

INVESTOR BRIEF

CDP'S INTEGRATED CLIMATE CHANGE AND FOREST PILOT 2020

INTRODUCTION: CDP'S INTEGRATED CLIMATE CHANGE AND FOREST PILOT 2020

Since 2016, there has been growing consensus on stronger integration of climate due diligence in the financial sector. The Task Force on Climate related Financial Disclosure's (TCFD) recommendations have been critical in mainstreaming climate risks and simultaneously calling for relevant disclosures that assess the strategic alignment of businesses with the risk and opportunities linked to the low carbon transition.

For the financial sector these recommendations expand the focus of due diligence and reporting beyond the operational impacts of the business, to the sector's financing activities. Up to 2020, of the 300+ financial institutions that disclosed through CDP, less than one fifth reported anything on the emissions impact from their loans, investments and insurance policies; indicative of a glaring gap in the known emissions foot-print for the sector as a whole. The focus has been on addressing risks from traditional carbon intensive businesses such as fossil fuels while the direct and indirect emissions impact from other drivers such as deforestation remain under the radar. Tropical deforestation is the second largest source of emissions globally with more than 70% of deforestation linked to commercial agriculture, particularly four key Forest Risk Commodities (FRC) – palm oil, timber, soy and cattle¹. The banking system plays an important role as the main source of credit across the FRC supply chain from term loans, trade finance, revolving credit facilities, bond and fund structuring, capital raising, project finance and more². This puts financial institutions in a position of great influence which should be leveraged towards implementing best practices on deforestation management to drive change in the real economy.

As the climate crisis intensifies, regulation is emerging in different parts of the world to catalyze action. Industry groups have also assumed leadership through methodological guidance on carbon accounting from Principles of Carbon Accounting Financials (PCAF), effective target setting guidance from the Science Based Targets Initiative SBTi and Principles of Responsible Banking. The scope of ambition is expanding beyond climate and leaders are already seeking guidance from collaborations such as the Banking Environment Initiatives' Soft Commodities Compact, Tropical Forest

Alliance and the more recent Task Force on Nature related Financial Disclosures (TNFD) to integrate water, forest and biodiversity as part of the wider best practice on effective climate and environmental management.

For the financial sector, this is an opportunity to proactively undertake due diligence that can identify the complete risk and opportunity profile across their portfolios, manage exposure to high impact sectors, and leverage the opportunities of the climate transition. CDP's financial sector engagement has evolved to meet this ambition. In 2020, a new set of standardized metrics enabled financial institutions to measure and report the portfolio impacts from climate change. In parallel, CDP also created a framework to expand the climate focus to include deforestation impacts through CDP's *Integrated Climate Change and Forest Pilot*.

Building on the metrics created to gauge portfolio climate impacts for the financial sector, the pilot integrates additional metrics to identify banks' exposure to forest risk commodities. The integrated questionnaire was presented to a high impact sample of banks in South East Asia with lending exposure to palm oil, timber and rubber. This effort provides a credible framework to navigate deforestation exposure and impacts for the financial sector while simultaneously equipping all stakeholders with a baseline on current practices and plausible next steps.

The Financial Services Climate Change and Forests Pilot 2020 is the very first structured, self-reported disclosure framework for banks focused on forest impacts. This brief is an overview of this pilot process and key findings to guide investor engagement on deforestation with financial institutions.

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Convergence of Climate and Deforestation Management

