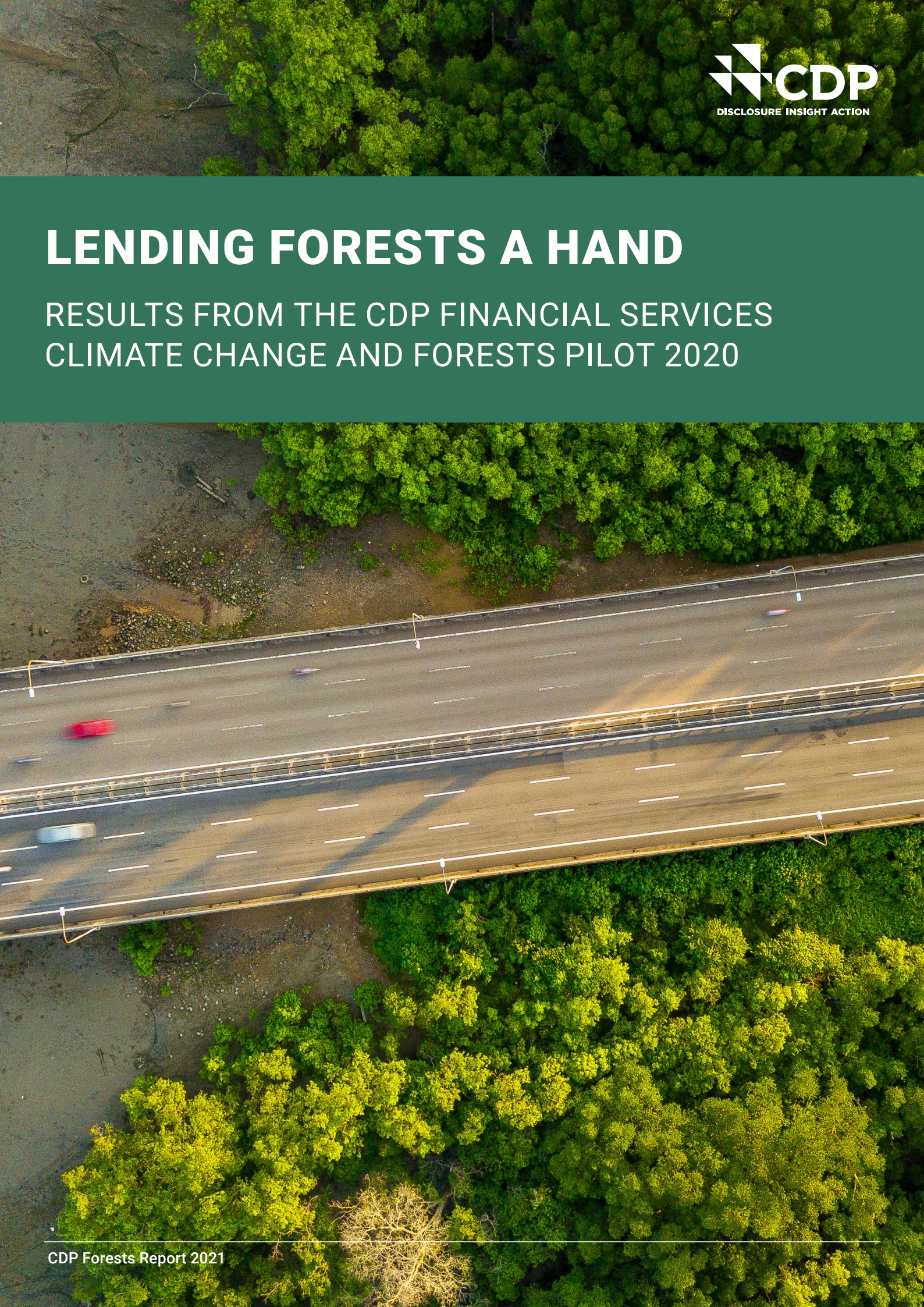


LENDING FORESTS A HAND

RESULTS FROM THE CDP FINANCIAL SERVICES CLIMATE CHANGE AND FORESTS PILOT 2020

CONTENTS

EXECUTIVE SUMMARY

Limiting global temperature rises to well below 2˚C will require both deep de-carbonization and, crucially, a halt to deforestation. The financial services sector will be critical in achieving the transition to a low-carbon, deforestation-free economy. Currently, the forces driving climate change and ecosystem destruction are deeply intertwined with our financial system. However, there are opportunities for the sector to be a key driver of change. Achieving net-zero will require massive investment in low-carbon technologies and sustainable agriculture, which only the financial sector can provide.

CDP aims to expand its questionnaires to cover a full range of environmental factors. For financial institutions, that means covering the impacts they have through their lending, investments and insurance underwriting. As a step towards that goal, and building on its existing work on climate change management within financial services, CDP worked with stakeholders to develop forests-related metrics for the financial sector, with a particular focus on the sector's funding of forest risk commodities (FRCs), which are the single largest cause of deforestation and forests degradation globally.

CDP has piloted the forests-related metrics with a select number of banks during the Financial Services Climate Change and Forests Pilot. The project was geographically focused on Southeast Asia – a high-risk global region for deforestation which lost 12% of its total previously forested area from 1990-2010; but also a region in which momentum is building behind the sustainable finance agenda.

The capital markets are a key audience for environmental data, but they also provide environmental disclosures. In 2020 CDP launched its first reporting framework specifically for the sector, focused on climate change portfolio impact. In delivering this pilot project, CDP integrated forests-related metrics into the existing reporting framework for financial services, rather than creating a standalone forests questionnaire. In doing so, CDP created the first structured, self-reported disclosure framework for forests-related information for banks.

The goal has been to involve the most significant lenders to the FRC sectors, harnessing our previous research on the topic. Out of the target group of banks invited, the response rate was 24%, resulting in a sample of 10 banks disclosing (seven ASEAN and three global). The participating banks are significant financial players, collectively holding loans of more than $2.5 trillion, and accounting for over 19% of all lending to the FRC sectors in Southeast Asia. Five of the ASEAN banks had not previously reported to CDP, demonstrating that the project helped develop and deepen engagement, extending the benefits of environmental disclosure to the financial sector in a region expected to contribute significantly to global economic growth in the future. CDP used the reporting framework to engage with banks, using methods throughout the project which were collaborative and focused on awareness raising and capacity building.

KEY FINDINGS

Key findings from the pilot project:

Banks in the sample are aware of climate change and deforestation as issues that could impact their business…

They are already integrating environmental concerns into governance structures, financing policies, risk processes and engagement with clients.

…although they focus mostly on one side of the 'double-materiality approach'.

The participating banks generally assess how environmental issues could affect their portfolios; they are less likely to assess environmental impact, particularly on forests.

There are areas that ASEAN banks can improve to catch up with their global peers...

They could aim to replicate best practices already implemented by leading global banks.

…but disclosure on forests must improve overall, especially relating to the financing of forest risk commodities.

Only one bank disclosed their financing of key FRCs, as most do not yet conduct analysis on how their portfolios impact forests.

Banks tend to view the topics of biodiversity and nature holistically, rather than seeing deforestation as a standalone topic…

There is interest in tools that would allow banks to assess their environmental risks and for a more rounded environmental reporting framework for the financial sector.

…however, their focus is often on upstream clients that have direct impacts on nature.

By using narrow definitions, some banks may overlook indirect deforestation risks in their clients' supply chains.

Scope 3 portfolio emissions are the most significant source of GHG emissions for banks.

Portfolio emissions were over 400 times higher than operational emissions for the only participating bank able to disclose its portfolio emissions.

There are substantial opportunities for banks in financing the transition to a low-carbon, deforestation-free future.

The disclosure of potential financial impacts of environmental opportunities outweighs the disclosure of potential risks (including the anticipated costs to realize those opportunities).

Based on the findings CDP has directly drawn conclusions and recommendations for banks, as well as for investors and policy makers. In particular, CDP calls on banks to:

- Consider both sides of the 'double materiality' issue; in addition to assessing how environmental issues might affect their portfolios, banks should assess how their portfolios impact the environment, including forests.
- Assess their portfolio's impact on deforestation throughout the supply chain (producers, processers, traders, manufacturers, retailers).
- Pro-actively engage with their clients to hold them accountable and guide them in their transition towards sustainability.
- Strengthen their reporting framework and fully disclose their lending practices, including their financing of FRCs.

There is an ever-greater need for robust, timely and actionable environmental data that the market can use to inform decisions. CDP intends to expand its questionnaires beyond its current questions on carbon emissions, deforestation and water security to include a full range of environmental factors as we are committed to accelerating global environmental ambition and driving action. For financial institutions, this means covering all environmental risks, opportunities and impacts driven by their lending, investments and insurance underwriting. The Financial Services Climate Change and Forests Pilot was a step towards that goal. As a next step, critical metrics will be included in our mainstream reporting framework for financial services companies in the future.

INTRODUCTION

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[1].

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 drive global warming above 2˚C by 2100[2].

The financial services sector will be crucial in achieving the transition to a low-carbon, deforestation-free economy. Currently, the forces driving climate change and ecosystem destruction, including unsustainable production of timber, palm oil, cattle and soy, are deeply intertwined with our financial system. Capital must be shifted away from companies with unsustainable practices. However, there are opportunities for the sector to be a key driver of change. Achieving net-zero will require massive investment in low-carbon technologies and sustainable agriculture, which only the financial sector can provide. Additionally, financial institutions' influence in the wider economy means they can catalyze change by engaging with the companies they lend to, invest in and insure.

The sector has been waking up and taking note of environmental issues which could risk the stability of our financial system. There has been a rapid emergence of new initiatives, mostly focused on climate change, such as:

- **Task Force on Climate-related Financial Disclosures (TCFD)** – Reporting recommendations for companies and financial institutions to give financial markets clear, comprehensive, high-quality information on the impacts of climate change.
- **Partnership for Carbon Accounting Financials (PCAF)** – A standard for accounting and reporting on greenhouse gas emissions in financing portfolios.
- **Science Based Targets initiative (SBTi) for Financial Institutions** – A framework for financial institutions to set targets and align their portfolios with the Paris Agreement.
- **CDP's own climate change questionnaire** – In 2020, CDP launched its first reporting framework specifically for financial institutions, focused on their financed impact on climate change. This saw more financial institutions reporting to CDP than ever before[i].

i Responses from banks, asset managers and insurers increased by 31 to 350 in 2020.

Yet, the financial sector interacts closely with environmental and social issues beyond climate change. The largest banks, investors and insurers are universal, meaning they provide a wide variety of financial services and lend to, invest in and insure every sector of the economy. This means through their portfolios they can potentially impact on multiple environmental and social concerns; and those concerns can present serious risks to the strength and performance of their portfolios. This was demonstrated acutely in 2020 as the COVID-19 health crisis spread into a still-developing economic crisis which will be impacting financing portfolios for years to come. Before this year, few would have predicted the risk could send such a shock through the financial system, with infectious diseases ranking behind all five of the top environmental risks in the World Economic Forum's Global Risks Report 2020, released before the crisis[3].

One environmental issue which has been attracting much attention is deforestation, and particularly the funding of forest risk commodities (FRCs) which are the single largest cause of deforestation and forests degradation globally[4, 5]. Financing from banks and investors allows vast numbers of small and large organizations to produce, process and profit from products grown and reared on land once belonging to nature. Nevertheless, the issue is a complex one; the same financing contributes to the creation of employment, enabling economic development and raising standards of living across the same supply chains.

Long term, CDP aims to expand its questionnaires to cover a full range of environmental factors. For financial institutions, that means covering the impacts they have through their lending, investments and insurance underwriting. As a step towards that goal, and building on its existing work on climate change management within financial services, CDP worked with stakeholders to develop forests-related metrics for the financial sector. This enabled us to pilot forests-related reporting with a select number of banks, and will enable ongoing improved environmental disclosures from the financial sector as those critical metrics will be included in our mainstream reporting framework for financial service companies in the future. The pilot project, known as the Financial Services Climate Change and Forests Pilot, was geographically focused on Southeast Asia – a high-risk global region for deforestation.

This report presents the anonymized, aggregated results from the pilot project, along with conclusions and recommendations which can be drawn from the exercise for banks, investors and policy makers. It follows on from the research report *Increasing transparency of banks: The transition to sustainable lending to the Forest Risk Commodity sector*[6], released earlier in the project.

CONTEXT: FORESTS-RELATED RISKS AND SUSTAINABLE FINANCE IN SOUTHEAST ASIA

Tropical forests play several pivotal roles including as a carbon store regulating the earth's climate[7], as host to nearly two-thirds of the earth's biodiversity[8], and as a home or livelihood for millions of people in developing countries worldwide[9]. As tropical deforestation continues unabated, forests' ability to play those roles diminishes. Rather than acting as a store, locked-up carbon is released; and at the same time natural, low-cost capacity for uptake of atmospheric carbon is lost. A recent study indicated, in fact, that tropical forests have now tilted towards a net source of carbon, due to continuing deforestation[10].

Southeast Asia accounts for almost 15% of the earth's tropical forests. It is, however, a major hotspot for deforestation; comparable only to the Amazon amongst global regions in the scale of habitat and biodiversity loss it is experiencing[11]. From 1990-2010, the region lost 1.6 million hectares of forest per year, equivalent to 12% of the total area previously covered[12]. Over 40% of the biodiversity in Southeast Asia could vanish by 2100[13].

