FORESTS AND SUSTAINABLE FINANCE
THE ROLE OF CHINA

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CONTENTS

Authors

Yue Qi
CDP China Senior Policy Manager

Helen Finlay
CDP Global Senior Policy Manager

Contributors

Fei Li
Interim China Director

Viera Ukropcova
CDP Senior Project Officer, Forests

Davide Cerrato
CDP Senior Policy Manager, Sustainable Finance

Chenguang Zhao
CDP China Policy Manager, Sustainable Finance

Acknowledgements

Pietro Bertazzi
CDP Global Director, Policy Engagement

Sareh Forouzesh
CDP Associate Director, Forests

FOREWORD

Pietro Bertazzi
Global Director,
Policy Engagement

Fei Li
Interim China Director

Forests are natural carbon sinks and are vital to remove greenhouse gases and achieve carbon neutrality goals. They provide important habitats for biodiversity, which ensures greater climate resilience and the provision of goods and services from ecosystems to support water and food security.

Tropical forests in particular contain the highest rate of biological diversity in terrestrial ecosystems, home to more than 60,000 kinds of trees, 80% of the amphibians, 75% of birds, and 68% of the world's mammals. Yet critical forests were lost at alarming rates between 2015 and 2020, with the rate of global deforestation estimated at 10 million hectares per year[1].

Among the drivers of deforestation, forest-risk commodities, including soybeans, palm oil, beef and timber, are responsible for at least 40% of global deforestation and around 2.6 gigatons of annual CO_2 emissions - or 5% of the global GHG emissions[2]. Research shows that even if all the other anthropogenic GHG emissions are curbed, as long as the business-as-usual pathway for deforestation continues, we could not achieve the 2°C goal by the end of the century[3].

2021 is a critical milestone for nature, which will be at the heart of two key multilateral environmental processes at the COP26 of the United Nations Framework on Climate Change (UNFCCC) and the COP15 of the Convention on Biological Diversity (CBD). This is a pivotal moment to promote policy ambition and increase action to halt the financing of forest-risk commodity businesses associated with deforestation. Chinese policy makers are key players, both at the national level to facilitate an enabling policy environment for deforestation-free financing, as well as the international level to address deforestation risks in global forest-risk commodity value chains.

CDP invites Chinese financial institutions and companies to respond to this challenge, working together with CDP to halt deforestation driven by forest-risk commodity, mitigate the financial risks of deforestation, and to seize opportunities in the green recovery for a sustainable and low-carbon economy.

CHINA'S ROLE IN DRIVING SUSTAINABLE FINANCE

Demands from the Chinese market are driving the rapid increase of forest-risk commodity production[4]. China is now the world's largest importer of soybeans (60%) and timber (33%), as well as the second largest importer of palm oil (12%) and beef (17%)[5]. If deforestation is not addressed in these supply chains, China's high dependency on imported forest-risk commodities threatens the stability of its food security, potentially harming its economic growth, and undermining its climate leadership ambition.

Chinese financial institutions play a crucial role in creating incentives for sustainable forest-risk commodity production and trade through their investment and lending practices. Setting sustainable industry standards is also important for their bottom line; recent CDP research shows that if deforestation risks are not better understood and managed by financial institutions, exposure to forest-risk commodity businesses may risk significant and imminent credit losses[6].

Awareness of environmental, social and governance (ESG) issues has increased in China, driven by policy initiatives to promote green finance and to increase the globalization of China's finance market. ESG investing totals more than $30 trillion globally[7], however, disclosure of ESG by Chinese companies remains low, hindering their ability to access ESG-linked financing. As the participation of foreign investment in China's market rises, Chinese companies are likely to face greater scrutiny if they wish to take advantage of international financing.

OPPORTUNITIES FOR CHINA TO RATCHET UP AMBITION TO PROTECT GLOBAL FORESTS

Mitigating deforestation along forest-risk commodity value chains is in line with China's pursuance of global ecological civilization and the community of a shared future for mankind, as forests are a key pillar in achieving global climate and biodiversity goals. There are important policy milestones in 2021 for China to step up action to address deforestation in its value chains, including developing the Post-2020 Biodiversity Framework, integrating its recent carbon neutrality commitments into policy, including in China's 14th Five-Year Plan, and enhancing green partnerships with other countries and regions.

