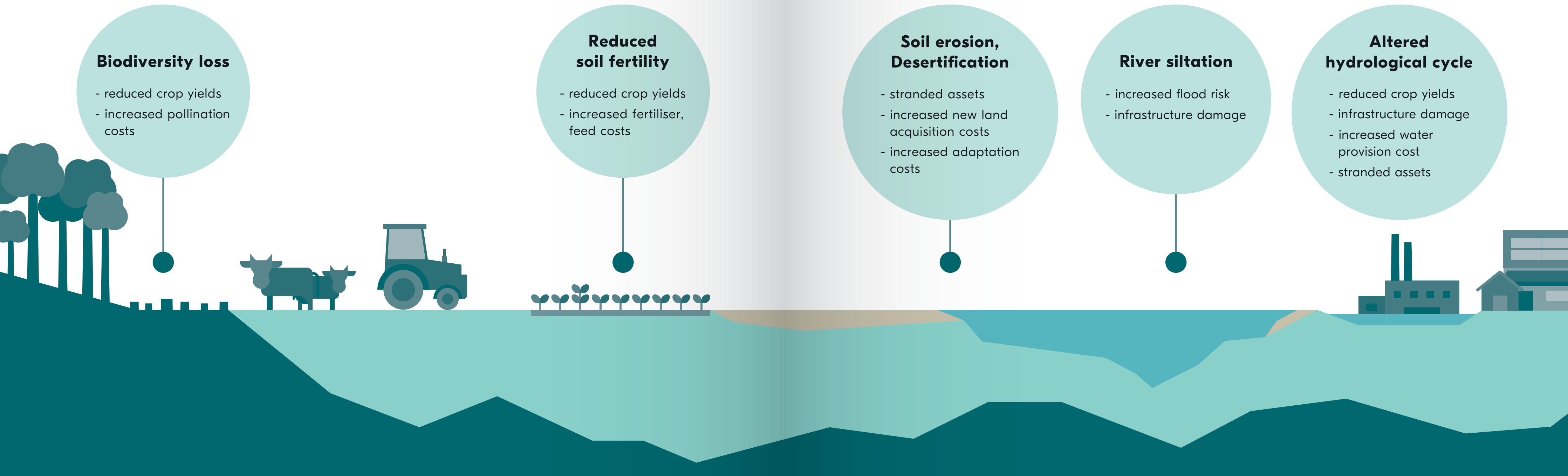
2. Physical risks

Investments in companies linked to soft commodity supply chains rely on the valuable services provided by tropical forests, such as maintaining and regulating regional rainfall, and providing soil stability and wildlife habitat. Deforestation compromises these services, driving higher costs and more volatile commodity prices.

Tropical deforestation contributes to temperature increases which are expected to impact agricultural production. A rise of 1°C in temperature is predicted to lead to an approximate 10% reduction in crop yields in some regions[9].

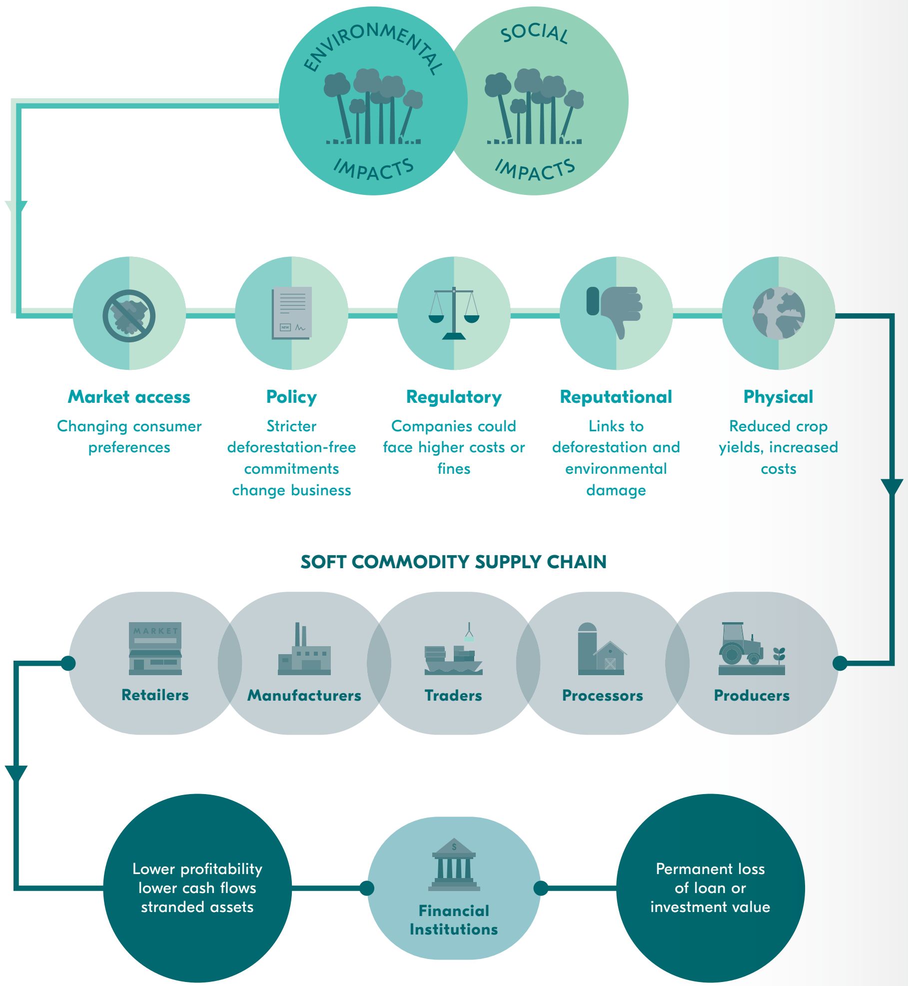
The impacts of deforestation on wildlife can affect species that play an important role in crop pollination. A study focused on coffee production found that forest-based pollinators increased yields by 20% within 1km of undisturbed forest and improved the quality of the coffee crop by 27%[10]. Where pristine forest is reduced or lost, pollinators lose habitat, affecting food production.