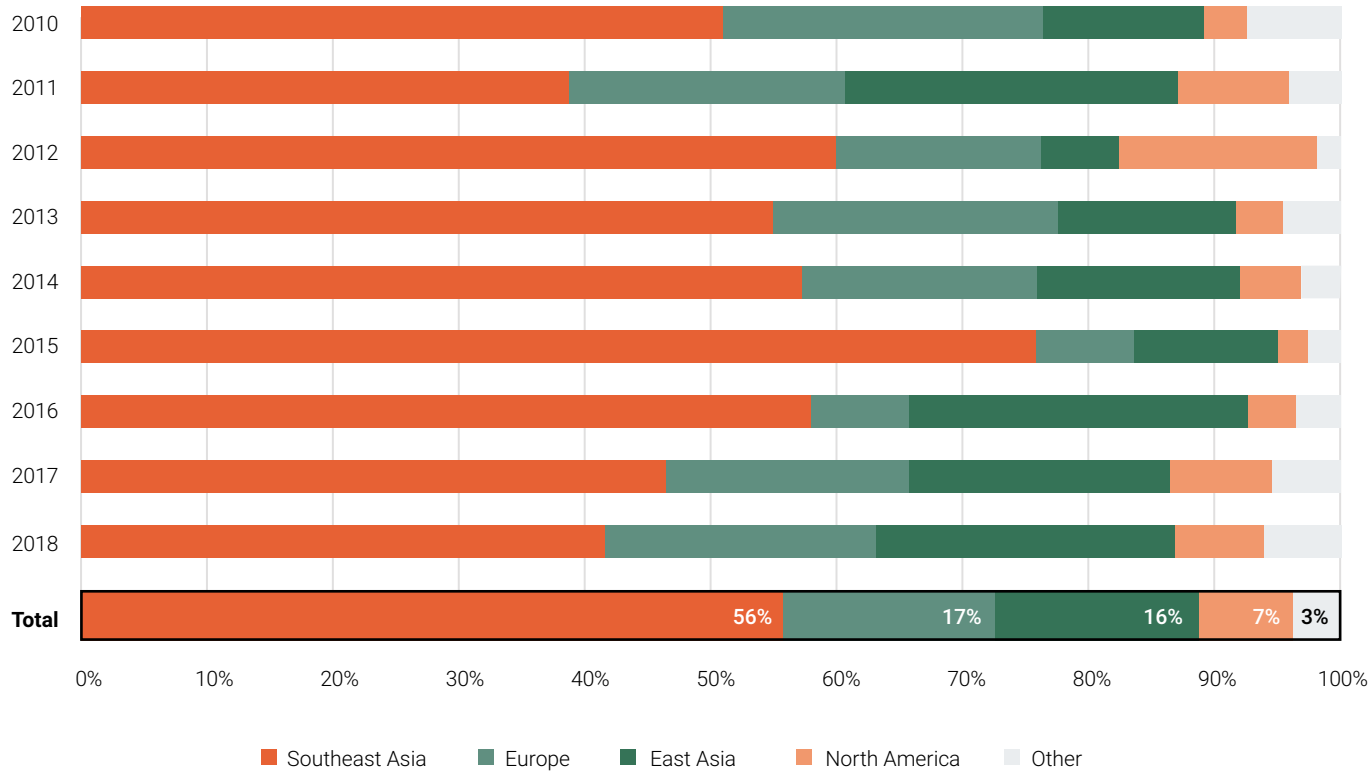
The single largest cause of deforestation and forests degradation globally is commercial agriculture - when forest area is cleared to produce cash crop commodities. In Southeast Asia, the key commodities are timber, palm oil and rubber[14]. The different industries are heterogeneous, but the palm oil and rubber industries in particular can be characterized as involving production by both plantation companies and smallholders (who may or may not be supported by larger companies as part of a plasma scheme). Much of the output goes through the hands of a small number of large global trading companies like Wilmar, Sime Darby and Cargill. All three industries require large amounts of capital to function, which is provided by banks and investors.

Despite FRCs currently ranking as the leading driver of deforestation in Southeast Asia, it is not necessary that their production must lead to land being cleared. With sound agricultural practices and careful management, FRCs can be produced sustainably. Several multi-stakeholder industry standards exist to define what sustainable production looks like. The most notable being Forest Stewardship Council certification (FSC) and Programme for the Endorsement of Forest Certification (PEFC) for timber, Roundtable on Sustainable Palm Oil certification (RSPO) for palm oil and Global Platform for Sustainable Natural Rubber (GPSNR) for rubber.

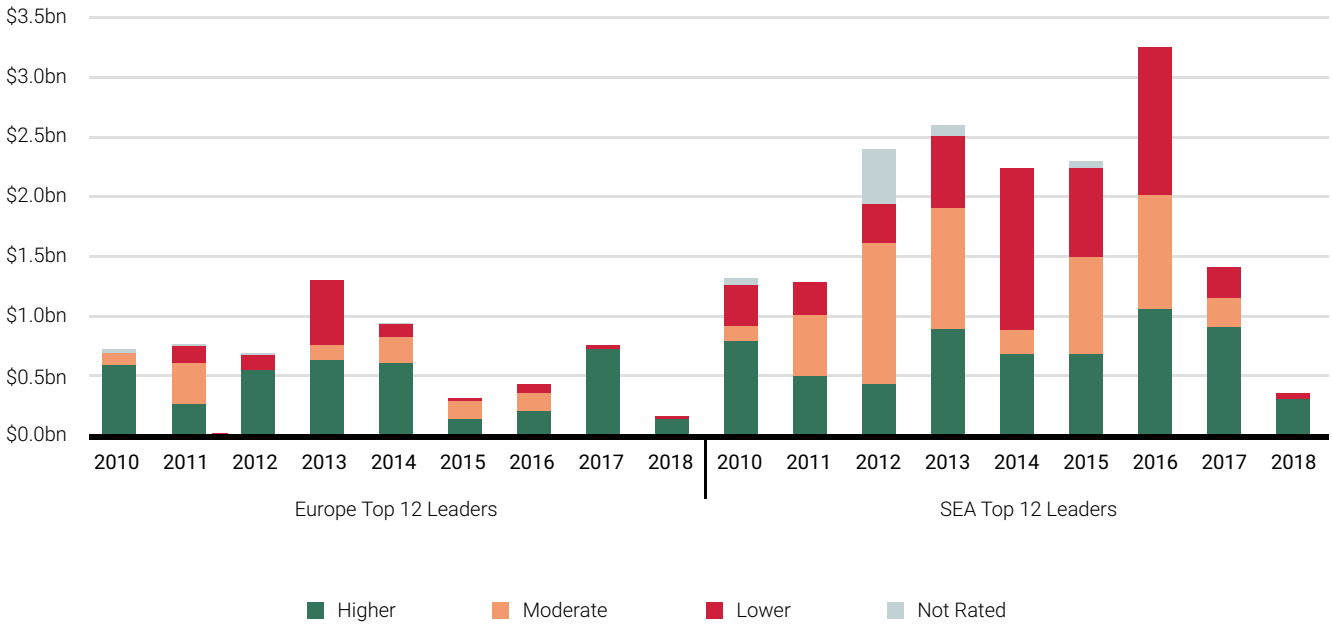
The research report released earlier in the project evaluated who was financing FRCs in Southeast Asia[15]. The key findings were that bank lending was the most important form of financing for companies in FRC supply chains and ASEAN banks were committing the most financing, leaving them most exposed to FRCs relative to the total size of their loan books. This was most obviously the case for the palm oil industry, to which ASEAN banks committed 56% of financing between 2010 and 2018. Results also found ASEAN banks are being less selective about which companies in the FRC supply chains they lend to. Of the loans committed by ASEAN banks, only 33% were to companies that SPOTT rank in the most sustainable band[ii], compared to 69% of loans committed by European banks.

ii ZSL SPOTT (Sustainability Policy Transparency Toolkit) assesses commodity producers and traders on their public disclosure regarding organization, policies and practices related to ESG issues (www.spott.org).

Global Palm Oil Financing by Region (%)



Palm Oil Lending by SPOTT Band



The analysis pointed to ASEAN banks being important stakeholders in combatting deforestation in Southeast Asia. However, most ASEAN banks had not previously been engaged with the CDP disclosure process. Of the 20 ASEAN banks identified in our research, only 5 had previously disclosed to CDP.

That said, there is momentum building behind the sustainable finance agenda in the ASEAN region. Banks are engaging with other, often local, sustainable finance initiatives and regulators are also pushing the agenda. In Malaysia, financial regulators established the Joint Committee on Climate Change (JC3) to pursue collaborative actions for building climate resilience within the financial sector[16]. In Indonesia, the financial regulator OJK set out a Sustainable Finance Roadmap and banks have convened the Indonesia Sustainable Finance Initiative (ISFI) which aspires to support its implementation[17]. WWF's SUSBA initiative has been tracking ASEAN banks' integration of ESG issues using public reports since 2017, with many improvements seen across their metrics[18].

With all this context in mind, the Financial Services Climate Change and Forests Pilot had two complementary objectives:

- To develop the world's first reporting framework on forests for banks, which enables all stakeholders to better understand, measure and manage risks and opportunities related to deforestation.
- To use the reporting framework to engage with banks and build their capacity for environmental management, tapping into the current momentum for sustainable finance in the ASEAN region.

These objectives are in keeping with CDP's Theory of Change which states that measurement of environmental risks, impacts and opportunities can lead to better environmental management, and contribute to a thriving economy that works for people and planet.

QUESTIONNAIRE AND ENGAGEMENT

Financial Services Climate Change and Forests Pilot Questionnaire

Since its foundation in 2000, CDP has worked closely with the financial services sector. Capital markets are a key audience for environmental data, but they also provide environmental disclosures. Banks, asset managers and insurers have reported reported on the climate change impacts of their operations to CDP for many years and in 2020 CDP launched its first reporting framework specifically for the sector, focused on climate change portfolio impact[19]. In delivering this pilot project, CDP integrated forests-related metrics into the existing reporting framework for financial services, rather than creating a standalone forests questionnaire. This approach has the benefit of reducing reporting effort and is a scalable solution going forward as the reporting framework for the financial sector evolves to include a more comprehensive range of environmental factors.

The Financial Services Questionnaire: Climate Change and Forests Pilot 2020 is the very first structured, self-reported disclosure framework for banks focused on forests. An overview of the questionnaire and where new forests-related indicators are included is shown alongside. For a fuller explanation of the forests-related indicators included and the development process, see our previous research report[20].

FS1 Governance	
FS2 Risks and opportunities	
FS3 Business strategy	
FS4 Implementation	
FS5 Portfolio impact	
FS6 Engagement	
FS7 Targets and performance	
FS8 Emissions methodology	
FS9 Emissions data	
FS10 Energy	
FS11 Additional metrics	
FS12 Carbon pricing	
FS13 Verification	

= forests-related indicators are integrated into the module

Questionnaire participants

Harnessing previous research identifying banks engaged in FRCs based on their lending to the palm oil, timber and rubber supply chains in Southeast Asia[21], the goal was to involve the most significant lenders in the Financial Services Climate Change and Forests Pilot. Out of the target group of banks invited, the response rate was 24%[iii]. This resulted in a sample of 10 banks disclosing to the questionnaire (seven ASEAN and three global). CDP recognizes 10 is a small sample from which to draw solid conclusions, and caveats the results presented here as such. However, this level of engagement with the pilot project represents a positive first step. CDP intends to drive forests-related disclosures from banks further by including the metrics developed as part of the pilot in our mainstream reporting framework for financial service companies.

Despite only consisting of 10 banks, the sample is a major success for a pilot project such as this. Firstly, the participating banks are significant financial players with the sway to drive genuine change in the real economy. Collectively, they hold loans of more than US$2.5 trillion; more than the GDP of some G7 nations such as Italy and Canada. Secondly, the banks collectively account for over 19% of all lending to the FRC sectors in Southeast Asia (based on data from Forests and Finance, 2019). Finally, the sample includes five ASEAN banks who had not previously reported to CDP. Through the pilot project CDP has developed and deepened engagement, extending the benefits of environmental disclosure to the financial sector in a region expected to contribute significantly to global economic growth in the future[22]. In some cases, this was the first time the banks had undertaken any GHG emissions accounting. The banks also took important steps such as setting their organizational and operational boundaries for GHG accounting and choosing a base year to start tracking emissions over time[23].

	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%

iv

iii This is comparable to the response rate to CDP's corporate forests questionnaire, which was also 24% in 2020 (and has been between 21% and 25% since 2015).

iv Loans and advances held on the balance sheet at end of financial year 2018. Taken from CDP (2020). Originally sourced from published company reports. Lending to FRC companies is between 2010-18. Taken from CDP (2020). Based on data from Forests and Finance (2019), showing lending to a group of over 190 companies with operations involving FRCs in ASEAN.