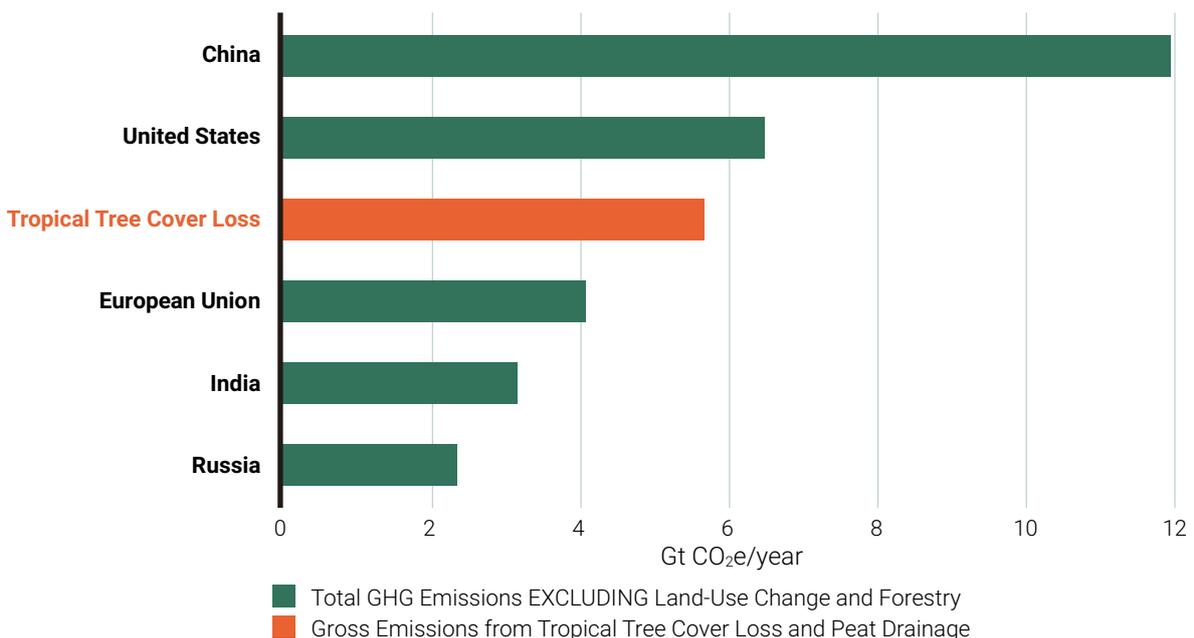
Climate change considerations sit in a range of ESG integration actions from portfolio selection, corporate engagement drivers and climate positive products. These actions are expected to amplify with the mainstreaming of Paris aligned goals and net zero climate ambitions in the last year. Against the backdrop of a uniquely challenging period of the global pandemic, businesses and economies have acknowledged the potential for systemic disruption by extra financial factors and climate change has received renewed attention. For example, net zero emission commitments, that are rooted in carbon neutrality, have grown manifold between 2019-20. More than 1,500 companies, 820 cities and 100 regions had made net zero commitments by September 2020 responding to global campaigns such as the Race to Zero³ and Climate Ambition Alliance⁴.

Halting tropical forest loss plays a crucial role in meeting these commitments. The U.N Food and Agriculture Organization estimate that around 129 million hectares of forest were lost between 1990 – 2015⁵. Over the last five years, the growing incidence of forest fires have aggravated this trend. This sustained deforestation not only impacts biodiversity and local livelihoods but also contributes to increasing greenhouse gas emissions (GHG). A special report by the IPCC on 'Climate Change and Land' highlighted that agriculture, forestry and other land use

account for 23% of global GHG emissions, the third highest emitter behind China and the United States of America. Even with all other anthropogenic emissions phased out, **'business as usual' deforestation can drive global warming above 2 degrees Celsius by 2100. Alternatively, stopping deforestation and restoration of degraded forests can contribute up to 30% of global mitigation potential**⁶. The findings of this work are critical and imply the efforts on climate stabilization won't be achieved without turning the tide on deforestation.

Addressing tropical deforestation is one of the nature-based solutions identified by the IPCC to meet net zero targets⁷ and realize the Paris Agreement goals. Over 70% of countries identified land use and/or forestry as solutions to meet their Nationally Determined Commitments (NDC). Key impact countries such as Brazil, Indonesia and Malaysia made strong commitments on deforestation to meet their GHG emission reduction targets. Regulation is following through to facilitate action, with a likely impact on sustainable sourcing and stringent land use requirements. For the financial sector this is a crucial time to scale up sustainable financing solutions to meet zero net deforestation goals while simultaneously assessing and managing portfolio exposure to deforestation.

If tropical deforestation were a country, it would rank third in CO₂e emissions



Source: Global Forest Watch, World Resources Institute, Seymour & Busch. 2016.

