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White Paper

6 June 2016, Royal Society, London

Catalyzing financial sector engagement in deforestation-free supply chains

Cattle, palm oil, soy and pulp & paper

This White Paper was produced by
TFA 2020

What are the objectives of the session?

The increasing demand by large consumer goods companies for deforestation-free commodities such as palm oil, soy, cattle, pulp & paper and others; shifting production patterns in producing countries; and international and bilateral support financial schemes for forest protection are creating new deal opportunities to finance deforestation-free supply chains. In this light, the Tropical Forest Alliance (TFA 2020) has produced a framing document on financing opportunities and is hosting a Deal Innovation Lab focusing on specific deals to realize deforestation-free supply chains. This session aims to introduce the framing document of this initiative. In particular, the objectives of the session are to

- review the role of the four major commodity supply chains (cattle, palm oil, soy and pulp & paper) in deforestation, progress in shifting to a deforestation-free model and size of opportunity;
- review the investment case for deforestation-free supply chains and the existing and potential role of various types of financing;
- discuss the challenges to the investment case, the requirements for greater finance and the roles of non-financial actors in enabling this;
- discuss the opportunities for the financial sector to play a greater role in supporting the transition to deforestation-free supply chains.

What do participants need to know about the topic?

Deforestation and forest degradation are taking place at a rapid pace, with special harm to primary forests in Latin America, Sub-Saharan Africa and Asia. In the decade from 2004 to 2015, the cumulative tree loss in these regions exceeded 60 million hectares, despite large reductions in deforestation in Brazil (the largest single contributor) since 2005.

Agricultural commodities drive roughly 80 percent of this deforestation,[1] **based on strong underlying demand and local conditions that make deforestation-linked production financially attractive.** Four major commodities – cattle, palm oil, soy and pulp & paper – are the largest drivers, with crops such as coffee, cotton, cacao and rubber playing significant roles in particular geographies.

Deforestation-free supply chains seek to meet demand for these major commodities through production chains that do not directly or indirectly lead to deforestation or forest degradation. Deforestation-free supply chains continue to produce commodities of significant commercial value, although in general terms they differ from traditional forms of production in two ways: (1) they involve more intensive forms of production; and (2) they invest in natural capital and the production of eco-system services for which there are not always well-established markets.

Deforestation-free supply chains present a mix of challenges and opportunities. There are a number of challenges facing deforestation-free supply chains, some of which are equally true for traditional supply chains – these include commercial challenges (e.g. higher upfront costs, longer payback period and lower returns), financing challenges (e.g. poor collateral and high transaction costs) and institutional or regulatory challenges (e.g. inadequate land tenure systems and disadvantageous capital adequacy requirements). At the same time, there are also potential advantages to deforestation-free supply chains. These include the leveraging of technological innovations that profitably improve productivity, a price premium from consumer markets that increases revenue, a reduction in commercial risks owing to more resilient production methods and a reduction in reputational risks.

Importantly, while their commercial characteristics do vary from traditional supply chains, deforestation-free supply chains meet many of the conditions essential for achieving at-scale financing.[2] They have clear revenue streams, collateral and liquidity conditions and risk profiles that can be evaluated and priced by investors. While public mechanisms are generally necessary to realize the value of eco-system services, deforestation-free supply chains produce a clear commercial product, and in some cases provide competitive commercial returns to investors based only on the value of commercial production. Institutional and regulatory challenges remain formidable in some cases, but deforestation-free supply chains have a clear advantage in this respect versus other types of conservation investment.

1 Kissinger G and Herold M. 2012. *Drivers of deforestation and forest degradation: A synthesis report for REDD+ policymakers*. Vancouver: Lexeme Consulting.

2 Credit Suisse. 2016. *Conservation Finance From Niche to Mainstream: The Building of an Institutional Asset Class*. Zurich: Credit Suisse.

These commodity supply chains already mobilize tens of billions of dollars a year in finance, yet estimates of the amount of finance going to deforestation-free supply chains are at least an order of magnitude lower. Currently, the vast majority of financing for these supply chains comes from state subsidies, state owned or backed financial institutions, self-financing and supplier finance, with access to commercial debt and equity markets for very large production and processing players. International donors, development financing institutions, local (wholly) commercial financing institutions and international commercial financing institutions are relatively small sources of direct finance for these supply chains. While many players in the supply chain have made progress toward more sustainable practices, the scale of investments that are fully deforestation-free remains relatively small, and the direct role of private financial institutions in driving such investments is even smaller.[3]

The commercial and financing characteristics differ greatly across supply chains, regions and producer types, but there appear to be opportunities that are ready for scale. From a small cattle rancher in Colombia to a large, integrated pulp and paper producer in Indonesia, the underlying commercial attractiveness and financing requirements vary greatly. In some cases, barriers to finance exist as much for traditional supply chain investments as for deforestation-free investments – fundamental changes in public policy will need to precede significant financial flows. Yet in other cases, reasonable conditions for investment have been created and the potential for large-scale finance appears within reach, even if some public action is still required.