Engagement

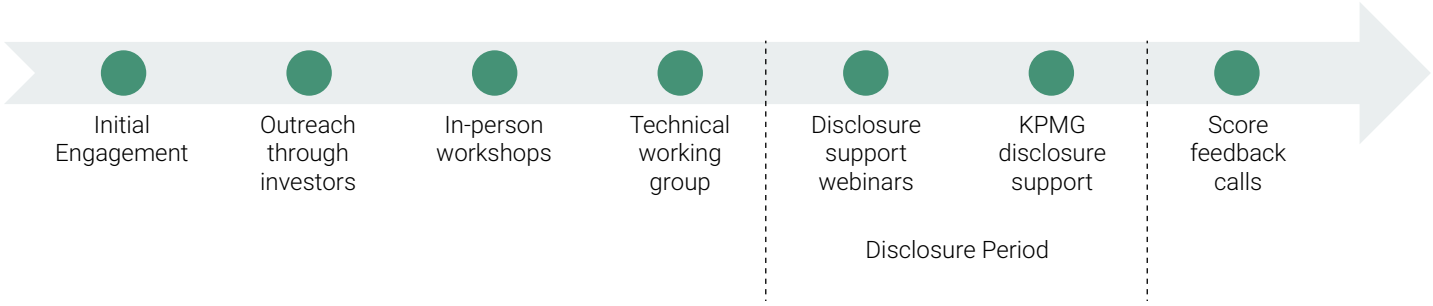
The engagement methods used were collaborative and focused on awareness raising and capacity building, particularly with ASEAN banks who had not previously reported to CDP.

It is common for ASEAN banks to be either largely state-owned or largely owned by local institutional investors which act with a quasi-governmental mandate, for instance managing national pension schemes. This opened a productive route for engaging with ASEAN banks – through these institutional investors. In addition, investors leveraged CDP's annual Non-Disclosure Campaign for targeted engagement with some ASEAN banks.

In March 2020, CDP organized workshops for banks in Kuala Lumpur, Jakarta and Singapore to introduce its mission, work and reach. Following the in-person workshops, the questionnaire was consulted on in a technical working group.

The collaborative, capacity building engagement approach continued during the disclosure period in the form of bespoke one-to-one support provided to each bank by our accredited partner KPMG.

Post the disclosure period, personalized score feedback was provided to each participating bank. All scores from the Financial Services Climate Change and Forests Pilot are private to the responding bank.



RESULTS

The disclosures obtained through the pilot project are a fascinating resource, and reveal much about how the participating banks are responding to the environmental challenges of both climate change and forest-related risks. However, the key findings presented here focus primarily on forests. This is in recognition of the pilot's value as the very first structured, self-reported disclosure exercise for banks focused on forests.

Banks in the sample are aware of climate change and deforestation as issues that could impact their business…

They are already integrating environmental concerns into governance structures, financing policies, risk processes and engagement with clients.

There are areas that ASEAN banks can improve to catch up with their global peers...

They could aim to replicate best practices already implemented by leading global banks.

Banks tend to view the topics of biodiversity and nature holistically, rather than seeing deforestation as a standalone topic…

There is interest in tools that would allow banks to assess their environmental risks and for a more rounded environmental reporting framework for the financial sector.

Scope 3 portfolio emissions are the most significant source of GHG emissions for banks.

Portfolio emissions were over 400 times higher than operational emissions for the only participating bank able to disclose its portfolio emissions.

…although they focus mostly on one side of the 'double-materiality approach'.

The participating banks generally assess how environmental issues could affect their portfolios; they are less likely to assess environmental impact, particularly on forests.

…but disclosure on forests must improve overall, especially relating to the financing of forest risk commodities.

Only one bank disclosed their financing of key FRCs, as most do not yet conduct analysis on how their portfolios impact forests.

…however, their focus is often on upstream clients that have direct impacts on nature.

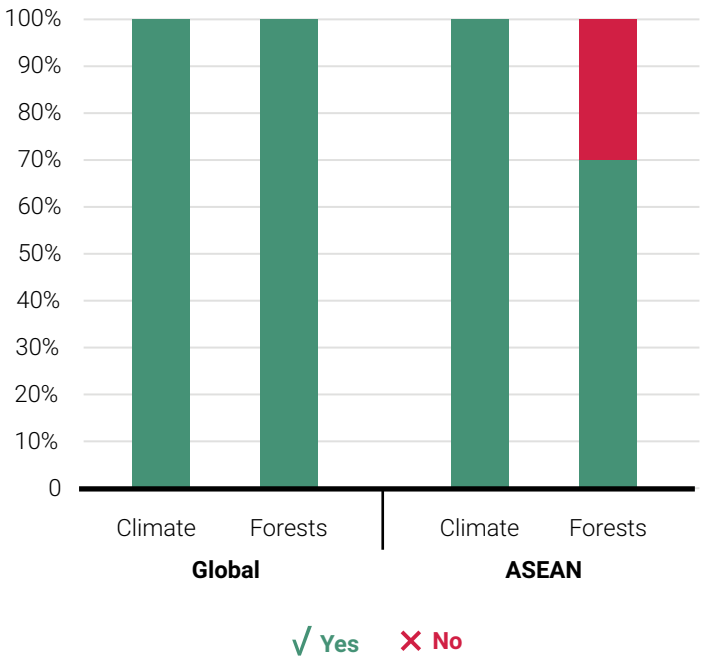
By using narrow definitions, some banks may overlook indirect deforestation risks in their clients' supply chains.

There are substantial opportunities for banks in financing the transition to a low-carbon, deforestation-free future.

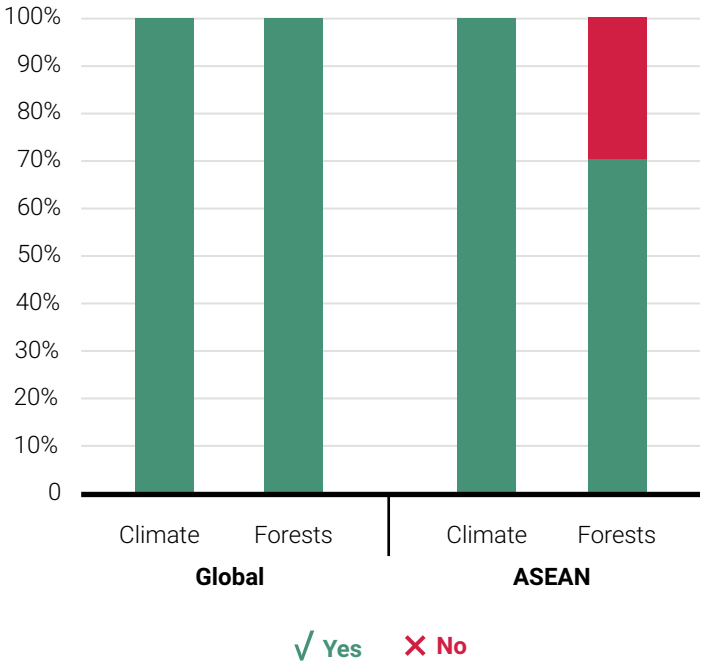
The disclosure of potential financial impacts of environmental opportunities outweighs the disclosure of potential risks (including the anticipated costs to realize those opportunities).

Banks are aware of climate change and deforestation as issues

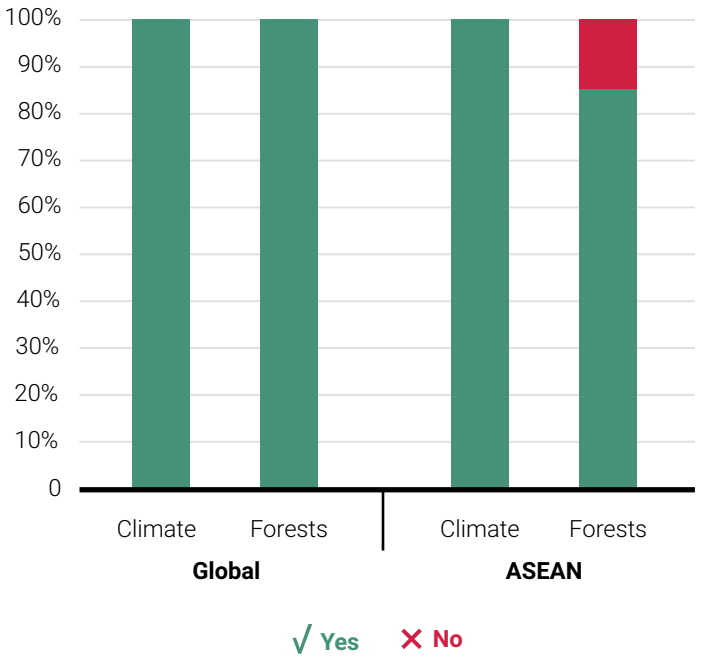
Is there a board-level oversight of climate- and forests-related issues within your organization?



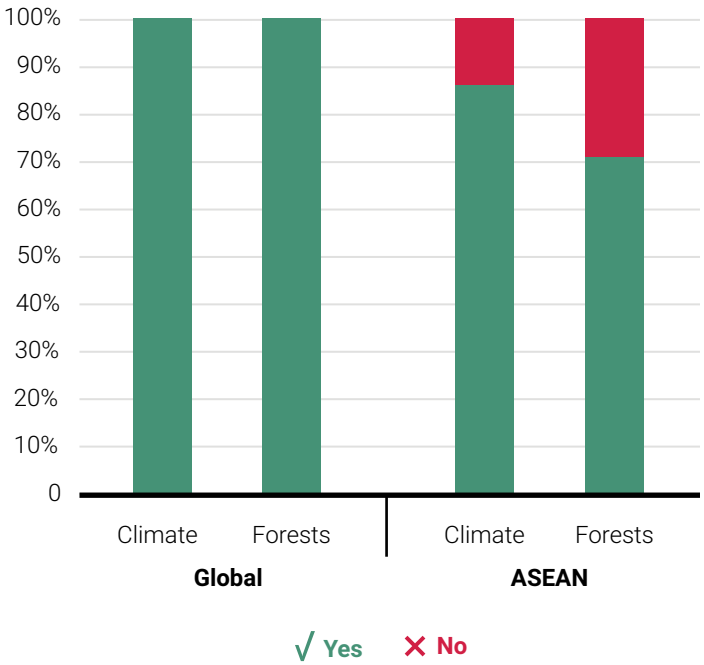
Are climate- and forests-related issues considered in the policy framework of your organization?



Do you consider climate- and forests-related information when conducting due diligence?



Do you engage with your clients climate- and forests-related issues?



In responses to the pilot questionnaire, banks demonstrate they are aware of climate change and deforestation as issues with the potential to impact their business. They have largely started to integrate environmental concerns into their governance structures, financing policies, risk processes and engagement with clients.

All banks indicate they have board-level oversight of climate-related issues and almost all have board-level oversight of forests-related issues. Invariably it is the same person or committee on the board with joint oversight of the two, suggesting boards maintain oversight over environmental concerns, or even over all ESG concerns, holistically.

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 to be expected as commodity-specific policies setting out criteria lenders expect or require of their clients in FRC supply chains have become 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.

Palm oil is the commodity most often covered in financing policies, followed by timber. Cattle and soy receive less coverage, particularly within the financing policies of the ASEAN banks. This is unsurprising as palm oil is such a huge component of ASEAN economies like Indonesia and Malaysia, and has been receiving a lot of negative attention recently – some directed at the banks and investors funding the industry[24]. It would be interesting to analyze similar disclosures from banks in LATAM, to investigate if the lack of financing policy coverage for cattle and soy (both important drivers of deforestation in the Amazon) is driven only by geography or if there actually is ground to be made in including requirements on cattle and soy companies in financing policies.

Banks are also integrating environmental concerns into their risk processes. All banks indicate they consider climate-related information when conducting due diligence or credit risk assessments on their clients, and all except one consider forests-related information. Banks also indicate in their responses that they are conducting portfolio analysis to assess exposure to climate- and forests-related risks.

There are a wide range of tools used in conducting client risk assessments and portfolio analysis, including interviews and site visits with borrowers, questionnaires on ESG risks and expert reviews from dedicated sustainability professionals when complex risks are involved. The most sophisticated risk management process disclosed by a bank involved a green weighting system which adjusts the expected return used in deal approval processes based on the sustainability of the activity financed. A process such as this suggests the bank could be ready for sustainability considerations to be included in capital requirement rules by regulators.

There is an ongoing debate in the sustainable finance community around the advantages of different approaches based on engagement versus divestment[25]. However, there is increasing consensus that portfolio engagement should be part of any financial service company's strategy. Once you are divested, your influence over a company ceases and you lose the ability to enact change in the real economy. In the context of FRCs, this is evidently true. There will be a place in a low-carbon, deforestation-free future for commodities such as palm (which is more efficient at producing oil on a per hectare basis than alternative oilseed crops) and timber (which is touted as a sustainable substitute for GHG-intensive building materials such as concrete and steel). It follows that divesting from FRCs is not desirable, but banks instead should be engaging with their clients to ensure they are producing and consuming commodities sustainably.

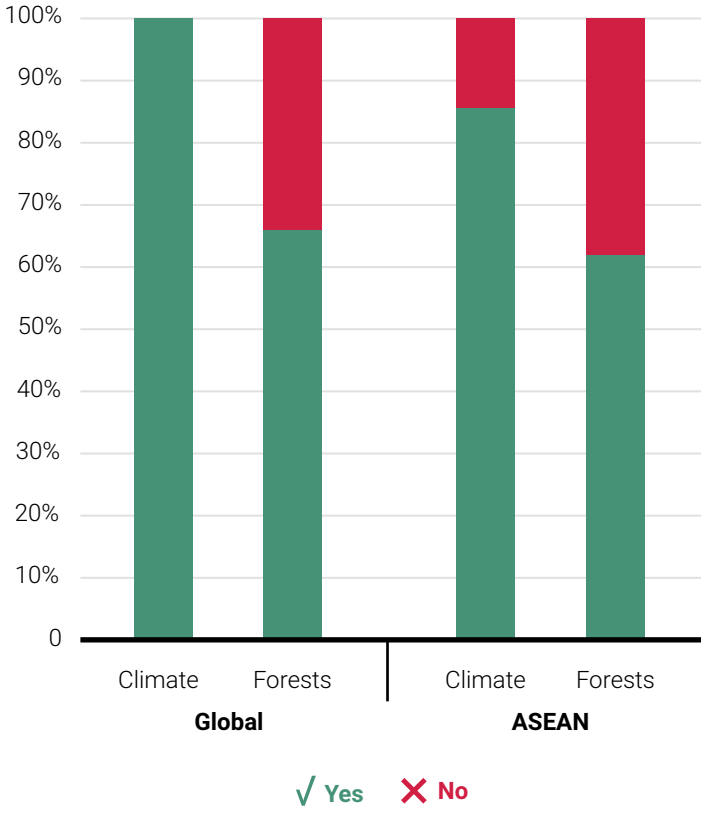
All banks indicate they engage with their clients on either climate- or forests-related issues, and levels of engagement appear high from the disclosures. ASEAN banks are more likely to engage with their clients through education and information sharing, where the aim is to educate and inform clients but not necessarily instigate specific actions. Global banks are more likely to collaborate and innovate with their clients, with the aim of encouraging clients to take action to reduce their environmental impacts.