Growing awareness of these physical risks links back to key transition risks, through increasing regulatory, company and consumer action to reduce environmental harm. This leads to growing and further market access, regulatory, and reputational risks.



Linking impacts to investment values

Deforestation risks can result in lower profitability, reduced cash flow, increased liabilities and stranded assets.



Disclosing forest risks

CDP report that over $900bn of total annual turnover is at risk from deforestation[11]. Indeed, in 2016, over 80% of agricultural producers, who responded to CDP's forest questionnaire, reported deforestation linked impacts that resulted in substantive changes to operations, revenue or expenditure over the past five years[12].

Financial institutions also need to consider the role of deforestation in their climate impact and risk reporting commitments.

Tropical forests play an important role in regulating climate by storing carbon. Tropical deforestation currently contributes directly to around 12% of global greenhouse gas (GHG) emissions[13].

Reversing deforestation is therefore key to achieving the 2015 Paris Agreement commitment to keep global temperature increases to below 2°C.

The Task Force on Climate Related Financial Disclosure (TCFD) recognises this in its recommendations, with future mandatory climate impact reporting frameworks and carbon taxation or trading schemes likely to include deforestation.

The TCFD identifies the agricultural, food and beverage, and forestry sectors as key sectors with high likelihood of climate-related financial impacts. Companies and financial institutions involved in these sectors will have to provide specific disclosures on emissions and on managing climate change related risks if they adopt the recommendations.

Deforestation frontiers

Tropical forests continue to be lost at unsustainable rates.

Over half of the world's tropical forests have been lost to date[14]. Further deforestation on this scale will substantially increase risks faced by financial institutions.

Financial institutions increasingly need to take a global view in assessing their forest risks.

New deforestation frontiers are opening across Latin America, South East Asia, and Central and Eastern Africa in response to growing demand for food.

Unsustainable soft commodity production is increasing pressure on all tropical forests, increasing the business risks for stakeholders in these supply chains.

WWF forecast that business as usual from 2011 to 2030 would result in the global deforestation of an area equivalent to almost half the size of the Brazilian Amazon[15].

Recommendations and Benefits

Financial institutions can begin to identify and mitigate deforestation risk exposure by:

- ✓ Developing and implementing robust and explicit deforestation policies
- ✓ Incorporating deforestation issues directly into analysis and investment decision making processes
- ✓ Deepening engagement with portfolio companies connected to deforestation supply chains and setting out clear expectations on deforestation commitments

Decisive action can lead to several benefits for financial institutions:

- ✓ Strengthened and more effective corporate engagement
- ✓ Enhanced risk management and execution of fiduciary duty
- ✓ Potentially superior portfolio risk adjusted returns
- ✓ Increased transparency and strengthened client trust
- ✓ Wider contribution to UNSDGs and transition to a sustainable global economy

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GORDON AND BETTY MOORE FOUNDATION

This work is part of a collaboration among the Gordon and Betty Moore Foundation and other partners designed to eliminate the loss and degradation of tropical and sub-tropical forest ecosystems that results from the production of globally traded agricultural commodities by ensuring that key commodities (beef and soy) are sourced only from deforestation-free areas. For more information see www.moore.org.

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Global Canopy is an innovative, entrepreneurial non-profit organization. We work on the market forces driving deforestation. We focus on the corporate supply chains that are cutting forests down, and the big finance behind funding forest destruction. Our work brings unprecedented transparency to the complex global supply chains that run from farms in forest regions to consumers worldwide, and to the trillions of dollars in investment and lending that power them.