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Deforestation and Forest Risk Commodities

One of the leading causes of deforestation is commercial agriculture. Within this palm oil, timber, cattle and soy production are the main drivers. Direct impacts can be seen in specific regions - for instance, palm oil production is concentrated in South East Asia (SEA). The region is also witnessing significant deforestation, between 1990-2010, it lost 12% of gross forest coverage to expanding palm oil plantations. Palm is among the highest yielding oil crops and this efficiency has inflated demand for palm oil as a raw material in most FMCG products – global production quadrupled between 1995-2015 to 62.6 million tonnes and is expected to reach 240 million tons by 2050. This boom has translated into growing employment and income opportunities for the local population, and in parallel played the major role in tropical forest reduction. Unless proactively addressed, deforestation is likely to intensify further.

Agriculture value chains and drivers of deforestation are complex. To effectively address commodity-driven deforestation, we need commitment and action by all actors in these value chains. Financing is one critical lever that can driver wider adoption of sustainable production and sourcing of forest risk commodities. Banks provide a range of finance and financial services to businesses across the FRC supply chains - term loans to agricultural growers, project finance to processors, trade finance to commodities traders; and revolving credit facilities, to bond and fund structuring for corporations across a range of industries including food and beverage, chemicals, personal care, pharma, retailers and others. CDP's research indicates that bank lending is the primary source of financing for

companies in the FRC supply chains in South East Asia (SEA). Between 2010 and 2018, ASEAN Banks accounted for 56% of the financing to the palm oil sector⁸. Only 33% of these loans were committed to companies ranked in the highest sustainable band by ZSL SPOTT⁹. Together, these statistics point to the dual role that banks can play in institutionalizing sustainable forest practices while simultaneously addressing a key environmental risk within their portfolios.

Based on this premise, CDP launched a collaborative effort to create a framework to assess deforestation impacts for financial institutions, to be piloted with a select group of banks with the highest exposure to palm oil, timber and rubber¹⁰. Spread across 18 months, the initial phase was devoted to robust stakeholder consultations with 20 SEA Banks, 20 global banks, Malaysian and Indonesian regulators, institutional investors and other civil society organizations. The output is a structured, uniform and comparable disclosure framework for banks with metrics that complement the existing climate change portfolio impact assessment approach.

The participating banks were then invited to report against the resultant metrics/questionnaires – an inaugural effort to integrate FRC exposure and related deforestation management for the financial sector with climate management. This *"Integrated Climate Change and Forest Financial Services questionnaire"* (the pilot questionnaire) was well received with 10 of the 40 target banks responding to the questionnaire.

HIGHLIGHTS OF THE PILOT QUESTIONNAIRE AND DISCLOSURE PROCESS

1

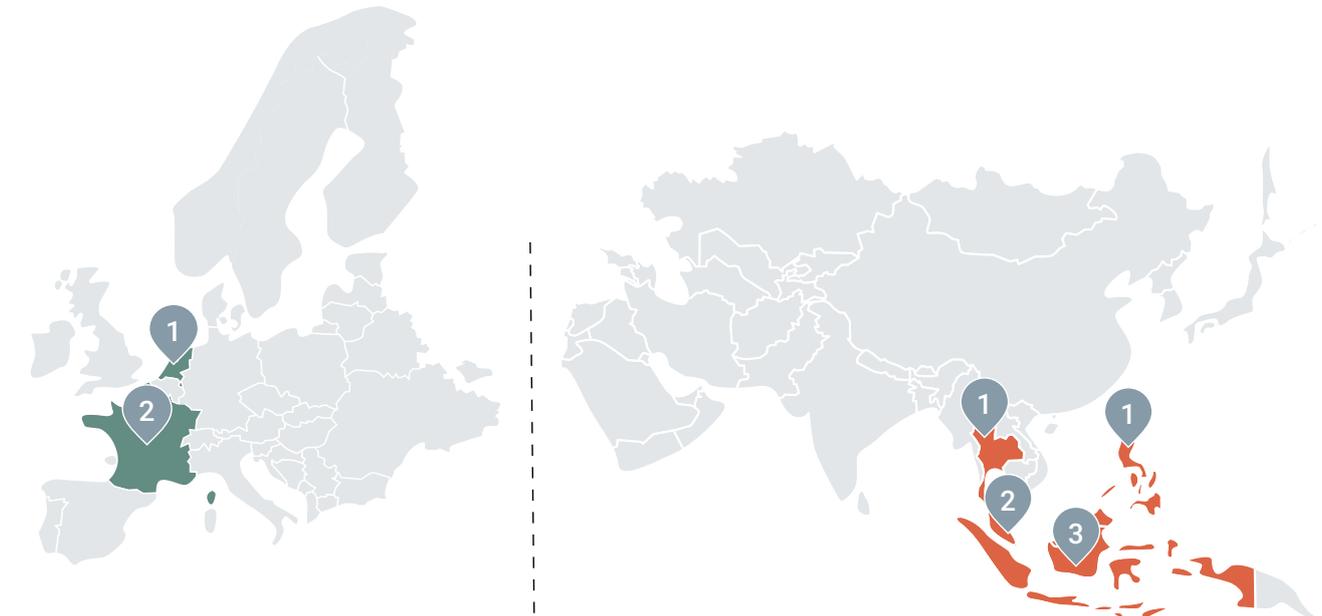
The participating banks are significant in terms of their capital exposure to FRCs and have the potential to drive real impacts. Collectively, the banks account for over 19% of all lending to the FRC sectors in Southeast Asia¹¹.

