

FOREST COMMODITY FINANCE

IMPLICATIONS FOR SOUTHEAST ASIA'S POLICY MAKERS

EXECUTIVE SUMMARY

Singapore, Malaysia and Indonesia are central to global Forest Risk Commodity production. Singapore acts as a finance conduit to many companies financing or directly involved in production whilst Malaysia and Indonesia account for between 85-90% of global palm oil production¹.

Southeast Asia
is home to

15%

of the world's tropical rainforests, around 20% of global plant, animal and marine species³ and significant stores of carbon

Southeast Asia is also home to 15% of the world's tropical rainforests² which are home to around 20% of global plant, animal and marine species³ and significant stores of carbon. Trade-offs between conservation and economic development means forests are under serious threat, with some parts of Indonesia and Malaysia projected to lose up to 98% of their remaining forests in the next nine years⁴.

This policy brief uses a novel approach to assess and understand the risks faced by Financial Institutions (FIs) and Forest Risk Commodity (FRC) producers from climate and land use change. The findings quantify the expected aggregate impact of forest and climate change risk on the near-term financial performance of the sector, which result in increased Probability of Default (PD) if the risks are not mitigated. The analysis highlights the most influential intervention points to minimize risks, which also contribute to decoupling forest and climate change risk from economic growth.

Many risk modeling approaches are based on historic trends. Due to the evolving nature of forest and climate riskⁱ, those methods can mis-estimate the true impacts. In this analysis KPMG's Dynamic Risk Assessment (DRA) relies on expert elicitationⁱⁱ and network theory to identify and generate an interconnected assessment of risks, it is an alternative method which overcomes data limitations. The method taps into the knowledge and experienceⁱⁱⁱ of finance and commodity market experts to generate a list of key risks from which the likelihood, severity, near-term scenario, velocity and connections are established⁵.

The analysis identified 19 individual risks relevant to finance and production of Southeast Asian FRCs. Within this four key clusters of risks are expected to rapidly affect each other in a cascading effect when any individual risk is triggered. The risk clusters are:



Political Scenarios



Concentration Risk



Customer Sentiment



Fire Risk

i. Hence the requirement for Expert elicitation.

ii. Expert elicitation is used when data is not available, of poor quality or past data is not expected to be representative of the future.

iii. How experts assimilate information. They are (i) experienced, (ii) widely read, (iii) adjust their views to new information, (iv) open-minded and (v) self-correcting. As such, they sense all the time whether they may need to readjust their views, which refers to their sensing capacity.

The analysis predicts that Fire Risk has the potential to affect FRC producers' revenue by 24% and the Concentration Risk^{iv} cluster can reduce revenue 22% within a period of 33 months should any one of the risks be activated.

These clusters pose the greatest material risk to banks due to the expected and significant impact on the possibility of stranded assets, loss of biodiversity and ecosystems collapsing, which in turn increases the Probability of Default. This will impact a borrower's cashflow and consequently repayments to the lender. Deteriorating repayment capability and increased impairments are to be expected with possible repercussions for FRC producers in terms of future access to capital and availability of funding for sustainable and profitable forest commodity production. This affects lenders' returns, especially when the cumulative impact of lending to many FRC producers (which is common) is considered. Repercussions include negative impacts on the health and stability of local communities and national economies relying on the FRC sector and impacted by the banking sector. This is particularly relevant for Malaysia and Indonesia.

The list below reveals the seven most influential individual risks from the risk list. The most efficient mitigation strategy to reduce risk across the entire network of nineteen risks is to prioritize mitigating:



We recommend four immediate actions to support policy makers, regulators and FIs to understand and manage forest and climate change risk:

- 1 Promote & improve meaningful and integrated disclosures** - improved disclosures on climate change and forest risk, that are integrated with financial disclosures, allows for better decision making, monitoring and assessment of risk by both FIs and regulators.
- 2 Assess risks holistically instead of individually** - quantify linked risks using financial models to understand and manage their magnified aggregate outcomes.
- 3 Implement mitigating actions that target the most influential individual risks** - including *Climate Change, Ethical & Sustainable Supply Chains, Pace of Regulation, Rule of Law, Political Situation, Fire Risk and Transition Pathways*. Such actions translate primarily into enhanced disclosures and due diligence practices.
- 4 Focus on preventing impactful risk clusters from materializing** - bring *Biodiversity and Concentration, Reputation Issues and Changing Customer/Community Attitudes* to the top of the agenda for policy makers, regulators and banks.

iv. The 'Concentration Risk cluster' includes Biodiversity and Concentration, Climate Change and Vulnerability to Pests and diseases

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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 2021, 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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