Banks focus mostly on one side of the 'double materiality approach'

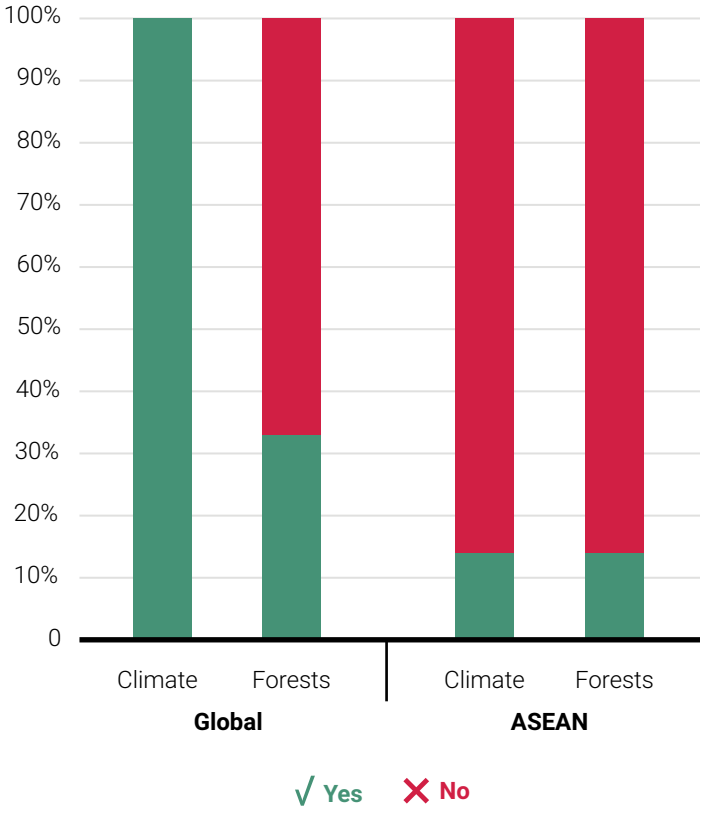
A 'double materiality approach' to assessing environmental issues leads to an issue being evaluated as material if either it can influence the development, performance and position of the company in a material way, or if the company's activities have a material impact either environmentally or socially[26]. The concept of double materiality is at the heart of EU's Non-Financial Reporting Directive. It is implicitly recognized in CDP's Financial Services Climate Change and Forests Pilot Questionnaire in that it asks both if banks assess their portfolio exposure to risks and their portfolio impacts.

The responses to the pilot questionnaire indicate that banks are currently more focused on one side of the 'double materiality approach'. The participating banks generally assess how environmental issues could affect their portfolios; but are less likely to assess how their portfolios impact the environment. The trend is particularly marked for impact on forests, although it also applies to climate change for ASEAN banks.

Do you assess your portfolio's exposure to climate- and forests-related risks?



Do you conduct analysis to understand how your portfolio's impacts climate and forests?



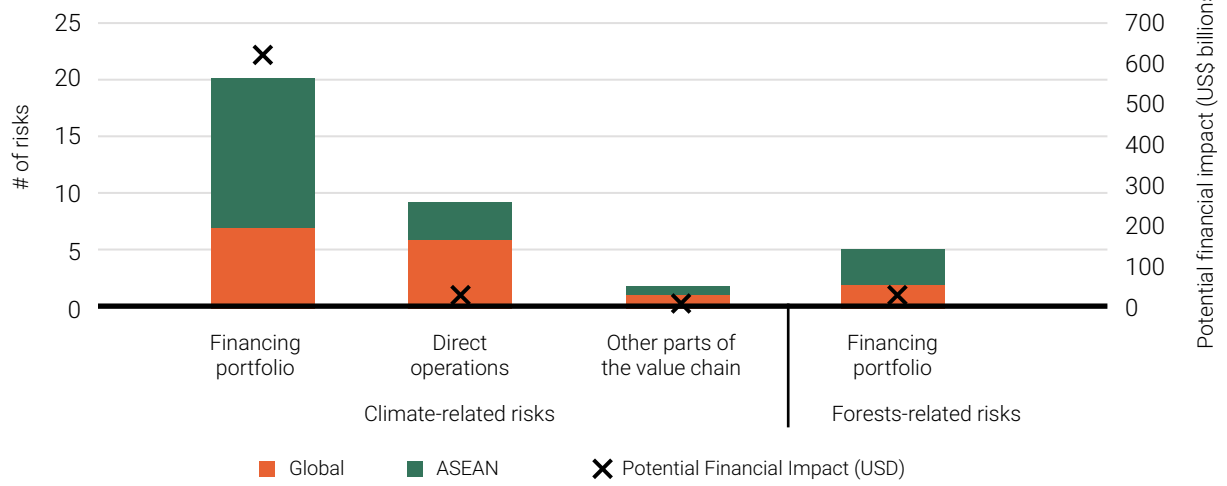
As mentioned above, banks integrate climate change and deforestation into client due diligence, credit risk assessments and portfolio analysis. Global banks are also quantitatively assessing how their portfolios perform under different future climate change scenarios. Thus, the banks in the sample can describe their environmental risks well. However, they are much less able to describe the impact of their portfolios on climate change and deforestation. Only one bank disclosed their Scope 3 portfolio emissions and only one bank disclosed their financing of FRCs (given that most of them do not conduct analysis on how their portfolio impacts forests). Banks that are not currently doing so indicate they plan to assess the impacts of their portfolio in the next two years, so there are encouraging signs that both sides of the 'double materiality approach' will receive focus in the near future.

Of the environmental risks banks have assessed and disclosed, most occur in the financing portfolio (most individual risks disclosed and most potential financial impact reported), including all forests-related risks. This is unsurprising as it is now widely recognized that financial services companies face higher environmental risks in their portfolios than in their own operations.

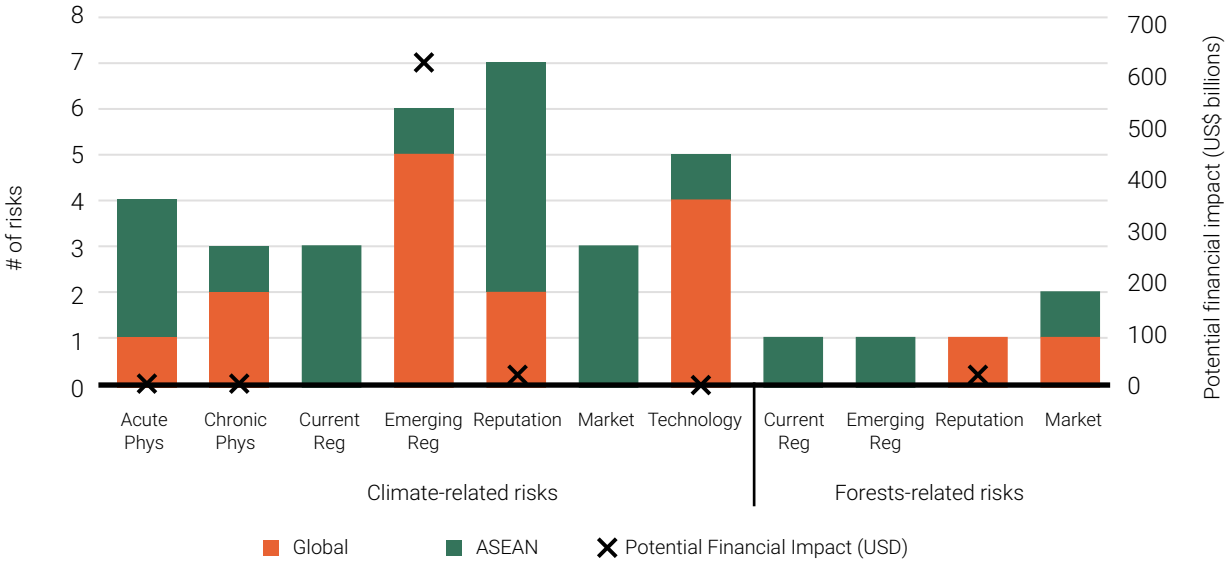
An array of risk drivers are important to the participating banks, however regulatory and reputational risks are the most commonly disclosed (regulatory risks having the highest reported potential financial impact). Banks were more likely to report risks driven by emerging regulation than current regulation, indicating they anticipate a ramping up of environmental regulation and suggesting regulators wield considerable influence and can advance a sustainable financial system. A ramping up of regulation is being borne out in the arenas of both climate change and deforestation; the UK recently became the first G20 government to announce mandatory TCFD regulations[27] 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[28, 29]. 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. One major difference is that 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 in developed markets. It appears ASEAN banks may be worried that association with environmental risks might dissuade owners of global capital from investing in them. Banks were not able to provide a potential financial impact figure for all risks they face. For forests-related risks it was common for this to be missing. This may be some indication that the aggregate potential financial impact figure for forests-related risks is an underestimate.

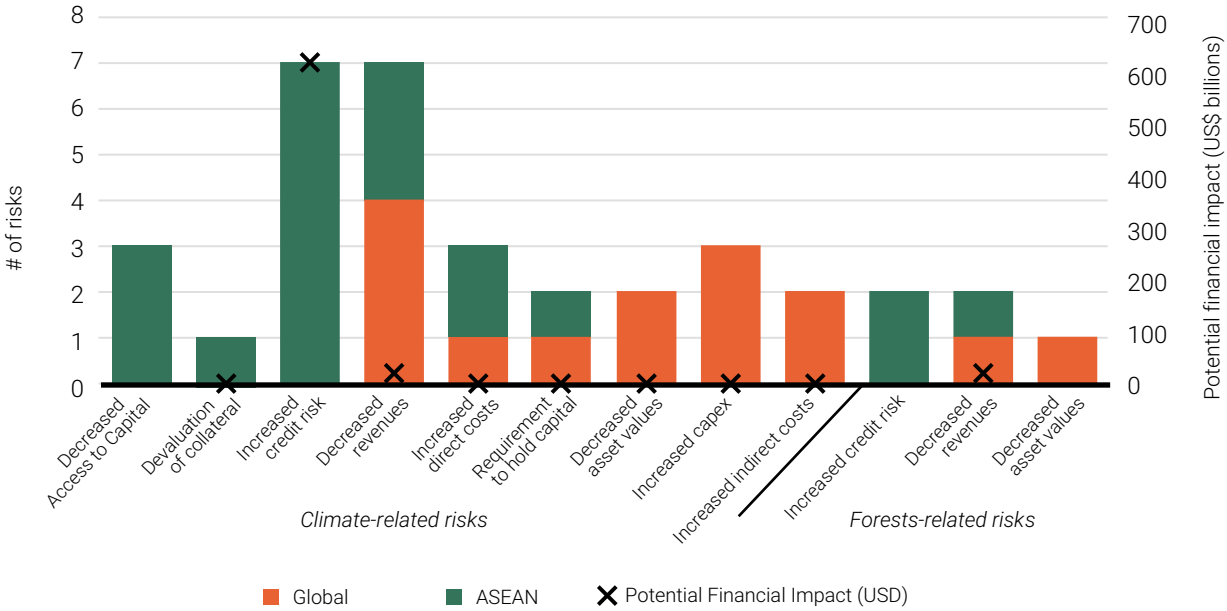
Where in the value chain does the risk driver occur?



Primary driver of risk



Primary potential financial impact of risk identified



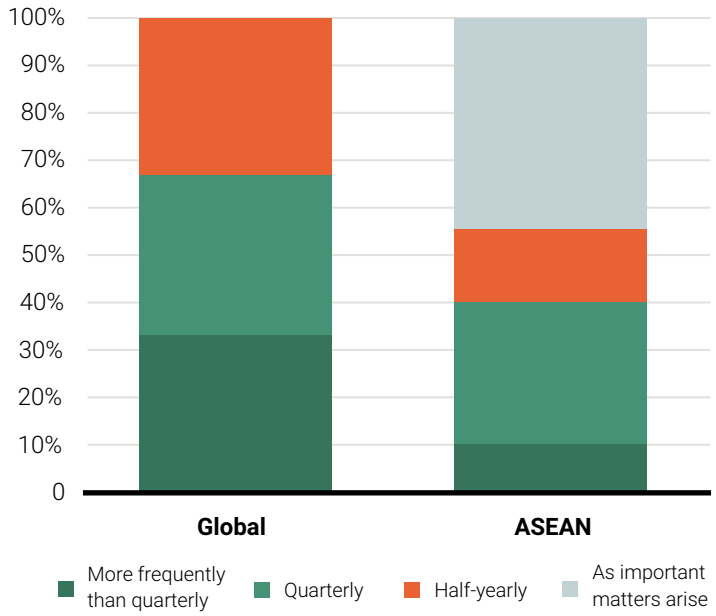
There are areas in which ASEAN banks can improve to catch up with their global peers

Although most banks are doing the basics of integrating environmental concerns into governance structures, financing policies, risk processes and their engagement with clients, a closer examination of the data shows there are areas ASEAN banks can improve to catch up with their global peers.