2

The questionnaire presented climate change and forest metrics for portfolio analysis, a best practice recommended by the TCFD. For European banks, who were early adopters of climate management, the forest metrics offered a useful blueprint to review forest strategy. The ASEAN banks leveraged the integrated climate and forest focus to take first steps on GHG emissions accounting and simultaneously refine the scope and coverage of forest impacts.

3

The project was executed through consistent collaboration with more than 20 key stakeholder groups – banks, investors, SEA regulators, SEA policymakers. Awareness building sessions, alignment with local regulations and credible capacity building support were well received by the ASEAN banks. Of the seven ASEAN banks that participated in the pilot, five have no history of standardized environmental disclosure through CDP; partaking in the pilot project is indicative of growing awareness on sustainable banking.



Number of banks in each country

Europe

Southeast Asia



Responding banks



Loans and advances



Lending to FRCs in ASEAN (2010-18)



% of global lending to FRCs in Asean

	Responding banks	Loans and advances	Lending to FRCs in ASEAN (2010-18)	% of global lending to FRCs in Asean
GLOBAL BANKS	3	US\$2,139,515m	US\$1,651m	2.58%
ASEAN BANKS	7	US\$439,940m	US\$10,813m	16.92%

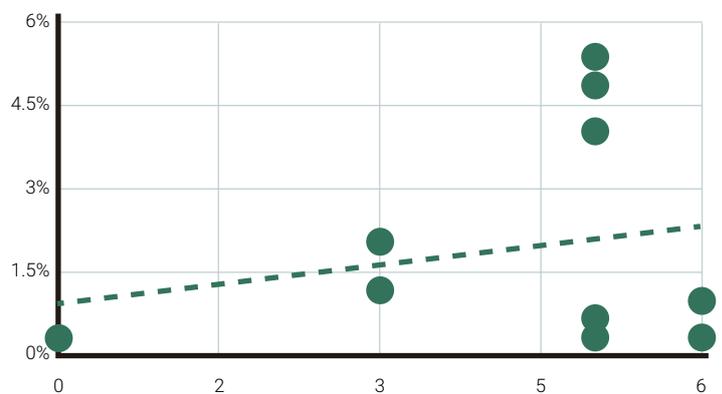
KEY FINDINGS

The integrated questionnaire allows us to compare the scope of current practices on integrating climate and forest management into core bank lending activities. With a sample size of 10 banks, the resultant disclosure data does not lend itself to intensive data analysis. However, it is a useful starting point on the baseline of existing climate and forest due diligence in bank lending while simultaneously equipping investors with data backed climate/forest engagement themes.

In general, it is encouraging to see a positive correlation between a bank's share in global FRC lending and the related disclosure on portfolio analysis. The quality of the reporting is contingent on the availability of corporate disclosures and a standardized portfolio assessment framework. Through the annual disclosure cycle and engagement platforms, CDP aims to meet both needs to ensure that that financial sector has the necessary tools to support their environmental management strategies.

