FINANCIAL INSTITUTION GUIDANCE: SOFT COMMODITY COMPANY STRATEGY

Supporting financial institution engagement on deforestation risk

Comments and queries

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About Global Canopy

Global Canopy is an innovative environmental organisation that targets the market forces destroying tropical forests. Our mission is to accelerate progress towards a deforestation-free global economy - through improved transparency, innovative finance and strategic communications. Since 2001, we have catalysed new thinking and action by leading governments, companies and financial institutions worldwide. To find out more about our work visit www.globalcanopy.org

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Introduction

This document lays out the scientific and business case for how and why companies should address the risks and opportunities associated with deforestation driven by the production of soft commodities including palm oil, timber products, cattle products, and soy. It is intended that these expectations will inform and assist the engagement of financial institutions with companies around deforestation-related impacts. The expectations are aimed at the boards of companies involved in soft commodity supply chains and are a starting point for engagement between financial institutions and companies around these issues. The expectations are relevant for all companies involved in soft commodity supply chains, acknowledging that there are some sectors where risks and opportunities are more salient, and subsequent expectations are critical.

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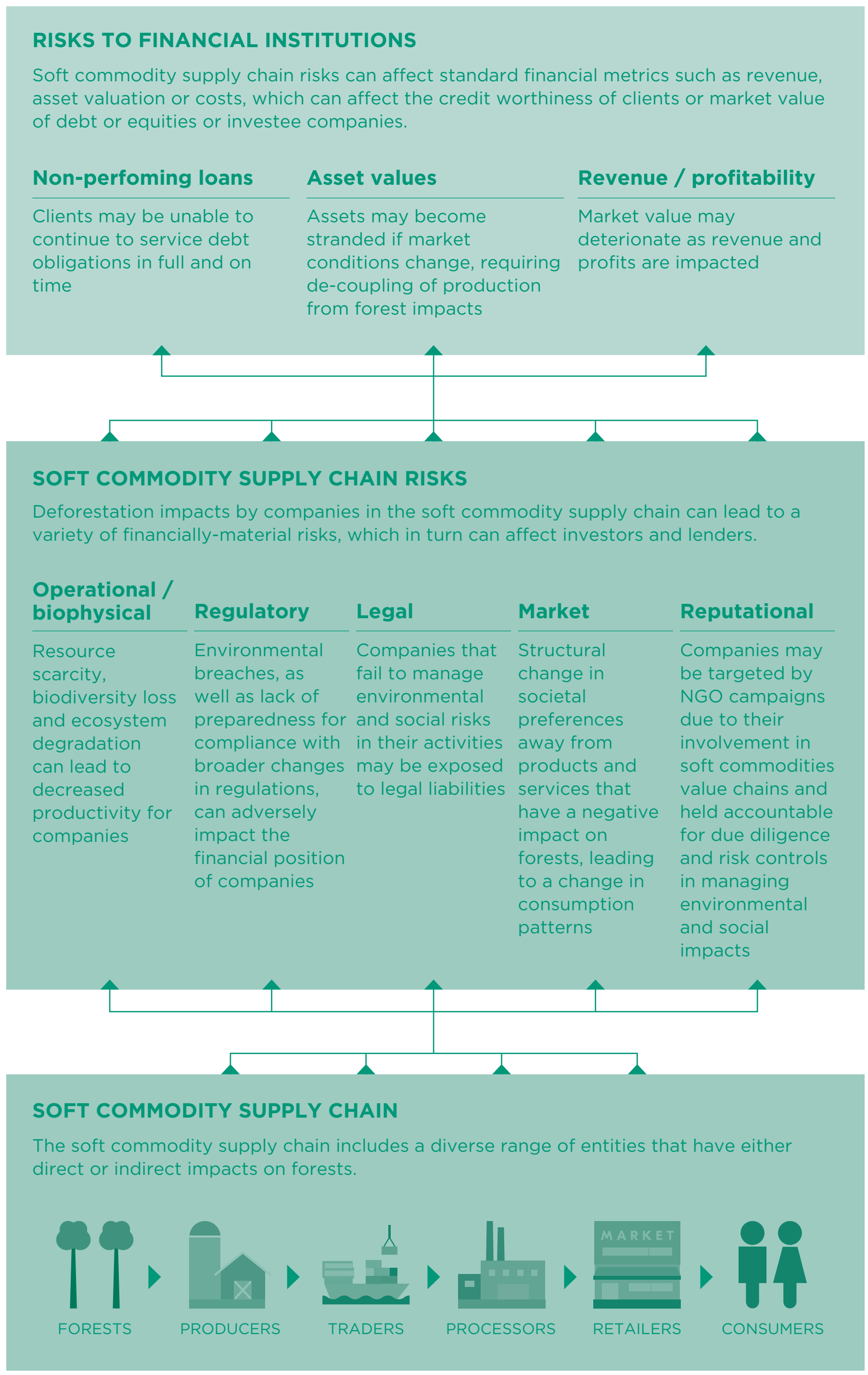
Relevance