Achieving at-scale finance will require strong engagement from financial institutions, which will need to use their own inventiveness to develop effective financing solutions suitable to each case. A number of initiatives involving leading financial institutions, NGOs and public sector actors are supporting increasing engagement, and helping establish investments and financing instruments to 'prove the concept'. Such efforts have helped create favorable investment conditions and pioneered new forms of conservation finance. Moving from pilots to scale requires deeper engagement of financial institutions, and their treatment of deforestation-free supply chains as a mainstream investment and asset class. Crossing this threshold would set off a virtual cycle in which the sector's own profit-driven inventiveness catalyzes large, stable and relatively low-cost capital flows, which in turn improve the commercial viability of deforestation-free investments, increasing incentives for supply-chain actors to develop such investments, and for public action to enable such investments.

Engagement of the financial sector is not the only challenge to achieving deforestation-free supply chains, nor are deforestation-free supply chains the only solution to deforestation. For example, significant effort is required to create robust legal conditions for the protection of forests. Jurisdiction-level mechanisms are essential to ensuring the deforestation-free investments of some actors do not simply push deforestation activities to other actors. Nevertheless, there remains room for greater financial sector participation to drive progress while broader action is still underway, and to motivate such broader progress.

3 NatureVest and EKO Asset Management Partners. 2014. *Investing in Conservation: A landscape assessment of an emerging market.* Arlington, Virginia: NatureVest.

What are the current challenges in relation to the topic?

The challenges to stronger engagement from financial institutions can be categorized broadly into (1) lack of financial attractiveness of opportunities and (2) lack of knowledge of opportunities.

The previous section discussed the challenges that deforestation-free supply chains face in being attractive to investors. We believe our current and previous work demonstrates that the potential scale of the opportunity is large enough to garner interest from financial institutions, but fundamental challenges to the investment case remain across the financing chain from primary to secondary finance.

Nevertheless, there are reasons to believe that a knowledge gap also exists, and that this also inhibits the engagement of financial institutions in deforestation-free investments. Deforestation-free investments present a number of knowledge challenges that do not align easily with the core capacities of financial institutions. These include:

- lack of credible, standard information that allows investors to distinguish a deforestation-free investment from other forms of investment
- the complexity involved in assessing and securing the commercial value of eco-system services, which are not widely traded, and managing the various counterparty relationships
- relatively small and scattered nature of investment pilots to-date, and the lack of an accumulated track record for such investments
- broadly speaking, the nature of these and other risks go beyond what is currently assessed by the standard risk assessment tools used by investors.

Which concrete measures do you propose to overcome these challenges?

TFA 2020 aims to increase financial institution engagement by conducting Deal Labs in which investment deals *ready for financial scale-up* are discussed with financiers and other actors (e.g. commodity buyers, public sector actors and NGOs) necessary to the deals' commercial viability. The Deal Lab will look at select real deals and deal opportunities to look at how they can be structured to increase their attractiveness for mainstream financial actors and to gain scale. Workshop participants will include select members of the financial sector, consumer goods companies and producers, as well as government and civil society representatives.

The desired outcome of the Lab is the preliminary design of solutions that are deal-specific and financially viable, and can be replicated and scaled up across supply chains and geographies. The outcomes of the workshop will feed into the ongoing activities of TFA 2020 to support the emergence of a continued deal pipeline for deforestation-free commodities.

To support the design and preparation for the Deal Labs, TFA 2020 has conducted an analysis of the challenges and opportunities across the major supply chains (to be presented as background to this session).

What are the remaining open questions?

- To what extent do scalable opportunities exist despite the challenges? What are they?
- For opportunities within striking distance (i.e. without major reforms or structural changes in the market), what is required to put them over the line?
- Who are the essential actors to make this happen – across the supply chain, across the financial sector and across government and non-government actors?
- How can the extended Deal Lab format (including preparation and follow-up) help develop such opportunities?

What are your proposed milestones for implementation?

An initial Deal Lab is planned for September 2016. Lessons from this event will be integrated into the design going forward. The aim is to conduct subsequent labs as an ongoing vehicle for action-oriented engagement with the financial sector to achieve at-scale investments.

Who carries responsibility for/ can support implementation?

Stakeholder groups to be involved to support implementation include:

- consumer-facing companies, including those of the Consumer Goods Forum
- commodity producers and traders
- financial intermediaries, including global and local banks and those of the Banking Environment Initiative
- investors, including impact investors, private investors and institutional investors
- governments of producing and donor countries
- smallholder farmer organizations
- civil society organizations
- international organizations, including multilateral development banks and financing facilities.

Select background documents

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Global Landscapes Forum | *London*

The Investment Case

6 June 2016, Royal Society, London

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