Some of the trends from the project responses are assessed through the TCFD recommended disclosure themes below –

% FRC lending vs action taken



Actions taken refer to a set of metrics on portfolio exposure analysis and impact assessment in the CDP pilot questionnaire. These include FS2.3, FS 2.1, FS 2.2, FS 5.1, FS 5.1e, FS 6.1¹².



GOVERNANCE

With robust climate management systems already in place, banks are well positioned to expand the scope of climate governance infrastructure to include forest impacts. For global banks, climate issues are better managed whereas ASEAN banks do marginally better on integrating climate and forest management. Deforestation is a dominant theme in SEA and it is positive to note that ASEAN banks are cognizant of forest impacts, even if robust governance measures are yet to be established. They are uniquely positioned to leverage existing best practices on climate management and apply the same towards a streamlined climate and forest management strategy from the outset.

- Board level oversight is well established and all banks report board oversight of climate issues. On forest, only two banks did not have board level oversight, both from the ASEAN region.
- A deeper assessment of the scope of board oversight

indicate that most boards do not include climate and forest themes as standing items and prefer to address them topically. Only two ASEAN banks report that climate and forest issues are a standing item in all scheduled board meetings – here the initial focus is on monitoring and reporting climate risk, within which forestry is a priority sector.

- All banks indicate they integrate climate-related issues into their financing policy framework and almost all integrate forests-related issues. The most common way for forests-related issues to be integrated is into credit or lending policies. This is expected as commodity-specific lending policies or specific requirements of clients in FRC supply chains are a key tool for banks. However, this contrasts with how climate-related issues are integrated. In addition to credit or lending policies, banks, especially global banks, integrate climate change into their more general enterprise risk policies.

KEY FINDINGS



RISK AND OPPORTUNITY ASSESSMENT

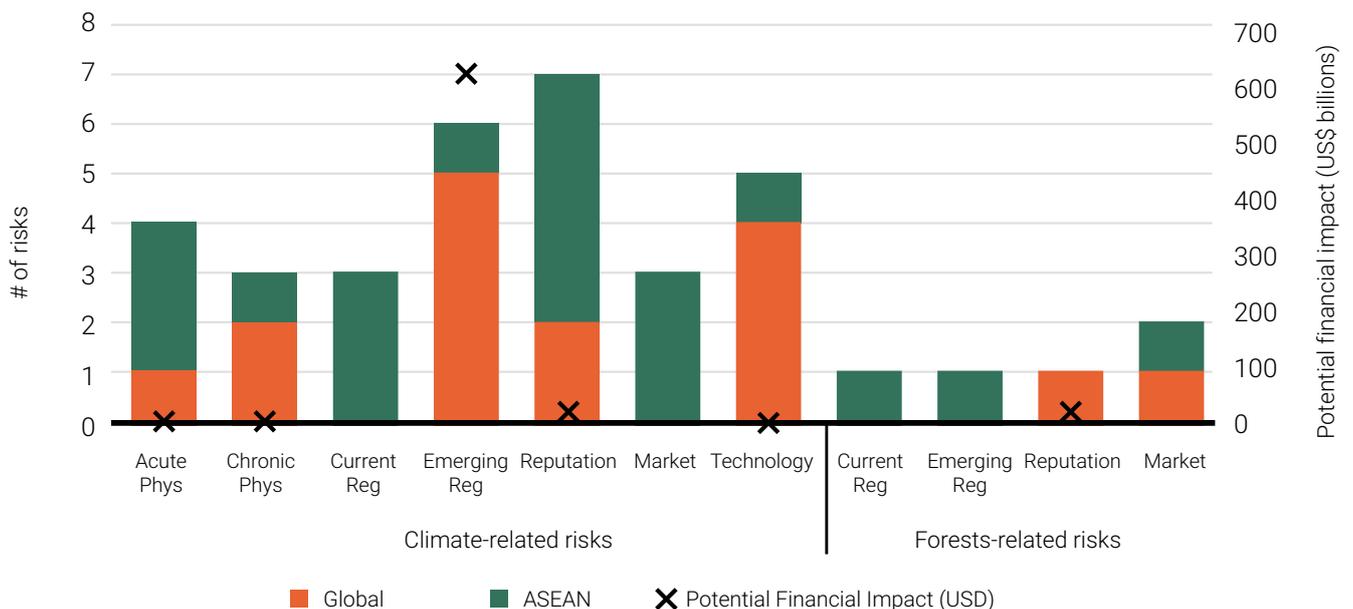
Under the TCFD recommendations, a robust assessment of climate-related risks and opportunities is crucial to guide a forward-looking climate transition strategy. In the pilot, banks reported on the existing risk assessment frameworks along with additional details on coverage and business integration. While it is a positive trend that risk assessment of financing activities is being undertaken by most banks, their scope continues to be limited to ESG specific processes and not applicable across the business.