Addressing deforestation driven by soft commodities is critical to achieving the transition to a low-carbon economy and meeting international ambition to prevent warming beyond 1.5/2°C. Deforestation and forest degradation account for approximately 10-15% of the world's greenhouse gas emissions[i]. Over the last decade, two-thirds of tropical deforestation has been caused by the production of a handful of globally traded soft commodities[ii], not only contributing to climate change but also leading to negative impacts on biodiversity and local peoples' rights and livelihoods.

In turn, these environmental and social impacts create reputational, regulatory, market and operational risk for companies exposed to these commodities. For example, local changes in climate may reduce agricultural yields, in turn reducing company profits. A company's brand reputation may be negatively affected by being directly or indirectly (i.e. through their suppliers) associated with deforestation and exploitation of local peoples' rights[iii]. These risks all have the potential to cause higher operating costs, lower margins and price volatility for investee companies[iv] (See Fig. 1).

Figure 1
The impact of finance flows on forests and the risks created for financial institutions, available from: http://www.naturalcapitaldeclaration.org/asset/download/157/NCD%20-%20SOFT%20COMMODITIES%20RISK%20%28FULL%29.pdf



The risks facing companies are not just theoretical. In 2017, 87% of companies disclosing to CDP's forests questionnaire[1] identified at least one inherent risk related to producing, marketing or sourcing soft commodities with the potential to generate a substantive change to their business operations, revenue or expenditure (Table 1).

Table 1
Percentage of 201 -
companies disclosing to CDP's forests questionnaire in 2017 that identified operational, regulatory, and reputational risks related to producing, marketing or sourcing soft commodities that have the potential to generate a substantive change to their business operations, revenue or expenditure.

COMPANY SECTOR	Operational risks	Regulatory risks	Reputational risks	At least one risk
Agriculture production	81%	75%	94%	94%
Consumer durables, household and personal products	83%	56%	94%	100%
Food and staples retailing	45%	64%	91%	91%
Industrials	72%	59%	78%	88%
Materials	82%	76%	88%	97%
Retailing	46%	62%	85%	85%
All companies	65%	62%	80%	87%

The acknowledgment that these risks have the potential to impact businesses is also evidenced by the scale of recent company commitments to remove deforestation from soft commodity supply chains - for example, the pledge made by the Consumer Goods Forum board to mobilise action by its 400+ members to help achieve zero net deforestation in soft commodity supply chains by 2020. A more recent commitment is the Cerrado Manifesto. Through the Manifesto, 23 companies pledged to halt deforestation and prevent the clearing of native vegetation in the Cerrado. Yet not all the supporting companies have put adequate deforestation policies in place. Of the 250 companies assessed in Global Canopy's Forest 500[2], over 40% have not made public a commodity-specific deforestation policy, and among companies reporting to CDP, only 13% have adopted a robust time-bound zero (net) deforestation commitment[3].

Given the potential of the operational, regulatory, and reputational risks to affect business in the mid to long term, it is important to understand a business' plan to mitigate these risks. Where gaps in management of these risks exist, financial institution engagement can help drive action and attention by companies to address these deforestation-related risks. This positive engagement therefore has the potential to increase company profits and improve returns on investment.

[1] CDP analysis draws on the disclosure from 201 companies that responded by August the 2nd 2017 to the request for information from 380 investors representing $29trillion in assets.

[2] The Forest 500 assesses the policies of 250 companies, 150 investors and lenders, 50 jurisdictions, and 50 other powerbrokers, each selected based on their exposure to forest risk commodity supply chains. Companies are scored from 0 to 100 (sometimes simplified as 0-5 based on 20 point bounds) based on the strength of their policies on deforestation. For more information see www.forest500.org

[3] That excludes high conservation value (HCV) or land under conservation and high carbon stock (HCS) land or peatland from exploitation, and which requires the free, prior and informed consent of local people to any land-use activity that affects them.

Guidance for company engagement

To ensure robust and resilient business strategies, and to encourage a smooth transition to a lower carbon economy, we have set out expectations and guiding questions for financial institutions to raise in their discussions with the board and management teams of companies in soft commodity supply chains. These expectations are intended as parameters under which to 'stress test' business strategies to prepare for future business conditions.