On 22nd September 2020, China's President Xi Jinping announced that China aims to achieve carbon neutrality before 2060 at the UN 75th General Assembly[8]. Carbon sinks play an indispensable role in achieving the carbon neutrality vision, while forests, as one of the key pillars of nature-based solutions (NbS), offers huge potential for carbon mitigation and sequestration. Building on the work as co-lead of the Nature-based Solutions Coalition during the 2019 UN Climate Summit, where a manifesto and collection of best practices to promote NbS were issued[9], China could signal the importance of reducing deforestation in forest-risk commodity value chains by addressing target 3: "*generate the shifts needed in domestic finance to value nature…green supply chains… and promote green finance*".

As the presidency of the China Banking and Insurance Regulatory Commission (CBIRC) COP15, where a new framework for Post-2020 Biodiversity actions will be developed, China is seeking for ambitious but pragmatic proposals to enrich the final outcome. Almost all the previous Aichi targets, which ended in 2020, failed to be achieved[10], including target 4: "*Governments, business and stakeholders at all levels have taken steps to achieve or have implemented plans for sustainable production and consumption and have kept the impacts of use of natural resources well within safe ecological limits*."[11] An ambitious post-2020 global biodiversity framework requires a strengthened role for the private sector, as proposed in the draft negotiation text- "*reform economic sectors towards sustainable practices, including along their national and transnational supply chains, achieving by 2030 a reduction of at least [50%] in negative impacts on biodiversity*". It is also expected that corporate environmental disclosure is enshrined in the final text of the framework, promoting transparency in forest risk commodity supply chains and fostering the integration of environmental protection assessments in business operations.

On 14th September 2020, during the virtual meeting between President Xi Jinping and the EU leaders, a high-level dialogue on environment and climate was launched. Xi underscored that China and EU should strengthen their bilateral green partnership and constructively engage in multilateral mechanisms to combat global issues of climate change and biodiversity loss. As China and the EU are the top two forest-risk commodity importers, joint policy efforts on promoting deforestation-free value chains will positively reinforce the efforts of one another.

CHINA'S GREEN FINANCE POLICY LANDSCAPE

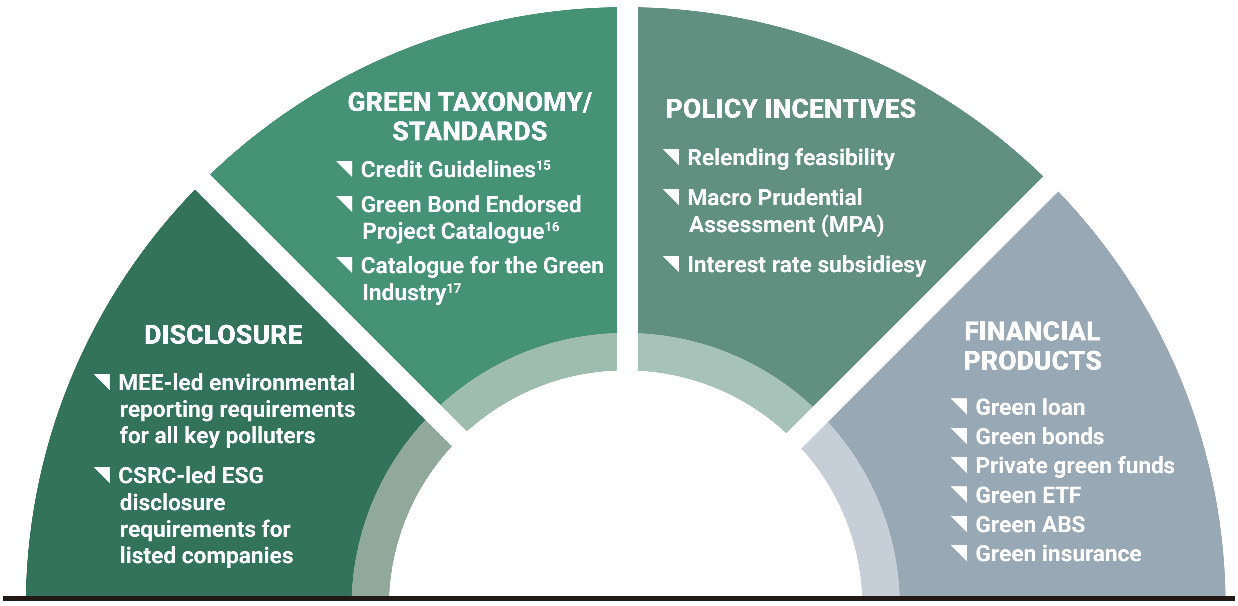
Green finance has developed rapidly in China in recent years to support the efforts on reducing pollution, combating climate change, as well as protecting ecology and the environment. In 2016, the Chinese government published the *Guidelines for Establishing the Green Finance System*.