In their board- and senior management-level governance of climate- and forests-related issues, it appears global banks are being better structured than ASEAN banks. All global banks indicate environmental issues are reported to the board periodically, whereas 44% of ASEAN banks report to the board only as important matters arise. In addition, all global banks have organized board- and senior management-level committees with responsibility for environmental issues. Only 71% of ASEAN banks have organized committees (only 43% at board-level), with a much wider assortment of C-suite positions having ultimate responsibility for environmental issues at the participating ASEAN banks.

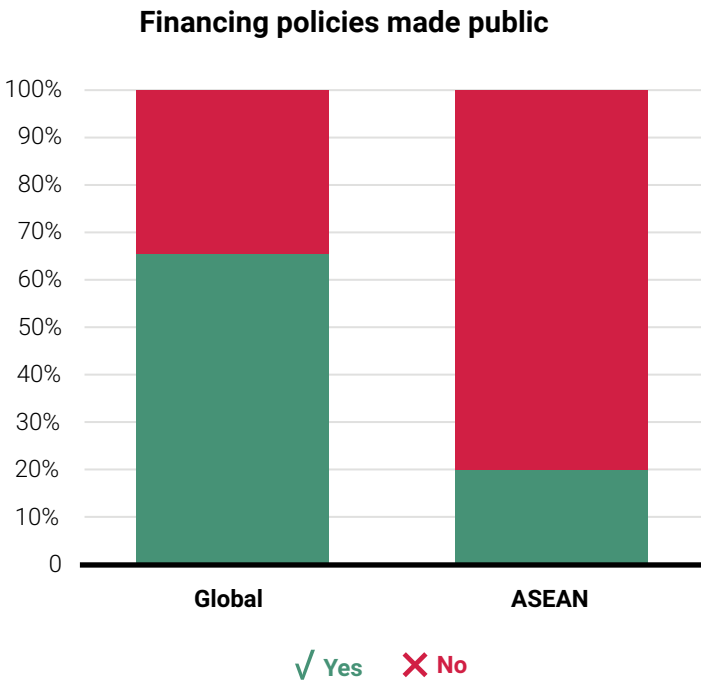
This is likely simply a result of global banks being more mature and further along their sustainability journey than the ASEAN banks participating in the pilot. Sustainable finance is a relatively new topic to banks in developing economies with five of the ASEAN banks participating in the pilot reporting to CDP for the very first time. It implies banks in developing economies can improve their governance of environmental issues by replicating governance structures already employed by leading global banks.

Frequency of reporting to the board on climate- and forests-related issues

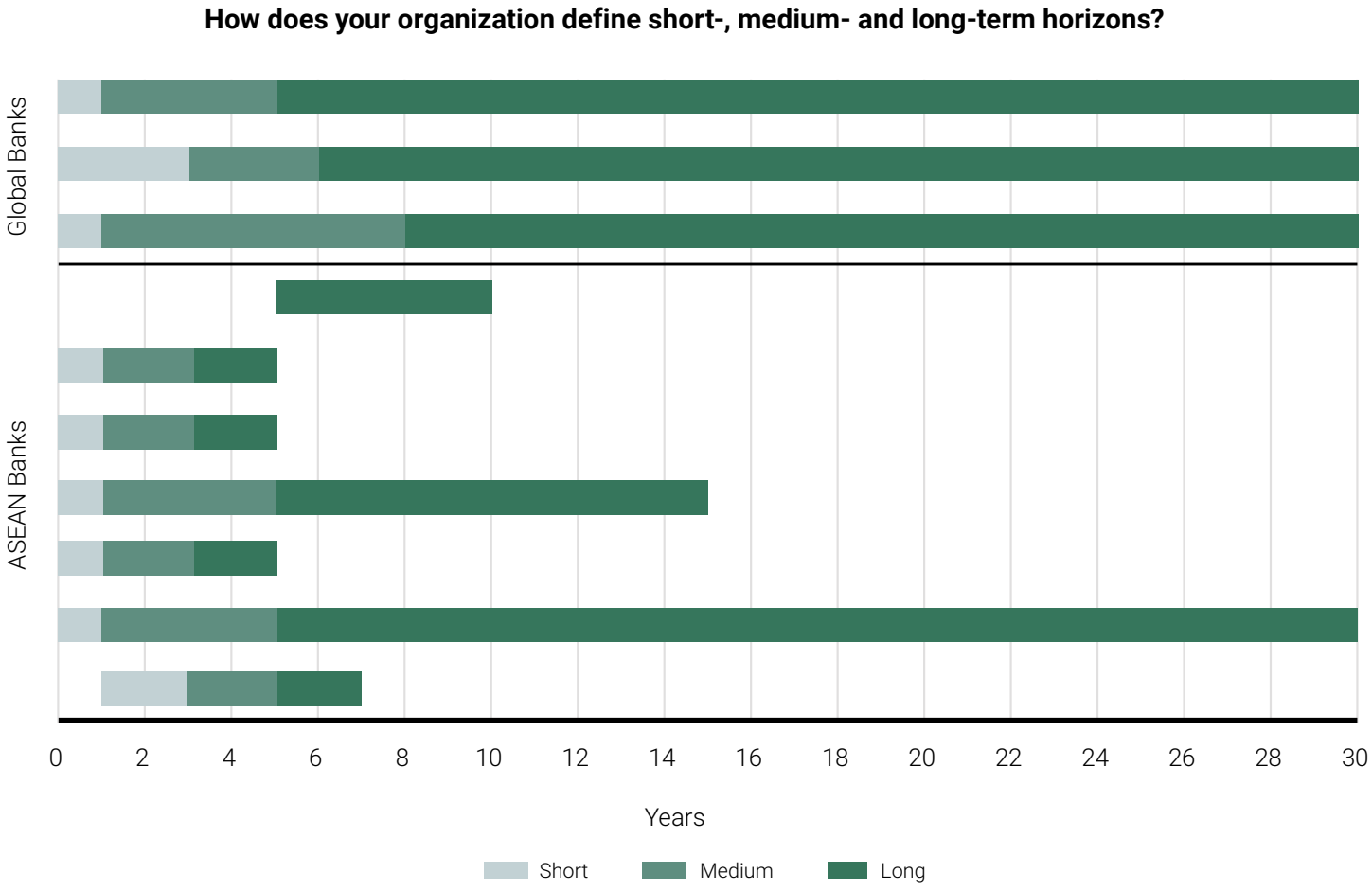


It also appears global banks have more stringent financing policies. Their policies are more likely to cover all of their portfolio and are less likely to have exceptions in which their policy does not apply. In addition, 67% of the financing policies reported by global banks are made public, compared to only 20% of the financing policies reported by ASEAN banks.

The best FRC financing policy disclosed in response to the pilot is implemented by a global bank. It requires its clients to commit to measures including (but not limited to): zero net deforestation, no development on peat regardless of depth, zero burning, no conversion of High Carbon Stock (HCS) or High Conservation Value (HCV) areas, and securing Free, Prior and Informed Consent (FPIC) from local communities for developments. The policy's coverage is comprehensive and they require clients to comply for their own operations and supply chain. The best way for banks in developing economies to improve their financing policies may be to replicate best-practice policies of leading global banks. CDP also encourages all banks to make their financing policies integrating environmental considerations public.

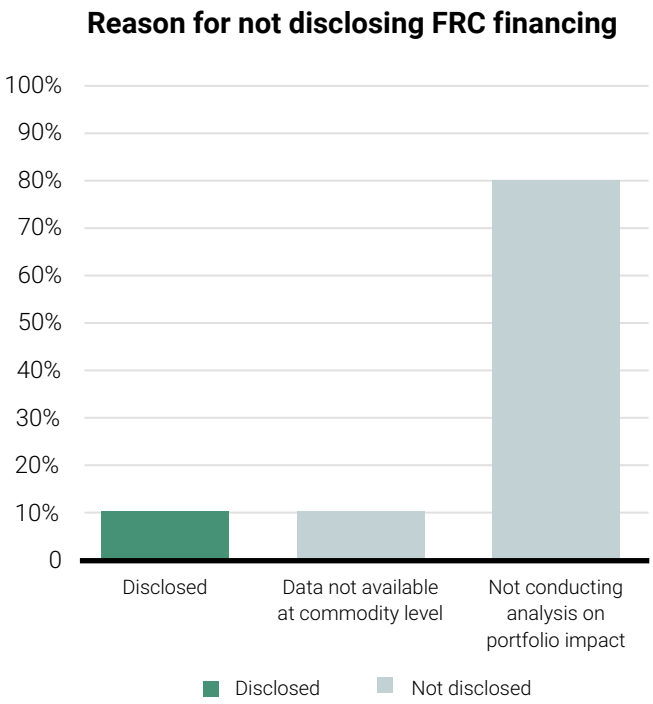


Finally, the risk processes of global banks are more developed than those of ASEAN banks participating in the pilot. This is seen most obviously in the disclosure data on time horizons over which banks assess risks (and opportunities). Global banks think much longer term when they consider climate-and forests-related risks. The most marked difference is in the definition of the long-term horizon, where all global banks consider at least 30 years. Only 43% of ASEAN banks consider any more than 7 years. This shows a greater understanding of the risks of climate change by global banks, as the most severe impacts of climate change will be felt over the long-term.



Disclosure on forests must improve overall

While global banks are ahead of ASEAN banks in many areas, it should not distract from the fact disclosure on forests must improve overall, especially relating to the financing of FRCs. Only one bank participating in the pilot disclosed on their financing of FRCs (given that most of them do not conduct analysis on how their portfolio impacts forests).



The majority of banks did not disclose their FRC financing because they do not yet conduct analysis to understand how their portfolio impacts forests. However, one bank already conducts analysis but did not disclose their financing of FRCs. Seemingly this was because they did not have data (or did not want to disclose data) on a granular, per commodity level. They were able to say what their overall credit exposure to agriculture, food and tobacco was, although this is not a granular enough level to identify deforestation risks and impacts. This is instructive to banks that are still to put in place processes to analyze their portfolio impact on deforestation – they should ensure the processes allow them to assess their portfolio on a per commodity basis.

Banks' lack of transparency around FRC financing means they cannot demonstrate the positive steps they are taking on climate and forests. NGOs are doing critical work in uncovering the financing flows that underpin the economy, but when they present huge financing figures for FRCs, the implication is that all of that financing is unsustainable, which is not necessarily the case. By increasing transparency, banks can better manage the risks and issues to their busniess. They should be transparent about how much they are financing timber, palm oil, cattle and soy – but also transparent around conditions which must be met by companies for that financing, so they can demonstrate their financing is sustainable.

As so few banks disclosed their financing of FRCs, it is impossible to tell from the disclosure data how much financing is advanced to companies producing and consuming FRCs sustainably, and how much is advanced to companies producing and consuming unsustainably. Improved transparency will is the start of the journey to better environmental performance. CDP will drive disclosure on FRC financing in the future by including critical metrics developed as part of the pilot in our mainstream reporting framework for financial service companies.