1. Transparency and disclosure

Companies should be transparent about the expectations and questions raised in this document so that financial institutions can use this information to identify how deforestation may affect companies' economic performance and prospects. With company information, financial institutions and third parties can hold companies accountable for the impacts of their business practices and ensure that they have an appropriate strategy to transition to a low-carbon economy.

Expectation of companies:

Have a reporting framework in place that robustly measures progress towards achieving policies and enables public reporting on an annual basis at a minimum. This reporting can be through a company's annual report and website or through platforms that help to standardise the information being reported (see box 1).

Questions for financial institutions to ask the board:

- **Reporting progress** - Is there a clear framework in place that allows progress towards achievement of policies? If so, how often is the policy reported against and is this report made publicly available?
- **Strategy adaptation** - Does the company transparently report changing goals and milestones regarding their progress to reducing deforestation-related impacts?
- **Subsidiary disclosure** – Does the company disclose all the subsidiaries that it owns or partially owns that produce or consume forest risk commodities?
- **Complaints and land conflicts** – Does the company report active social conflicts or complaints registered against them, including land, labour, and human rights disputes?

2. Board oversight and management of risk and opportunity

Risk assessment procedures should inform the response strategy formulated by companies to manage and mitigate the deforestation-related risks identified. The questions below aim to capture whether companies have adequate processes in place to mitigate identified risks and seize opportunities presented.

Expectation of companies:

Clearly define board and management governance processes to ensure oversight of risks and opportunities associated with deforestation and the transition to sustainable soft commodity value chains. Integrate the management of deforestation risks and opportunities into the business strategy and ensure business models are resilient in the face of changing reputational, operational, and legislative risks associated with deforestation. It is essential that adequate processes are in place to identify both direct and indirect risks associated with deforestation.

Questions for financial institutions to ask the board:

- **Understanding the importance of forests** - What procedures does the board employ to ensure that it fully comprehends the implications of deforestation for the mitigation of climate change as well as the impact on local water and food securities?
- **Identifying risks** - What mechanisms does the board have in place to ensure that direct and indirect deforestation risks and opportunities are identified and fully understood? Specifically, how are opportunities and risks assessed at both the company and asset level? How does the company prioritise the risks and opportunities identified?

- **Board oversight** – Does the company's board have a committee that is formally focused on sustainability issues, and if so, does the committee charter reference deforestation or deforestation related risks? Does the company link executive compensation to sustainability issues?
- **Adjusting company strategy** - What processes does the board have in place to ensure that deforestation risks and opportunities are managed through the company business strategy?
- **Adapting to changing externalities** - How does the board ensure that the company strategy is flexible to account for changing risks and opportunities?
- **Deforestation strategy** – Does the company have an overarching strategy for addressing its direct and indirect impacts on forests?

3. Company policies and strength of mitigation strategy

Once risk and opportunities are known, companies can act to ensure policies and processes adequately address the identified risks. The questions below aim to build greater understanding on how commodity-related risks are governed within a company, including what policies have been set at the corporate level and whether deforestation-related issues are integrated into company strategy and planning. The governance of deforestation issues is crucial to formulating a response to manage and mitigate the risks and to ensure opportunities associated with producing or sourcing forest risk commodities are identified and acted upon.

Expectation of companies:

Develop time-bound publicly-available policies to mitigate deforestation risks arising from business practices. These policies should prevent the loss of sensitive and globally important forests and protect the rights and livelihoods of local communities. It is essential that these policies are in place for all commodities that a company produces or procures.

Questions for financial institutions to ask the board:

- **Is publicly available** - Are these policies available publicly, and easily accessible, to enable independent verification?
- **Covers all commodities** – Does the company have commodity specific policies for all forest risk commodities that it is exposed to?
- **Is timebound** - Does the company have a timebound policy for eradicating deforestation from their production/procurement of soft commodities? Are there interim milestones that enable progress to be monitored and reported against?
- **Protects sensitive and globally important forests** - Does the company have a commitment to protect globally important forests (i.e. peatlands, High Conservation Value, High Carbon Stock)? What processes are in place to enable the identification and protection of these forest types?
- **Minimises emissions** – Does the company have a policy in place to minimise emissions associated with the production and procurement of forest risk commodities?
- **Protects the rights and livelihoods of local communities** - Does the company have in place policies that ensure the rights and livelihoods of local communities are protected, including comprehensive stakeholder engagement to achieve Free Prior Informed Consent and detailed policies on workers' rights (e.g. child labour, forced labour, freedom of association and other principles in ILO core conventions and the Universal Declaration of Human Rights)?
- **Applies to the whole business** - Does the company's policy apply to all of its business, including all business units, companies within the group and supply chains?