A green finance policy system was then established with four key pillars, including the green taxonomy/standard, disclosure, policy incentives, and financial tool innovation (Table 1). In July 2020, China's first dedicated environmental fund, the National Green Development Fund Co., Ltd., was launched by the Ministry of Finance, the Ministry of Ecology and Environment and Shanghai Municipality. It is designed to support the "green transformation" of the Chinese economy and has already raised 88 billion RMB.

With the enhanced ambition to tackle environmental challenges at both global and national levels, Chinese financial regulators have attached greater importance in managing environmental and climate financial risks. The People's Bank of China (PBoC) recommends improving the identification, early-warning and forward-looking responses to climate-related risks by building methodologies and tools, promoting the implementation of a unified green standard, and encouraging financial institutions to incorporate climate-related risks into risk management frameworks[12]. After the announcement of enhanced 2030 climate commitments and the 2060 carbon neutrality vision, the PBoC has also shown greater ambition in facilitating the green recovery and green transition[13].

As the green finance policies evolve with the ambitious environmental agenda, more financial resources will be mobilized to sustainability-related area, and it is expected that deforestation-free finance could facilitate China to decouple deforestation with its global forest-risk commodities value chains.

Guidelines for Establishing the Green Finance System (2016)[14]



RAISING THE BAR ON GREEN TAXONOMIES

To ensure finance is in line with targets of deforestation-free forest-risk commodity value chains, the first step is to translate the ambition into taxonomies that guide financial decisions.

In May 2020, the PBoC, NDRC, and the CSRC jointly published a new version of Green Bond Endorsed Project Catalogue for public consultation[18]. It is built on the 2019 version of Green Industry Guidelines, 2015 version of Green Bond Endorsed Project Catalogue, and the Green Bond Guideline, and aims to provide a unified standard for green bond issuers. Under section 4 on Ecology and environment industries[19] it cites "*…The trading activities of green commodities are mainly applicable to agricultural products with sustainable certificates obtained by relevant international certification systems, including but not limited to sustainable Palm Oil Roundtable Initiative (RSPO), Responsible Soybean Roundtable Association (RTRS), Forest Stewardship Council Certification (FSC).*"

In June 2020, the CBIRC updated the Green Finance Statistic System[20], explicitly listing requirements for green goods trading. This new system includes article 8.6.1 that identifies soybean, palm oil, timber, beef, cocoa, and rubber as high environmental risk commodities, whilst further acknowledging certification by RSPO, RTRS, and FSC for green commodity labelling. These efforts have laid the foundation to further incentivize deforestation-free finance. Chinese financial regulators can build on this standard setting in the up-coming renewal of green taxonomies, focusing on transparency, traceability, minimizing environmental impacts, and certification.