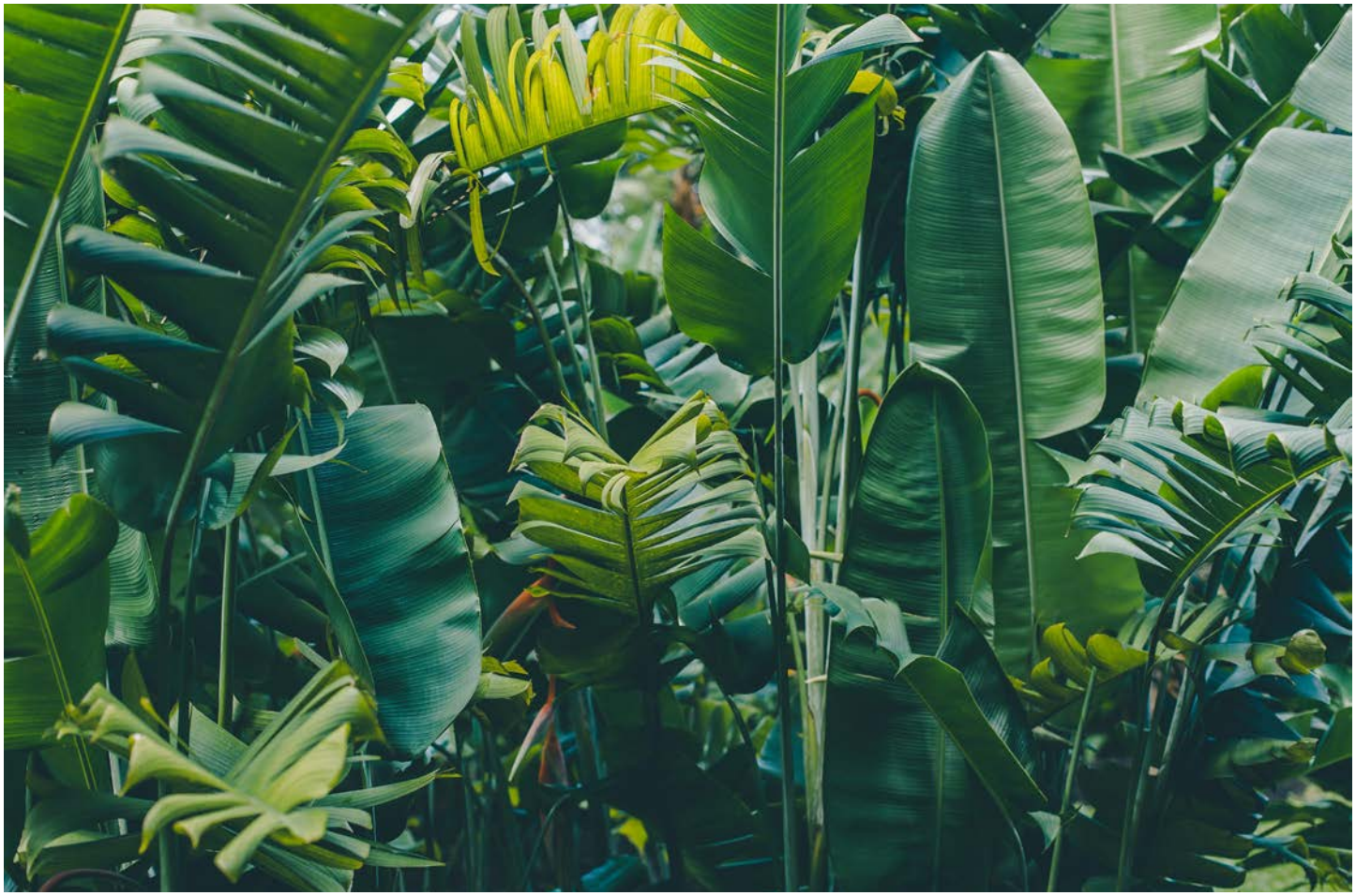
Banks view the topics of biodiversity and nature holistically

It is clear from their responses to the pilot that many banks do not see tropical deforestation as a standalone issue. Instead they are beginning to look at the wider topics of biodiversity and nature holistically, and tropical deforestation as one part of that.

This viewpoint is demonstrated in the disclosure data on risk processes for identifying, assessing and responding to forests-related risks. Several banks talk about risk processes considering 'biodiversity' and 'depletion of natural resources', covering not only their financing portfolios but also their procurement decisions. The sophisticated risk management process involving a green weighting system considers broad environmental topics such as biodiversity, water, waste and pollution in addition to climate change. Banks indicate they are participants in many different industry initiatives related to climate change, deforestation and sustainable finance; but the ones they most often refer to specifically in response to questions on deforestation are emerging initiatives such as the Task Force on Nature-related Financial Disclosures and the Finance for Biodiversity Pledge, which have a broader focus.

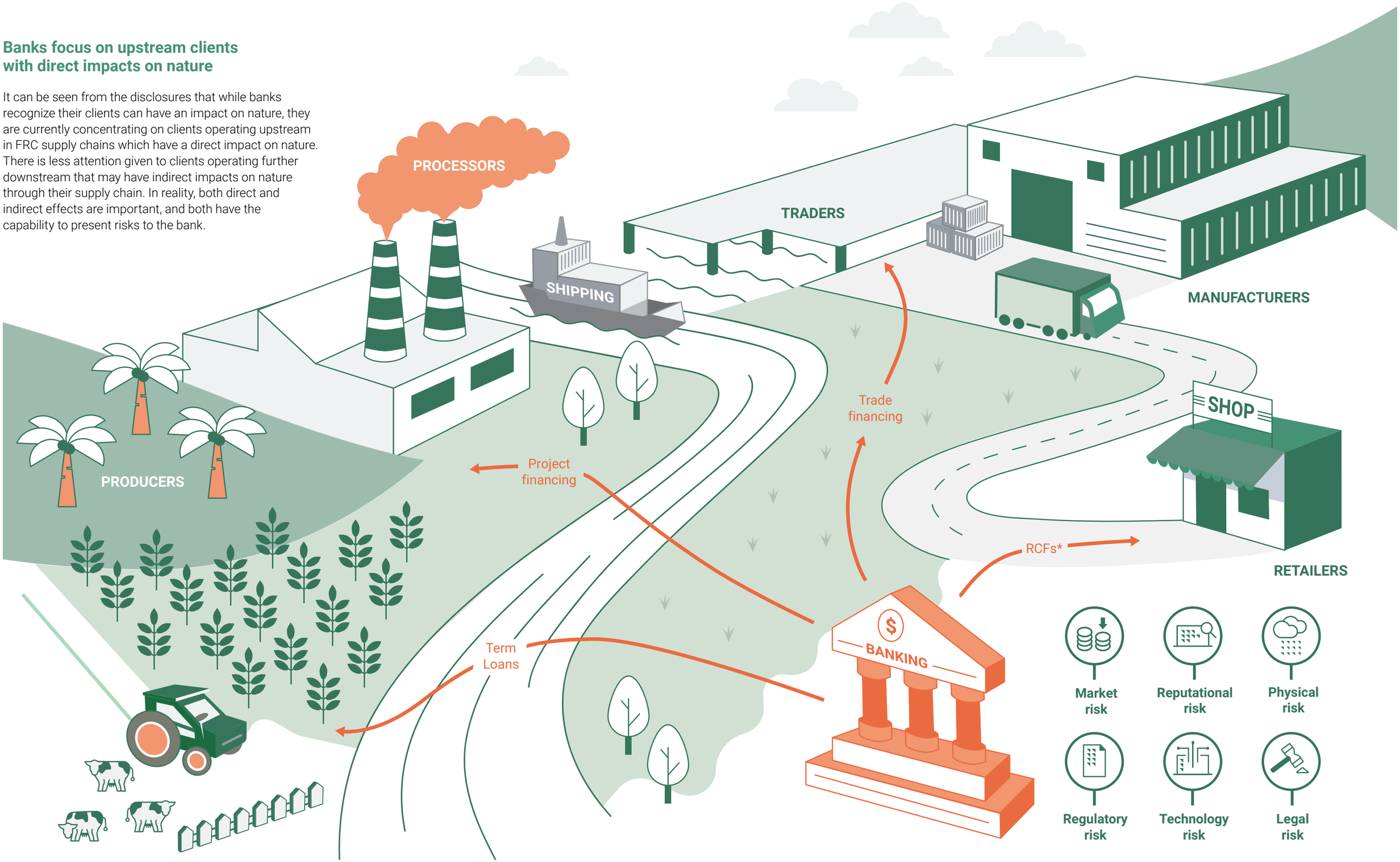
Banks participating in the pilot provide a wide variety of financial services and lend to and invest in every sector of the economy. Across their entire portfolio they are likely to be exposed to multiple environmental concerns across the full range of natural capital[30] meaning broader definitions have a good fit with their activities. Viewing deforestation as part of a wider topic of biodiversity or nature is a good thing – it has the potential to completely assess risks and impacts of which forests are component within the wider context.

This finding is instructive for CDP's interaction with the financial services system going forward. There is a greater benefit to financial institutions from a reporting framework that allows companies to report across a breadth of financial environmental factors. At the same time, financial institutions must still cover these issues in enough depth to fully understand the risks, impacts and opportunities.



Banks focus on upstream clients with direct impacts on nature

It can be seen from the disclosures that while banks recognize their clients can have an impact on nature, they are currently concentrating on clients operating upstream in FRC supply chains which have a direct impact on nature. There is less attention given to clients operating further downstream that may have indirect impacts on nature through their supply chain. In reality, both direct and indirect effects are important, and both have the capability to present risks to the bank.



*Revolving Credit Facility (RCFs)

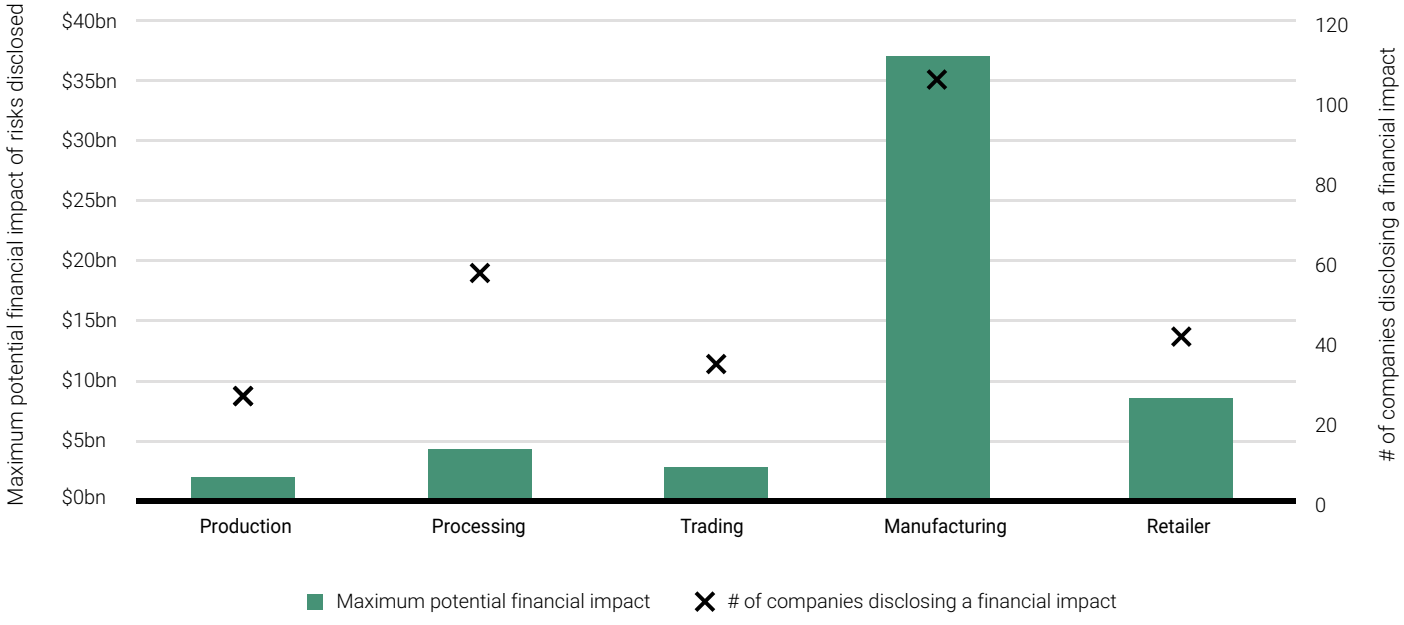
The concentration on upstream clients can be seen in the rationale some ASEAN banks give for not integrating deforestation concerns into governance structures, internal processes and their engagement with clients. The most common rationale given in each of those cases is that their lending to the agri-commodity sector is minimal. Worryingly, the two ASEAN banks which indicate they do not engage with their clients on deforestation disclose they have no plan to do so in the next two years, for the same reason.

The disclosed financing policies indicate the same issue as above. Only 20% of participating banks indicated their forest risk commodity policy set any expectations on their clients' supply chains.

Finally, it is interesting to compare the limited disclosures of FRC financing obtained through the pilot to the limited publicly available data on financing flows to companies involved in FRCs. The self-reported figures are much lower than the figures presented by Forests and Finance (2019). This suggests that the bank's definitions of FRC financing is narrower than Forests and Finance (2019), likely ignoring clients which operate further downstream such as traders, manufacturers and retailers.