- Majority (80%) of the banks conduct a risk assessment of their financing portfolios, equally prevalent among ASEAN and global banks. However, none of the banks have integrated the risk assessment into a company-wide enterprise risk management framework, a TCFD recommended best practice.
- An array of risk drivers are identified by the participating banks, however regulatory and reputational risks are the most commonly disclosed (regulatory risks having the highest reported potential financial impact). Banks were more likely to report

risks driven by emerging regulation than current regulation, indicating they anticipate a ramping up of environmental regulation and suggesting regulators wield considerable influence and can advance a sustainable financial system¹³. Of the forests-related risks identified, two are driven by market factors such as consumers changing behavior and demanding more sustainably produced commodities.

- Interestingly, ASEAN banks foresee the environmental risks they disclose impacting them in very different ways compared to global banks - ASEAN banks identify a potential financial impact of decreased access to capital, which is not reported by global banks. This may be partly explained by the fact capital for banks in developing markets is often provided by financial institutions from developed markets. ASEAN banks are cognizant of the reputational risks of deforestation which can impact investments from global institutions responding to tighter regulations and consumer backlash.

Primary risk drivers: climate and forests



KEY FINDINGS



PORTFOLIO ANALYSIS AND SCOPE 3 EMISSIONS

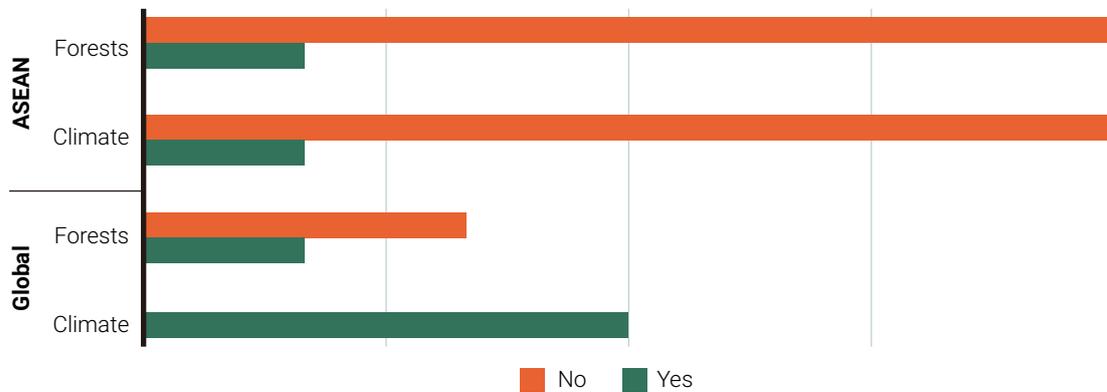
In the pilot we explore the double materiality concept, banks are requested to provide information on portfolio impact analysis and climate and forest impacts from their lending practices. Across all banks forest impacts are not prioritized and financed emissions disclosure is low as well. Relatively weak disclosure can be attributed to methodological and data gaps. Emerging methodology from the SBT FI and PCAF are now available in the market. Through client engagement on standardized disclosures, banks can drive parallel improvements in corporate reporting that can augment data availability as well.

Most banks conduct analysis on their portfolio's exposure to climate and/or forest risks. Three banks do not assess forest exposure within their portfolios.

In contrast, impact assessment of the bank's lending practices on climate change and deforestation is low. Only four of the 10 banks currently undertake a climate assessment which drops further to two for a forest themed assessment.