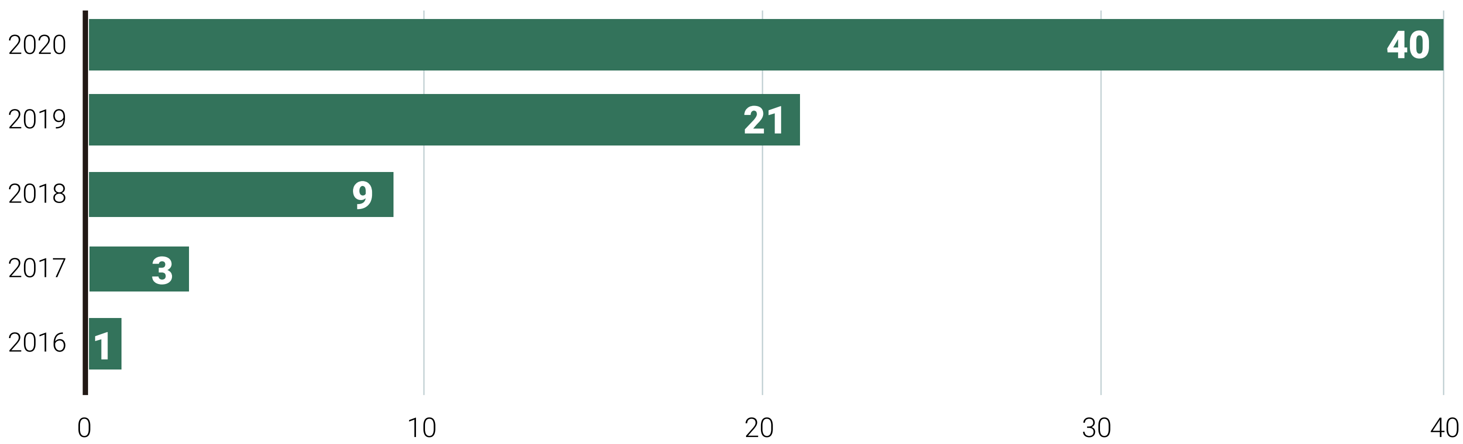
China and the EU are currently working on the 'common ground taxonomy' under the International Platform on Sustainable Finance (IPSF)[21], which provides a strong entry point for the top two global importers of forest-risk commodities to align and support one another on sustainable finance policy. Cooperating with other key consumer countries will be important to develop common and unified taxonomies/standards for sustainable commodities; integrating best practices would also send consistent signals to the producing countries to help avoid 'leakage' of deforestation.

POLICY ON CORPORATE ENVIRONMENTAL DISCLOSURE

Chinese companies' awareness of and capacity to address deforestation issues along its value chain is still lagging. Comparing with the 2020 global disclosure rate of 32%, the disclosure rate of Chinese companies responding to CDP's Forests questionnaire was only about 14.7%, which is not commensurate to China's market share of forest-risk commodities, nor in line with its climate and biodiversity leadership. The urgent need for Chinese companies to take-action is clear.

CDP believes that disclosure is the bedrock of action; it is a natural starting point for Chinese companies wishing to address their environmental impacts and prepare themselves for the inevitable trends of a green transition. It is encouraging to see that the number of Chinese companies reporting to CDP's forest questionnaire has rapidly increased over the past five years (see figure 1), demonstrating the increased importance placed on transparency. We expect and recommend more Chinese companies to start their deforestation-free journey with CDP through disclosure, and further to manage deforestation risks as well as identify and seize the opportunities in the deforestation-free transition.

Figure 1: Number of Chinese companies reporting to CDP on forest



Mandatory environmental disclosure requirements for listed companies is a priority in the development of the Chinese government's green finance policies, representing one of the strongest drivers to enhance data quality and availability to inform deforestation-free finance. Regulators should require financial institutions and listed companies to disclose environmental performance, including soft commodity driven deforestation where applicable, with the goal of promoting transparency of the soft commodity supply chains and to better inform financial decisions.

To aid in this task, regulators and institutions should employ the framework of the recommendations of the Task Force on Climate-related Disclosures (TCFD). The recommendations cover a wide spectrum of issues, most of which relevant for the soft commodities sectors, and both water and land use figure among the main categories of climate-related metrics and associated risks identified[22].

The TCFD has developed supplementary, sector-specific guidance, focused on the agriculture, food and forest products industries, as well as outlining specific climate-related risks connected to these sectors. The guidelines stress that the assessment of these risks "*involves a number of interactions and trade-offs among the climate-related aspects of land use, water, waste, carbon sequestration, biodiversity, and conservation, complicated by short-run competing goals around food security*". This goes to show the complex and interdependent nature of the risks associated with these sectors and highlights the need for stronger disclosure.

Based on the data obtained from their invested companies, financial institutions would be able to carry out scenario analyses of their investment portfolios, to identify their physical, regulatory, legal and reputational exposures to forest-risk commodities, as suggested by the TCFD guidelines for financial institutions themselves. This, in turn, would help regulators identify the best areas and tools of policy intervention to minimize the systemic risks stemming from deforestation.