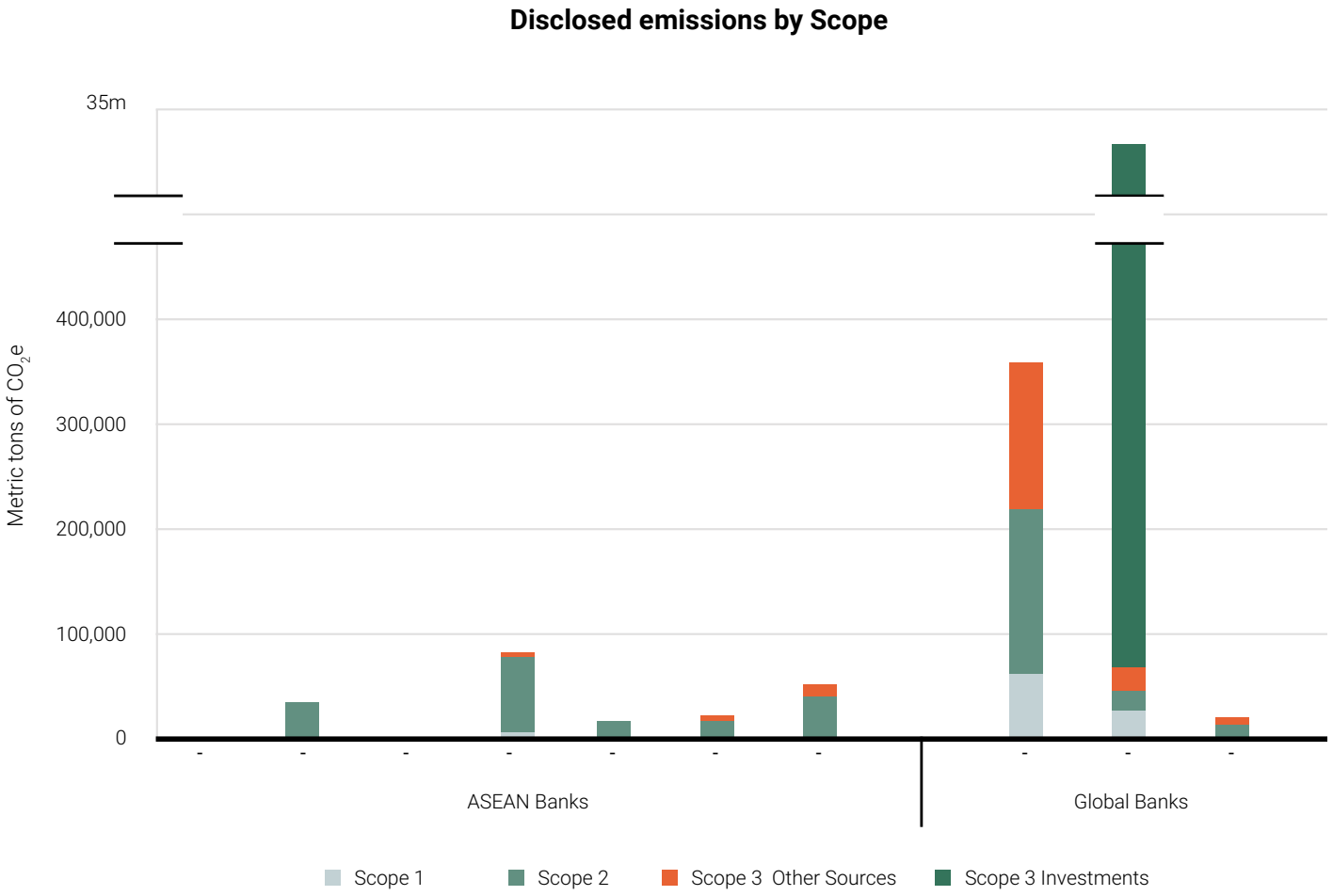
By using narrow definitions, some banks may overlook indirect deforestation risks in their clients' supply chains. Corporate disclosures to CDP's forests questionnaire show that these risks exist within downstream companies. Manufacturers and retailers actually reported the most potential financial impact of forests-related risks in 2020, however CDP's sample does skew towards downstream companies. These risks could flow through to the lenders of the companies if they affect their credit worthiness.

Maximum potential impact of risks disclosed by companies[v] operating in different stages of the FRC value chain



v In CDP's 2020 Forests questionnaire, 317 companies disclosed forests-related risks. Of these companies, 155 companies provided the potential financial impact of risks disclosed, totaling ~$53 billion. Out of the companies providing potential financial impacts, 59 operate in more than one stage of the FRC value chain. The financial impacts disclosed for risks reported by these companies has been divided equally across the stages of the value chain they operate in.

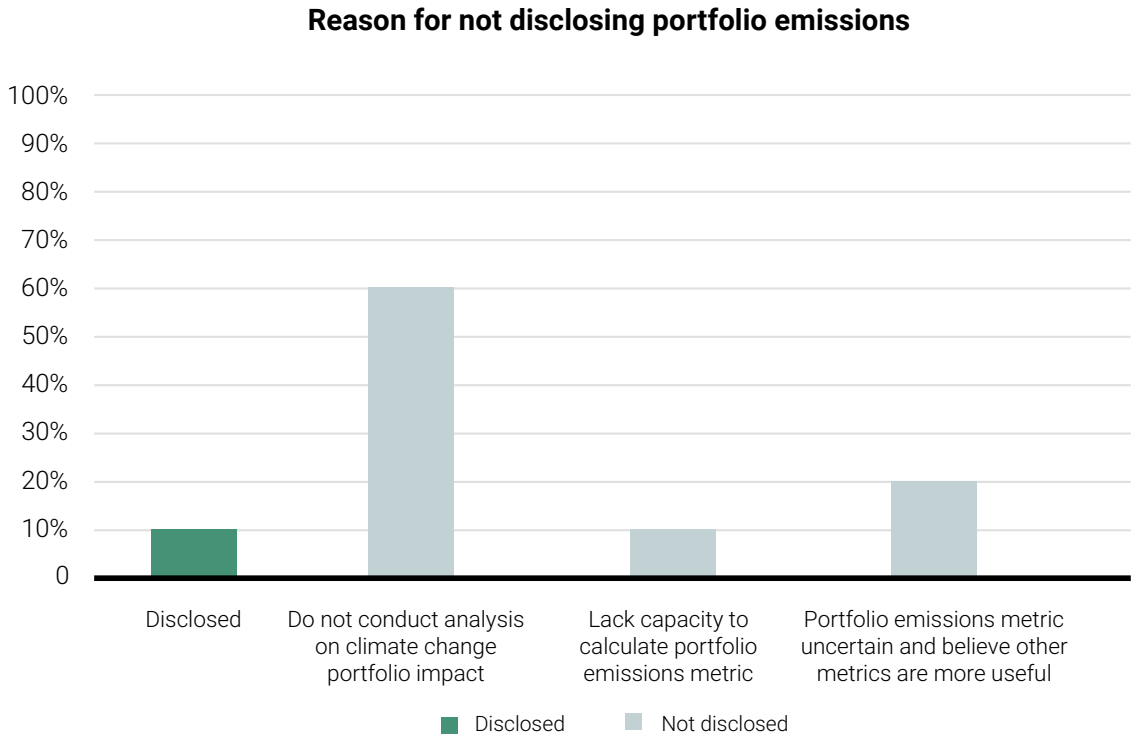
Scope 3 portfolio emissions are the most significant for banks



It is clear from the disclosure data that Scope 3 portfolio emissions are by far the most significant source of greenhouse gas emissions for banks. Only one bank disclosed their portfolio emissions, 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. Methodologies are currently available only for calculating portfolio emissions associated with certain asset classes, which prevents banks from reporting on their entire portfolios. This finding is not surprising but is important. CDP is working with other initiatives such as PCAF[31] and the Science Based Targets initiative[32] to mainstream the assessment and reporting of portfolio intiative emissions.

Amongst the banks participating in the pilot, reasons for not reporting portfolio emissions varied between global banks and ASEAN banks. For ASEAN banks it appears to be a capacity issue. Six banks do not yet conduct analysis on how their portfolio impacts climate change, while one bank does not yet have capacity to calculate a complex metric such as portfolio emissions and instead uses a simpler exposure metric. Global banks have more capacity, however two banks do not disclose portfolio emissions because there are uncertainties in methodologies and they believe other metrics are more decision useful[vi].

vi Metrics suggested as more decision useful were sector-based such as a breakdown energy mix financed.

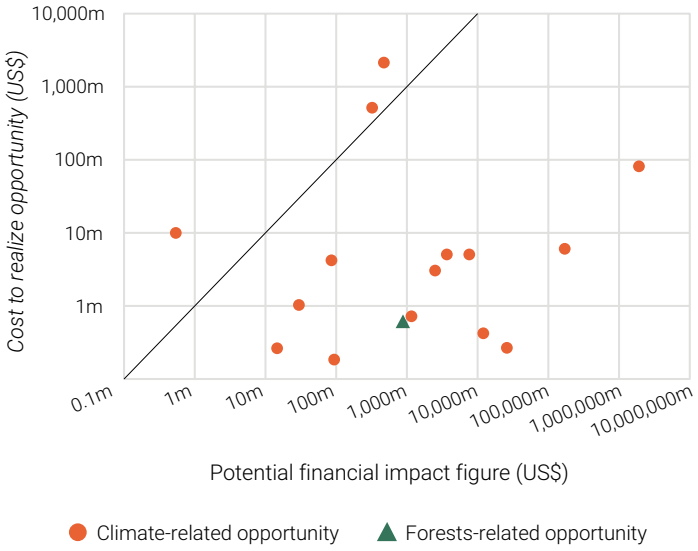


When calculating emissions associated with their lending and investments, financial institutions should consider emissions from land use change caused by their clients and investees. This is especially true for banks and financial institutions, such as those participating in the pilot, who are potentially exposed to deforestation risks.

Opportunities to finance the transition to a low-carbon, deforestation-free future

The final key finding which can be drawn from the Financial Services Climate Change and Forests Pilot is that there are substantial opportunities for banks in financing the transition to a low-carbon, deforestation-free future. The potential financial impacts of environmental opportunities disclosed outweigh the potential impacts of risks disclosed. Perhaps more importantly for the realization of opportunities, the potential impacts also outweigh the anticipated costs to achieve those opportunities in 81% of cases in which potential impact figures were provided[vii].

Potential financial impact vs. cost to realize opportunity



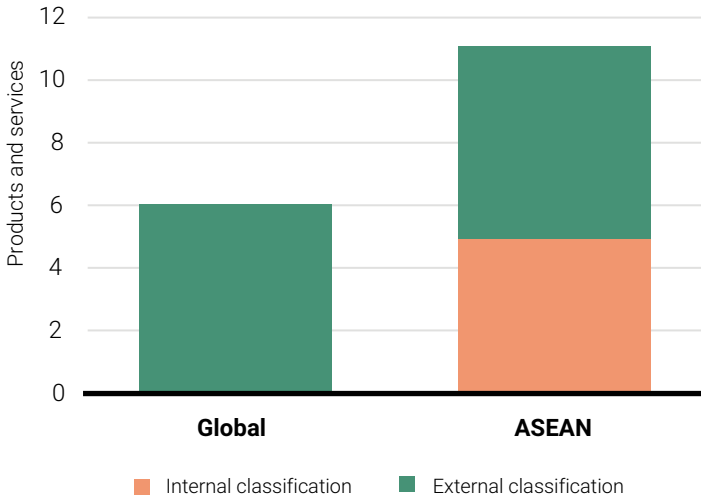
82% of opportunities disclosed occur within the banks financing portfolio, including all three disclosed forests-related opportunities. This trend is particularly marked for the global banks suggesting they have already pursued opportunities to increase efficiency and reduce emissions in their own operations.

The most common driver of opportunities disclosed is financing products and services (58% of opportunities). This statistic makes sense in light of the rapid real-world proliferation of new ESG financing products[33]. Most new ESG financing products making the news are climate-related. However, the disclosure data also demonstrates banks are developing financing solutions that support sustainable forest risk commodity supply chains. These include 'Organic Transition Loans' for crop farmers seeking organic certification and targeted guarantees. The former help farmers manage upfront costs associated with changing production practices. The latter provide de-risking to "catalyze transactions that actively prevent deforestation, stimulate reforestation, contribute to efficient sustainable agricultural production and improve rural livelihoods".

Along with the emergence of new sustainable financing products and services has come a number of standards and taxonomies for classifying ESG products. Global banks are more likely to use external taxonomies such as the Green Loan Principles and Sustainability-Linked Loan Principles to classify their products as sustainable, whereas

vii In some cases, potential financial impact was provided as a range and a median was taken. In some cases, potential financial impact could not be provided.

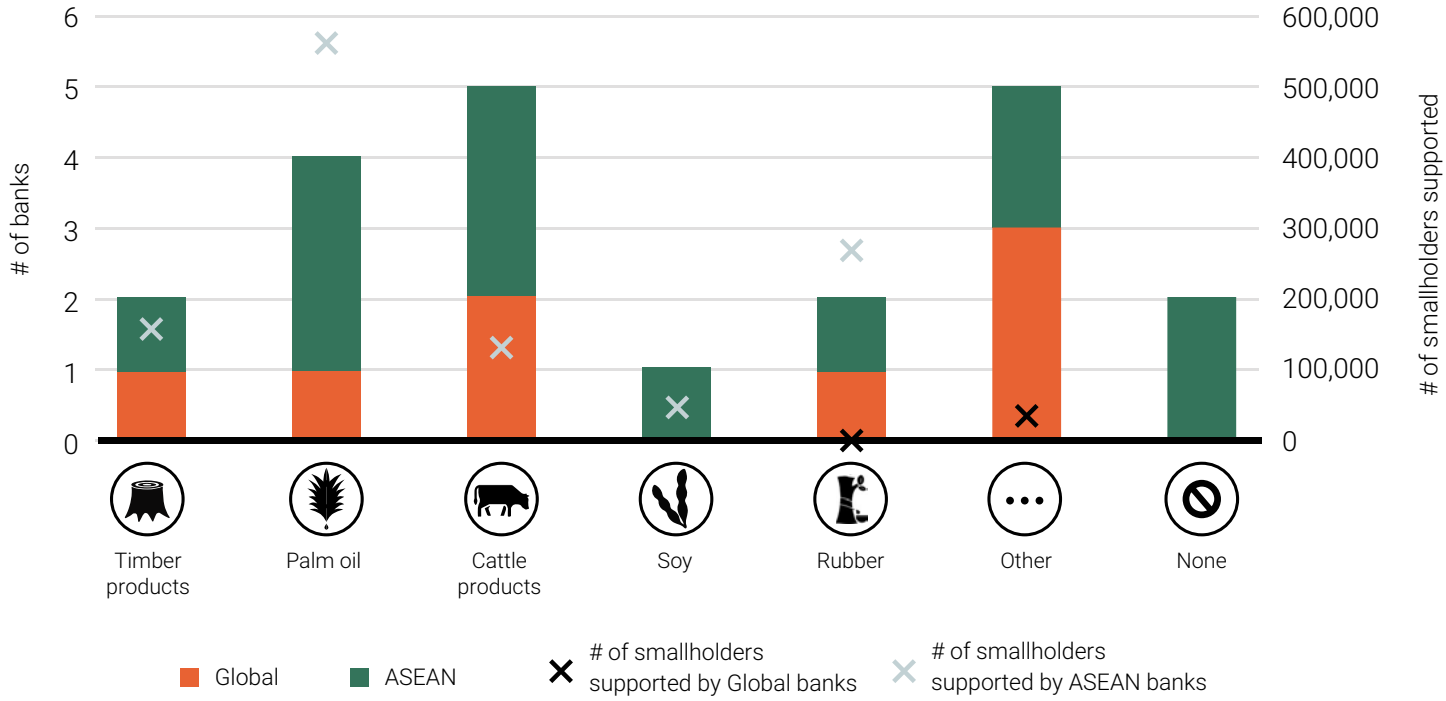
Taxonomy used to classify products as sustainable



ASEAN banks are more likely to use internally defined classification. That said, locally applicable taxonomies such as the ASEAN Green Bond Standards are sometimes being used by ASEAN banks.