4. Strategy implementation

Policies can demonstrate a company's awareness and dedication to address deforestation risks in the value chain. However, risks are not addressed until there is effective implementation of the deforestation policy which requires a roadmap of specific targets, including interim milestones. The level of ambition of these targets needs to clearly reflect the urgency of global environmental challenges. Baseline and risk assessment data can support prioritisation of action in various parts of the business, in turn ensuring that targets are effective and achievable. How these targets are subsequently embedded and incentivised within the company is key. Companies should engage with their suppliers to encourage and support compliance with their standards and ultimately to meet their sustainability targets. These may include specific action plans with individual companies or the development of tools and educational information for suppliers to use.

Expectation of companies:

Establish a clear method for supplier engagement and verification of supplier compliance with the company policy. This approach should include processes for regular monitoring and support the prioritisation of further supplier engagement in problematic areas. The assurance approach (i.e. certification vs improved traceability) should be tailored to the commodity and region of business operation and sourcing.

Questions for financial institutions to ask the board:

- **Supplier selection** - Are deforestation risks accounted for during the supplier selection process? Does the company enforce procurement standards that impact commodity sourcing?
- **Certification** - Does the company use third party certification as a way to make their business practices more sustainable? If so, does the company commit to increasing the proportion of their produced/procured commodities that are 'physically' certified rather than by offsetting unsustainable practices using credits?
- **Traceability** - Does the company have a strategy for increasing traceability back to the processing facility, or, for high risk regions, origin of production?
- **Monitoring compliance** - What processes are in place to monitor supplier compliance with the company policy? How frequently is this compliance checked?
- **Verifying compliance** - Does the company use third party verification and/or undertake internal audits to ensure policy compliance? What is the process if suppliers are found not to be in compliance?

Box 1 WHAT DATA EXISTS TO MONITOR COMPANY PROGRESS?

Numerous initiatives, including Global Canopy's Forest 500, CDP's Forests program, and ZSL's SPOTT, collect information on company progress towards mitigating risks associated with soft commodity production. In February 2018, Global Canopy, in partnership with CDP, Ceres, WWF, and ZSL will be launching SCRIPT (Soft Commodity Risk Platform), a new freely-available system to support financial institutions understand and mitigate the deforestation risks associated with financing companies operating in soft commodity supply chains. The system will curate data from key initiatives to enable financial institutions to measure company progress against the framework described in this document.

Key readings

CDP (2017) From risk to revenue: The investment opportunity in addressing corporate deforestation https://www.cdp.net/en/research/global-reports/global-forests-report-2017

CDP (2016) Revenue at risk: Why addressing deforestation is critical to business success https://b8f65cb373b1b7b15feb-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/001/328/original/CDP_2016_forests_report.pdf?1482313940

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Global Canopy (2017) Linking deforestation risks to investment value. https://globalcanopy.org/sites/default/files/documents/resources/Business%20Briefing.pdf

Global Canopy and CDP (2016) Turning Collective Commitment Into Action: Assessing progress by Consumer Goods Forum members towards achieving deforestation-free supply chains. http://forest500.org/sites/default/files/gcp_and_cdp_2016_turning_collective_commitment_into_action.pdf

Global Canopy (2015) Achieving Zero (Net) Deforestation Commitments: What it means and how to get there. http://forest500.org/sites/default/files/achievingzeronetdeforestation.pdf

References

[i] Houghton, R.A., (2013) The emissions of carbon from deforestation and degradation in the tropics: past trends and future potential, Carbon Management, 4, 539-546.

[ii] CLUA (2014) Disrupting the global commodity business: How strange bedfellows are transforming a trillion-dollar industry to protect forests, benefit local communities, and slow global warming.[Online] Available from: http://www.climateandlandusealliance.org/wp-content/uploads/2015/08/Disrupting_Global_Commodity.pdf

[iii] Natural Capital Declaration (2015) Bank and investor risk policies on soft commodities. [Online] Available from http://www.naturalcapitaldeclaration.org/asset/download/157/NCD%20-%20SOFT%20COMMODITIES%20RISK%20%28FULL%29.pdf

[iv] Chain Reaction Research (2016) Noble Group: Cost of capital and deforestation risks under priced? [Online] Available from: https://chainreactionresearch.files.wordpress.com/2017/01/noble-group-report-final.pdf

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