Aligning to a universal framework will have the added advantage of helping reduce the reporting burden of Chinese companies and providing comparable information to global investors, considering the increasing numbers of national governments that have recently endorsed TCFD's work, and even started mandating reporting based on its recommendations (see box.1).

Box 1: TCFD recommendations and countries adopting TCFD-aligned disclosure requirement

The Task force on Climate-related Disclosure (TCFD), established by the G20 Financial Stability Board, has established a disclosure framework to manage environmental information flows to financial institutions, and their work has gained widely support globally.

- In September 2020, New Zealand announced it will become the first country worldwide to implement mandatory TCFD reporting for large banks and insurers – a step that would ensure that around 90% of assets under management in New Zealand fall under TCFD reporting as soon as 2023.
- In November 2020, the UK became the first G20 country to set out its intention to mandate TCFD-aligned climate-related disclosures across the economy with most measures in place by 2023 and full coverage by 2025.
- In May 2020, the Canadian government made TCFD-reporting a requirement for large companies to access COVID-19 emergency loans under its Large Employer Emergency Financing Facility (LEEFF)[23].

DEFORESTATION RISK ANALYSIS AND INVESTMENT DECISION MAKING

The risks of inaction on deforestation are materializing and have been identified by the business sector across all forest-risk commodity supply chains. According to 2020 CDP data, an increasing number of companies are reporting risks of inaction on deforestation (see Figure 2), along with an increasing average impact of risk.

Globally, the largest risk identified by companies was of reputational and market nature, resulting in a potential financial impact of US$ 34.9 billion; followed by physical risks, regulatory risks, and technological risks amounting to US$ 12.7 billion, US$ 5.4 billion, and US$ 0.2 billion, respectively (see figure 3).

Figure 2: Maximum potential financial impacts of inaction on deforestation reported by companies to CDP