One area of opportunity almost all banks highlighted was providing financing to agricultural smallholders. This is somewhat surprising as it was assumed a priori that large global banks would lack the extensive branch networks in tropical regions to support rural smallholders in the palm oil industry. However, global banks reported supporting smallholder growers of other commodities such as rice and cocoa. They also reported supporting much fewer individual smallholders in absolute numbers.

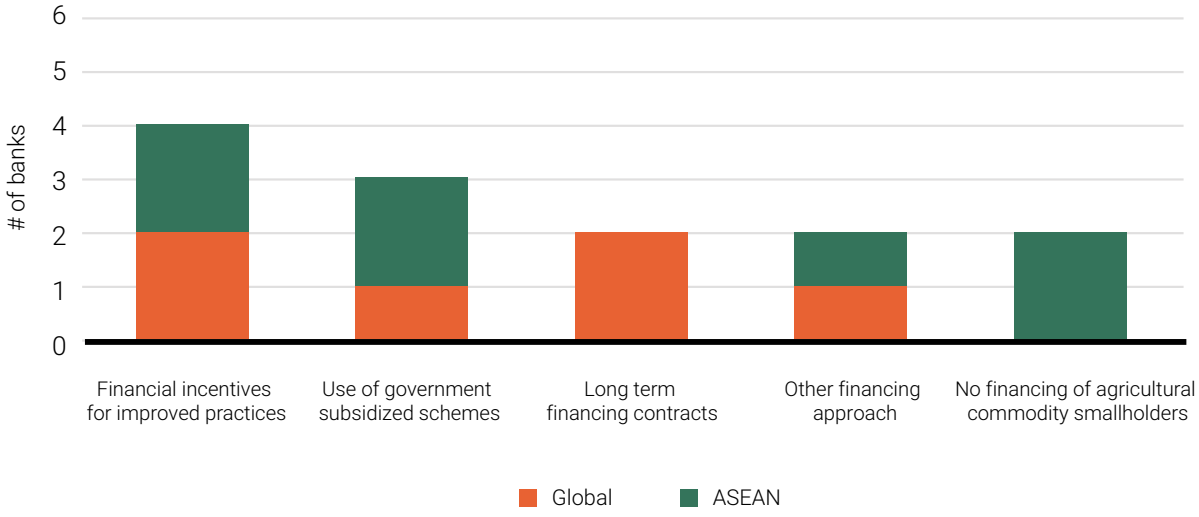
Do you provide financing to smallholders in any of the following agricultural commodity supply chains?



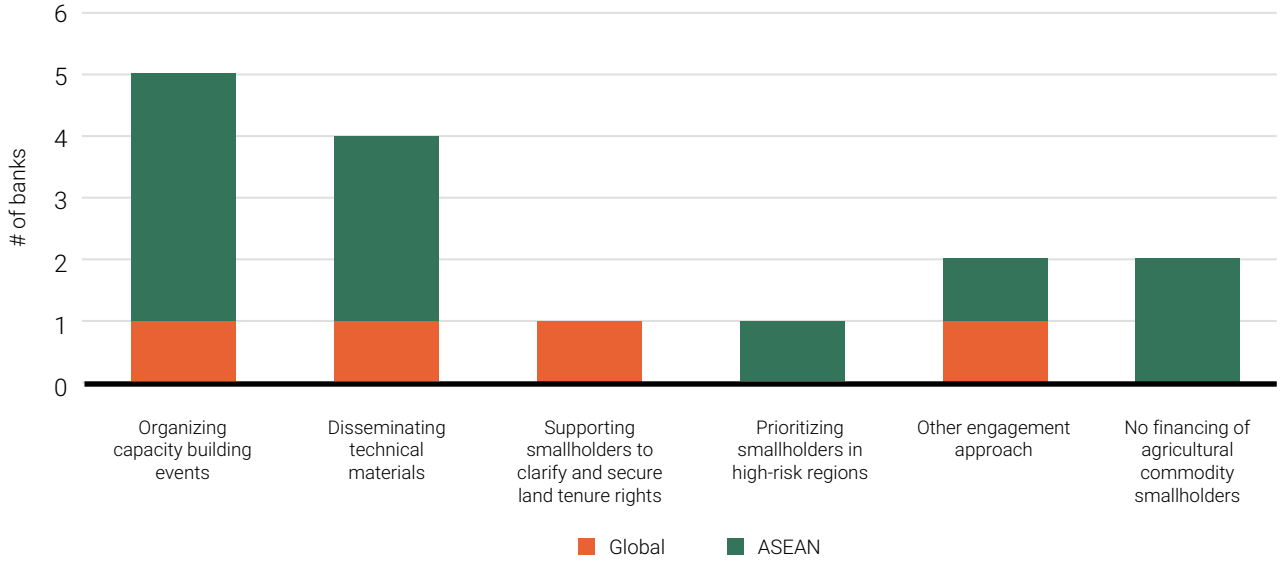
Smallholders are hugely important in palm oil and rubber production. They manage 40% of Indonesia's total palm oil plantation area, making them key to transition. However, access to credit for smallholder producers is a pertinent issue because in some cases a lack of access to credit (particularly the long-term credit required to finance replanting activities) is driving behaviors that result in deforestation or conversion of natural ecosystems[34, 35].

Smallholder financing and smallholder engagement approaches disclosed by the banks represent opportunities to advance environmental and social aspects of sustainability[36]. Common approaches disclosed by banks include financial incentives for improved practices, use of government subsidy schemes, organizing capacity building events and disseminating technical materials. Those supported by the banks participating in the pilot range from female rice entrepreneurs in Senegal to KUR-supported farmers of ginger in Indonesia.

Smallholder financing approach



Other smallholder engagement approaches



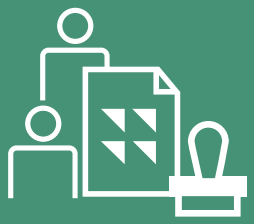
CONCLUSIONS

The financial services sector is crucial in achieving the transition to a low-carbon and deforestation-free economy. Most financial services companies' environmental risks come from portfolio financing, rather than their direct operations. Conversely, the environmental crisis also offers many business opportunities for the sector. Achieving net-zero will require massive investment in low- carbon technologies and sustainable agriculture, which only the financial sector can provide. Because financial services companies have influence far beyond their immediate operations, they play a unique role in tackling climate change and other pressing environmental issues, such as deforestation and biodiversity loss. Their influence in the wider economy means they can catalyze change by engaging with the companies they lend to, invest in and insure.

Many of these environmental issues have health impacts too. For example, deforestation and land-use change increase the risk of novel and potentially deadly pandemics. Reducing pandemic risk therefore means working with nature. Hence, this presents a timely opportunity for the financial services sector to trigger a huge leap forward to sustainable economies. Standardized, tailored disclosure of their impacts is the key first step.

The key recommendations to banks are to:

- Consider both sides of the 'double materiality' issue; in addition to assessing how environmental issues might affect their portfolios, banks should assess how their portfolios impact the environment, including forests.
- Assess their portfolio's impact on deforestation throughout the supply chain (producers, processers, traders, manufacturers, retailers).
- Act on their policies by pro-actively engaging with clients to hold them accountable and support them in their transition towards sustainability.
- Strengthen their reporting framework and fully disclose their lending practices, including their financing of FRC.



The key recommendations to policy makers and regulators are to:

- Strengthen their policy framework for banks with regards to climate management and protection of natural capital.
- Consider integrating environment-related issues into banks' capital requirements.
- Further develop taxonomies for sustainable activities and green financial products.
- ASEAN policy makers should consider supporting smallholder FRC financing, e.g. by providing government guarantees to lenders.

The key recommendations to investors are to:

- Assess their portfolio emissions – for reference see CDP's Technical Note on Portfolio Impact Metrics for Financial Services Companies.
- Consider portfolio engagement as an alternative to exclusion policy led divestment - once an investor has divested, its influence over the divestment company's environmental impact ceases.
- Engage further with their portfolio clients and actively participate in AGM voting on environmental issues.
- Engage further with policy makers and regulators with regards to environmental policies and regulations.

Where CDP will take its reporting framework from here:

As we look towards the critical years ahead, there is an ever-greater need for robust, timely and actionable environmental data that the market can use to inform decisions. Therefore, CDP intends to expand its questionnaires beyond its current questions on carbon emissions, deforestation and water security to include a full range of environmental factors as it is committed to accelerating global environmental ambition and driving action.

For financial institutions, it means covering all environmental risks, opportunities and impacts driven by their lending, investments and insurance underwriting. Building on the existing questionnaire on climate change management within financial services, CDP worked with stakeholders in the Financial Services Climate Change and Forests Pilot to develop forests-related metrics for the financial sector. Critical metrics will be included in the integrated reporting framework for financial services companies in the future. The integrated approach reduces reporting effort and is a scalable solution that CDP intends to implement in the future as the questionnaire for the financial sector is developed to include a more comprehensive range of environmental issues.

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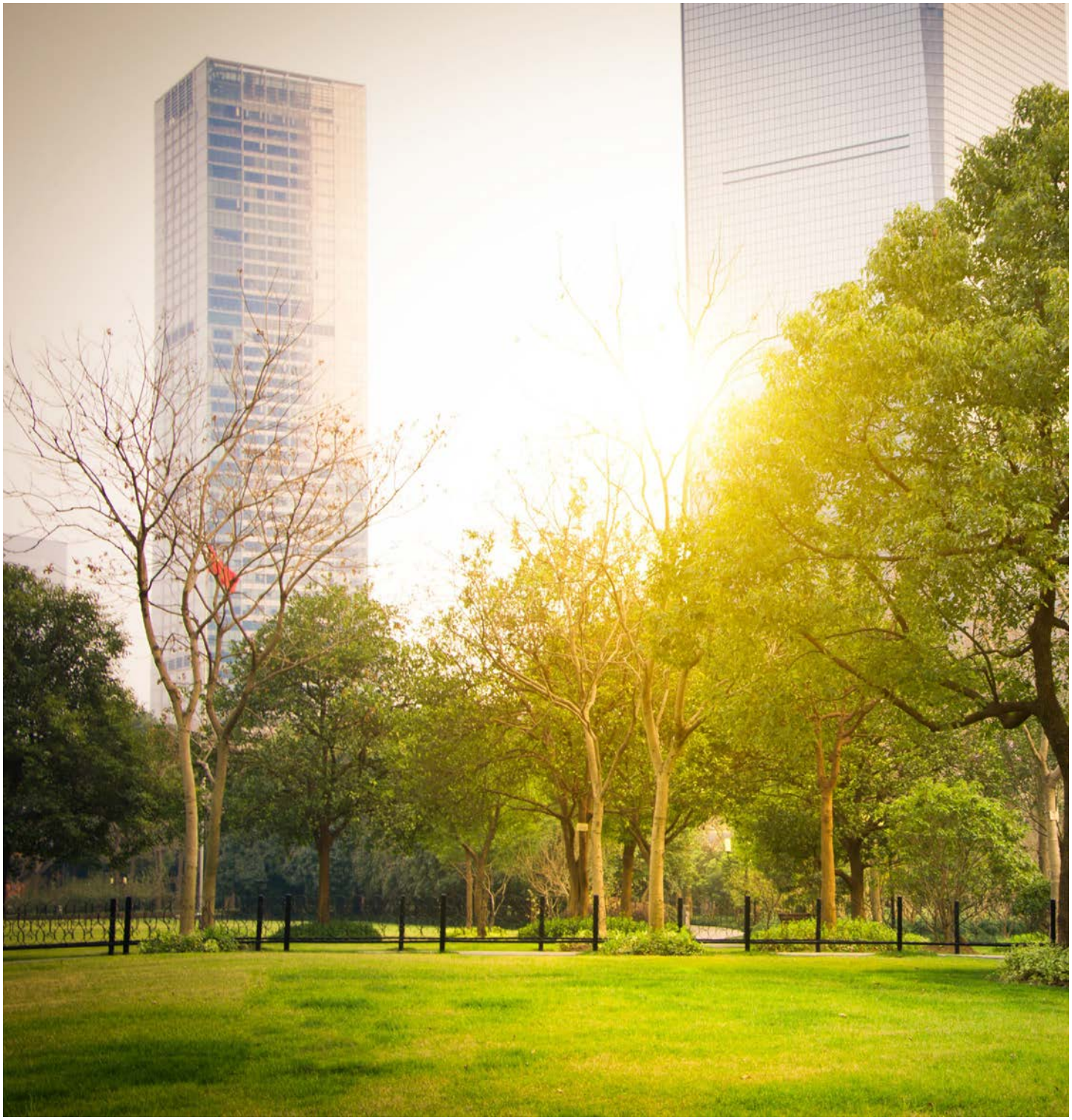

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