Only one global bank reported on scope 3 emissions from lending, which were over 400 times higher than their disclosed operational emissions. This is despite the bank only reporting on between 70% and 80% of their portfolio. Lack of disclosure among others was attributed to gaps in methodology.

Analysis of portfolio impacts on climate and forests



Sample disclosures: portfolio emissions

Operational Emissions (metric tonnes CO ₂)					
Scope 1	27334	Scope 2	35204	Scope 3	48479
Portfolio Emissions (metric tonnes CO ₂)					
Total Emissions	33410000	Coverage	70 - 80%	% Calculated using data from clients	100
Methodology	PCAF, Energy consumption data	Breakdown	Private Sector Lending, Real Estate, Agriculture Lending, SME Lending		

KEY FINDINGS



VALUE CHAIN ENGAGEMENT

Engagement with the value chain (clients, suppliers, and other partners) is a useful metric to gauge the intent and effectiveness of the bank's climate/forest management strategies. The premise of sustainable finance driving real economy impacts rests on the active role played by banks in building awareness on relevant environmental impacts, collaborating on innovative solutions and ultimately incentivizing and changing client behavior.

- Overall, banks are currently concentrating on clients operating upstream in FRC supply chains whereas suppliers, third-parties and downstream manufacturers and retailers are less likely to be included in engagement efforts.

- Banks also report on the type of engagement strategy. Among the ASEAN banks, relatively low touch themes of education and information strategy are reported by all banks. Global banks report a wider range of engagement themes including education, compliance and onboarding support, collaborating on innovations and lastly incentivizing behavior change. The best practice disclosed by a global bank is driving behavior change by dedicated engagement on climate risk exposures and through green loan products.



CONCLUSION AND RECOMMENDATIONS

The framework outlined by this integrated pilot along with the initial results from the first year of disclosure are useful tools for the financial sector, to initiate integration of climate and forest considerations into their core financing activities and in parallel exert their sizeable influence on incentivizing behavior change among their portfolio companies.

The pilot questionnaire is an ambitious step towards mainstreaming portfolio impacts of financing activities against an integrated climate and forests framework. It is also the inaugural effort on introducing a framework to measure and manage forest impacts for the financial sector. Banks play an instrumental role to enable business and subsequently their environmental impacts in the real world.

Transparency on relevant metrics, particularly on financing impacts, is the first step towards a complete assessment of exposure to high impact sectors/industries while simultaneously ensuring a data driven strategy to guide decarbonization efforts, both for the banks and through financing policies, for high impact sectors at large.

Financial sector stakeholders should familiarize themselves with the integrated climate and forest metrics to take advantage of the questionnaire as a tool to holistically navigate climate management.

The framework is a relevant tool for financial institutions in the initial stages of articulating forest strategies. Several banks that chose not to participate in the pilot disclosure, did recognize the value of the framework in guiding internal strategies and subsequent practices on climate and forest management. For financial institutions whose scope was limited to the operational climate impacts, the framework in the pilot is an opportunity to equip them for more robust standards, regulation and scrutiny on environmental impacts.

Financial institutions should refer to the metrics and best practice standards to guide portfolio impact assessment for robust reporting.

Financial sector guidance and methodologies are gradually emerging, and consistent client/portfolio engagement on relevant disclosures will facilitate more accurate assessments and monitoring of scope 3 financed emissions. These include carbon accounting for financing portfolios through the Partnership for Carbon Accounting Framework (PCAF), more robust environmental criteria in lending through the Principles of Responsible Banking, and methodological guidance on net zero ambitions through the Science Based Targets for Financial Institutions. Financial institutions that continue to limit public disclosures, both on climate and forest impacts, can no longer point to methodological gaps and can now be held accountable by shareholders/customers/clients. In the pilot disclosure, only one bank reported on their portfolio emissions, and only for climate change. Transparency on these impacts is an essential first step for financial institutions to guide net zero strategies, both for themselves and for the success of decarbonization efforts across varying sectors.

CONCLUSION AND RECOMMENDATIONS

Financial institutions are unlike other consumers of environmental data - they are uniquely positioned to influence businesses through engagement and product innovation.