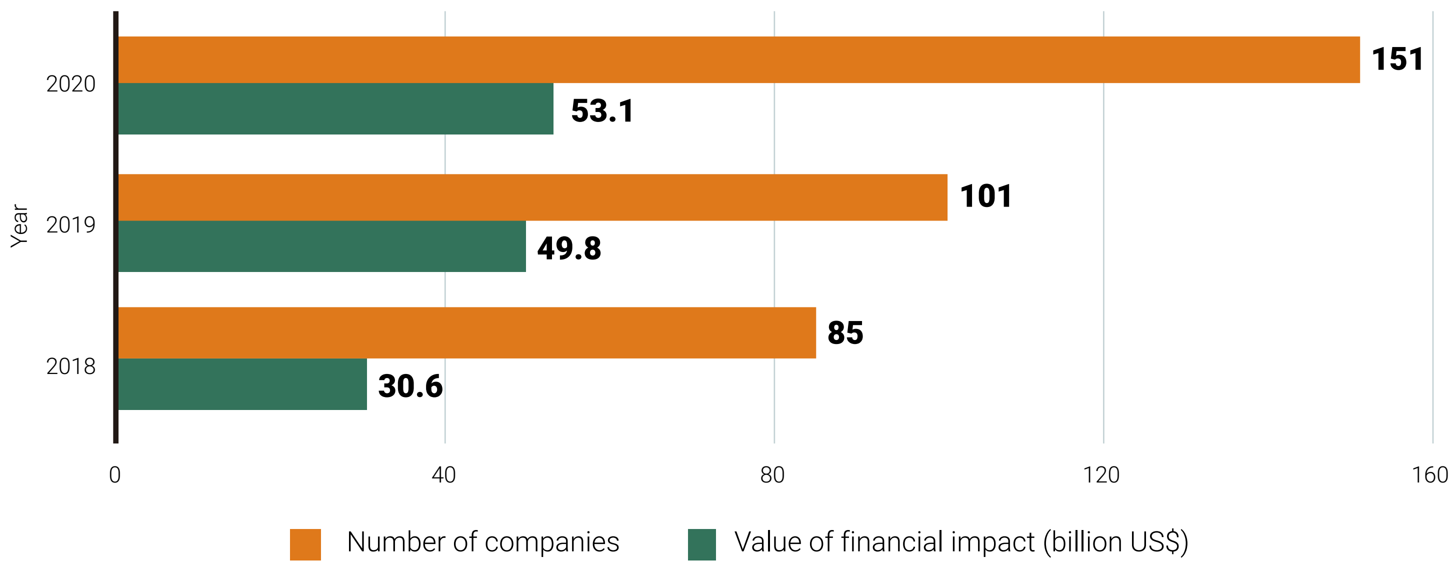
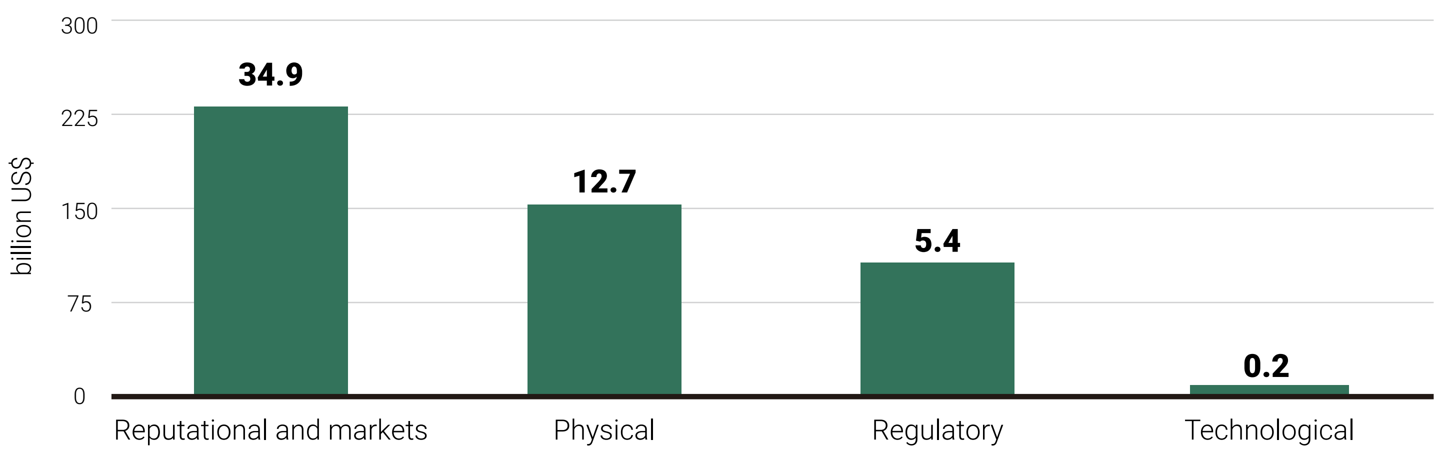


Figure 3: Estimated financial impacts by type of risks



> Risks associated with soy extend from the producers through trading companies to the manufacturers and retailers that consume them, risking potential business losses. Financial institutions invest in and lend to companies involved in the soy supply chain, exposing themselves to deforestation risks. According to CDP's assessment, at least $2.1 billion US$ of loans made by Chinese financial institutions to Chinese companies within the soy supply chain are exposed to deforestation risks, representing 40.1% of total loans provided to the sector; 7.1 billion US$ of bond and share issues are exposed, as are 1.55 billion US$ worth of shares. However, none of the financial institutions identified has assessed its capital exposure related to deforestation risks, nor have any developed dedicated policies to address deforestation risks. Only 23% (8 out of 35) have a policy in place to integrate general environmental considerations into financial decision making.

Chinese financial institutions still lack awareness on the risks of financing forest-risk commodity businesses, which is why clear policy signals and incentive measures are needed. Chinese financial regulators could set relevant indicators in the evaluation system for green finance performance and recommend best practice cases and tools to financial institutions to build capacity to manage the financial risks posed by deforestation associated with forest-risk commodity value chains.

CDP's integrated questionnaire for the financial service sector (see annex), which is developed in line with TCFD framework and recommendations, is a useful tool to support financial institutions to undertake scenario analyses on their exposure to forest risk commodities from a physical, regulatory, legal and reputational perspective, and to inform their respective institution's strategy and portfolio in the medium to long term.

CONCLUSION

The world is facing multiple, interdependent global crises, where dislocation in one area can ripple through and impact many others. The pandemic highlights how interconnected we are, and how impossible it is to disentangle the problems we all face in a globalized world. Despite huge challenges to re-boost economic development from the effects of COVID-19, there is an opportunity for recovery pathways to be inclusive and sustainable.

To realize these ambitions, it is necessary that the public and private sectors work together to promote a green recovery from COVID-19 that is in line with a new circular and regenerative economy. This is in line with statements from the Secretary General of the United Nations, Mr. Guterres, and G20 financial Ministers, who call for a green recovery that is inclusive, environmentally sustainable and focused on long-term impact[24][25].

While it will be important to think of new ways to address the effects of the pandemic, a framework response for sustainable development already exists with the Paris Agreement targets and the SDGs. Building on the achievements in developing green finance and exploratory work in supply chain innovation, deforestation-free finance is an excellent opportunity for China to deepen international cooperation with key partners and lead the global green recovery.

Policy Recommendations

Ratchet up ambition to promote deforestation-free value chains in key global environmental governance platforms, including:

- Forest-based Nature-based Solutions for climate at UNFCCC COP26;
- Enhancing the role of business and including their role in forest-risk commodity supply chain targets in the Post-2020 Biodiversity Framework; and
- Align policy measures for deforestation-free value chains under the China-EU green partnership.

Establish and enhance taxonomies/standards for sustainable forest-risk commodities by incorporating international best practices.

- This must include mechanisms for traceability, minimizing environmental impacts, certification and establishing common taxonomies through cooperation with other key consumer countries like the EU.

Incentivize financial institutions to better understand and manage deforestation risks in their investment and lending portfolio from a physical, regulatory, legal and reputational perspective.

- This includes developing robust policies that ensure funding is diverted from entities who fail to protect globally important forests, both in operations and supply chains.

Issue mandatory disclosure requirements to enhance transparency of financial institutions and public companies' environmental impacts related to forest-risk commodities.

- In order to allow companies to operate in the global economy, disclosure requirements should reflect international standards and frameworks, including the TCFD's recommendations.

ANNEX: CDP FINANCIAL SERVICES QUESTIONNAIRE: CLIMATE CHANGE AND FOREST PILOT 2020

Climate change is set to dominate the economies of the future. Since the 2015 Paris Agreement, conversations around the risks and opportunities it will bring have moved squarely into the world's most influential boardrooms and circles of government.

Limiting global temperature rises to well below 2°C will require both deep de-carbonization and, crucially, a halt to deforestation. Even with all other anthropogenic emissions phased out, 'business as usual' deforestation alone could still drive global warming above 2°C by the year 2100.

Climate change and deforestation create risks to the stability of our entire financial system, and to the soundness of the financial institutions which underpin it. This link has been emphasized by the Task Force on Climate-related Financial Disclosures (TCFD) since it was established by the Financial Stability Board (FSB).

The risks for financial institutions, as well as their impacts on the environment, occur primarily through their influence on the wider economy. This includes the emissions financed through their loans and investments, as well as their support for companies producing forest risk commodities unsustainably.

However, the transition to a sustainable economy also presents opportunities. Achieving net zero emissions by 2050 will require massive investment in low carbon technologies and sustainable agricultural practices. Only the financial sector can provide this.

CDP believes that measurement and disclosure are essential to the effective management of environmental risk. We have begun to fill a critical data gap with our 2020 climate change questionnaire, which asks financial institutions to report on their financing activities for the first time, in addition to their operational activities.

Building on that work, this pilot questionnaire asks about the impact of those financing activities on the world's forests, in addition to the climate.

This pilot questionnaire is aimed solely at banks in 2020. It is an opportunity for banks to engage with new forests-related metrics for the financial services sector; and also to engage with a more integrated way of reporting, with the potential to reduce reporting effort in the future. CDP believes an integrated approach is suitable given the interlinkages between deforestation and climate change, and the fact many banks view these issues holistically through the lens of ESG.