This includes not only direct operations but also the supply chain to ensure complete coverage and amplify impacts on the ground. They can play an instrumental role in deepening the awareness and relevance of standardized environmental reporting among businesses, by including climate and forest assessments in their client due diligence and onboarding strategies. In spite of client engagement being an established practice among

banks, the absence of board oversight and more robust risk assessments, leaves them ineffective and calls for dedicated capacity to drive up client engagement that can prompt the adoption of sustainable business practices. These range from commitments to zero net deforestation, NDPE, no conversion of High Carbon Stock (HCS) or High Conservation Value (HCV) areas and ensuring the implementation of Free, Prior and Informed Consent (FPIC) from local communities. Ultimately, banks can transform this data to channel capital and structure financial products to incentivize sustainable production. At the moment, only a handful of global banks focus on behavior change among clients, which is best executed through green products. The transition to a low carbon economy remains unsustainable without a fundamental shift in financing practices.



References:

- 1 The Roadmap to Financing Deforestation Free Commodities, TFA and World Economic Forum, <https://www.tropicalforestalliance.org/assets/Uploads/The-Roadmap-to-Financing-Deforestation-Free-Commodities.pdf>
- 2 University of Cambridge Institute for Sustainability Leadership (CISL). (2020). Banking Beyond Deforestation. Cambridge: University of Cambridge Institute for Sustainability Leadership
- 3 The United Nations Framework on Climate Change Commitments (UNFCCC) Race to Zero campaign has set a minimum criteria to design net zero targets and calls on businesses, regions, cities, investors and civil society to commit to such targets by 2050.
- 4 <https://cop25.mma.gob.cl/en/climate-ambition-alliance/>
- 5 <https://www.lse.ac.uk/granthaminstitute/explainers/whats-redd-and-will-it-help-tackle-climate-change/>
- 6 Increasing Transparency of Banks: The Transition to Sustainable Lending to the Forest Risk Commodity Sector, CDP, 2020
- 7 <https://www.ipcc.ch/site/assets/uploads/2019/11/SRCCL-Full-Report-Compiled-191128.pdf>
- 8 <https://www.ipcc.ch/site/assets/uploads/2019/11/SRCCL-Full-Report-Compiled-191128.pdf>
- 9 Sustainability Policy Transparency Toolkit (SPOTT) Ratings
- 10 Forest and Finance, 2019
- 11 Forest and Finance, 2019
- 12 FS2.3 - Have you identified any inherent climate- and/or forests-related risks with the potential to have a substantive financial or strategic impact on your business?
FS 2.1 – Does your organization have a process for identifying, assessing, and managing climate- and/or forests-related issues?
FS 2.2 - Describe your process(es) for identifying, assessing and responding to climate- and/or forests-related risks and opportunities.
FS 5.1 – Do you conduct analysis to understand how your portfolio impacts the climate and/or forests?
FS 5.1e - Why do you not conduct analysis to understand how your portfolio impacts the climate and/or forests?
FS 6.1 - Do you engage with your value chain on climate- and/or forests-related issues?
- 13 A ramping up of regulation is evident - the UK recently became the first major government to announce mandatory TCFD regulations (HM Treasury, 2020) and the EU decreed member states must phase out their claims of emissions reductions linked to the use of palm oil-based biodiesel by 2030 (European Commission, 2018; EFCA, 2018).

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About CDP

CDP is a global non-profit that runs the world's environmental disclosure system for companies, cities, states and regions. Founded in 2000 and working with more than 590 investors with over \$110 trillion in assets, CDP pioneered using capital markets and corporate procurement to motivate companies to disclose their environmental impacts, and to reduce greenhouse gas emissions, safeguard water resources and protect forests. Over 10,000 organizations around the world disclosed data through CDP in 2020, including more than 9,600 companies worth over 50% of global market capitalization, and over 940 cities, states and regions, representing a combined population of over 2.6 billion. Fully TCFD aligned, CDP holds the largest environmental database in the world, and CDP scores are widely used to drive investment and procurement decisions towards a zero carbon, sustainable and resilient economy. CDP is a founding member of the Science Based Targets initiative, We Mean Business Coalition, The Investor Agenda and the Net Zero Asset Managers initiative.

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