As this pilot questionnaire asks about both climate- and forests-related risks and opportunities, it is important to be clear from the outset what we mean by these terms:

- Climate-related risk refers to the potential negative impacts of climate change on an organization including physical risks and risks associated with the transition to a lower carbon global economy. Physical risks emanating from climate change can be event-driven (acute, e.g. floods) or relate to longer-term shifts (chronic, e.g. sea level rises). Transition risks include policy actions, technology changes, market responses, and reputational considerations.

- Climate-related opportunity refers to the potential positive impacts on an organization resulting from efforts to mitigate and adapt to climate change. For financial institutions this could be the development or greater uptake of financing products and services that help clients mitigate or adapt to climate change.

- Forests-related risk refers to the likelihood, over a specific time, of an organization experiencing an impact caused directly or indirectly by deforestation/ forest degradation or land use change (e.g. credit events at clients, fines, etc.).

- Forests-related opportunity refers to the potential positive impacts related to the sustainable production or consumption of forest risk commodities on an organization. For financial institutions this could be opportunities of financing operations to transition from unsustainable to sustainable production or consumption.

CDP recognizes that any company action that reduces deforestation will also benefit the climate due to the crucial role of forests in addressing the climate crisis. However, we ask that if an action only benefits or harms the climate through a reduction or increase in deforestation, you report this as a forests-related issue.

As this pilot questionnaire is aimed solely at banks, CDP asks that banks limit the scope of their disclosure to their bank lending activities. We recognize many banks also operate as asset managers and insurers and will be integrating climate and forests considerations into those business activities too. However, this questionnaire is focused on bank lending. Throughout, the term portfolio refers to the entire collection of loans and advances held on the balance sheet for which you own the receivable stream.

CDP believes limiting the scope to the lending portfolio in the pilot year should assist banks as many methodologies for measuring environmental risk in portfolios are asset class-specific and focused on loan portfolios.

There are 14 modules in this questionnaire, including the Introduction and Signoff modules.

The questionnaire follows a very similar modular structure to the 2020 climate change questionnaire, and in fact much of the information requested is the same. Banks that have already completed their climate change response for 2020 will not have to repeat the same information again here. Banks can indicate in FS0.1 if that is the case and will be able to skip a large number of questions accordingly. In certain questions where CDP believes banks may look at an issue holistically through the lens of ESG, there is an opportunity to answer holistically for both climate- and forests-related issues if that best reflects your approach. This will mean including some climate-related information despite already having completed your climate change response for 2020.

Modules of the CDP financial services questionnaire

Module 0	Module 1	Module 2	Module 3	Module 4
Introduction	Governance	Risks and opportunities	Business strategy	Implementation
Module 5	**Module 6**	**Module 7**	**Module 8**	**Module 9**
Portfolio impact	Engagement	Target and performance	Emission methodology	Emission data
Module 10	**Module 11**	**Module 12**	**Module13**	**Module 14**
Energy	Additional metrics	Carbon pricing	Verification	Sign off

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CDP
DISCLOSURE INSIGHT ACTION

For more information please contact:

CDP China

Fei Li
Interim China Director
fei.li@cdp.net

Yue Qi
Senior Policy Manager
yue.qi@cdp.net

Chenguang Zhao
Policy Manager, Sustainable Finance
chenguang.zhao@cdp.net

CDP Global

Pietro Bertazzi
Global Director, Policy Engagement
pietro.bertazzi@cdp.net

Helen Finlay
Senior Policy Manager
helen.finlay@cdp.net

Sareh Forouzesh
Associate Director, Forests
sareh.forouzesh@cdp.net

CDP Worldwide
Level 4
60 Great Tower Street
London EC3R 5AD
Tel: +44 (0) 20 3818 3900
forest@cdp.net
www.cdp.net

About CDP

CDP is an international non-profit that drives companies and governments to reduce their greenhouse gas emissions, safeguard water resources and protect forests. Voted number one climate research provider by investors and working with institutional investors with assets of US$106 trillion, we leverage investor and buyer power to motivate companies to disclose and manage their environmental impacts. Over 9,600 companies with over 50% of global market capitalization disclosed environmental data through CDP in 2020. This is in addition to the hundreds of cities, states and regions who disclosed, making CDP's platform one of the richest sources of information globally on how companies and governments are driving environmental change. CDP is a founding member of the We Mean Business Coalition.

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