UNDERSTANDING NEW REGULATORY FRAMEWORKS IN LAND USE FINANCE

Learnings from the ESKEN webinar

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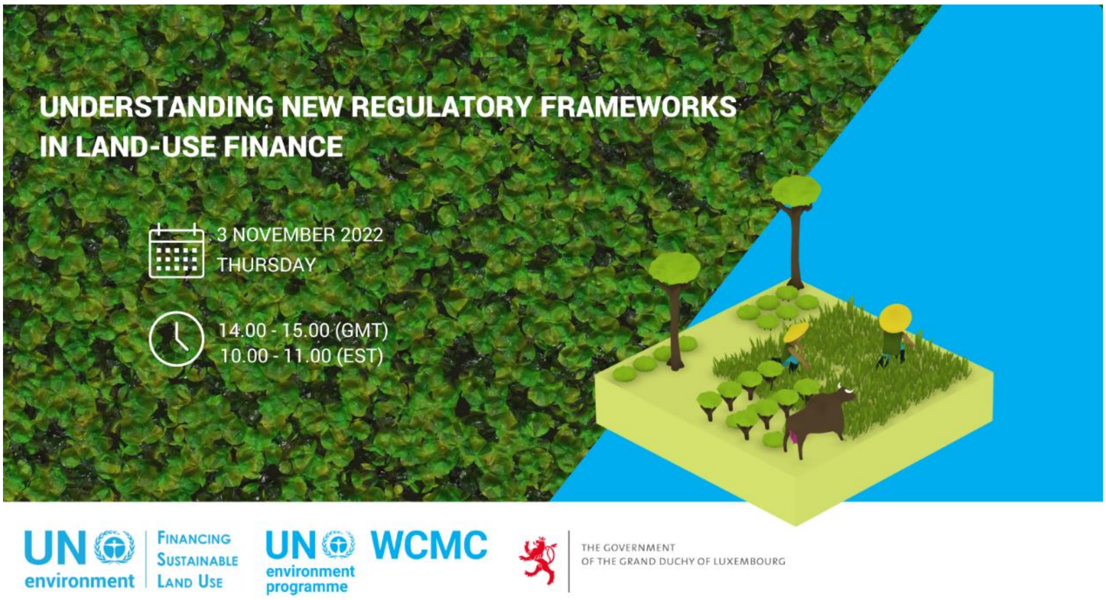

The Environmental and Social Knowledge Exchange Network (ESKEN) is a workspace for a community of practice involved in the environmental and social (E&S) aspects of financing deforestation-free commodity production, protection of natural ecosystems, forest landscape restoration, and other forms of sustainable land-use.

The ESKEN webinar 'Understanding New Regulatory Frameworks in Land Use Finance' was held on the 3rd of November 2022 (the slides and recording of the webinar can be accessed on our website). It discussed the potential land-use related regulatory risks arising from the development of recent regulatory frameworks. The webinar was delivered by:

- **Satu Glaser**, Senior Programme Officer, Nature Conserved, UNEP-WCMC
- **Fernanda Gimenes**, Engagement Manager for IFACC, Tropical Forest Alliance, The World Economic Forum
- **Romie Goedicke**, Associate Lead at Nature – Partnerships & Development, UNEP-FI

And moderated by:

- **Raphaele Deau,** E&S Lead, UNEP-Climate Finance Unit
- **Rodrigo Cassola**, Nature Economy Senior Programme Officer at UNEP-WCMC

Brief context: Regulatory Risks in Land Use Finance

Regulatory risks are changes in laws and/or regulations that can have a negative impact on the costs or a change in the competitive landscape that potentially affects a business. For financial institutions involved in Environmental, Social and Governance (ESG) issues, the inability to meet regulatory obligations and not complying with existent and future requirements will also result in other risks — such as legal sanctions, unexpected financial costs, and reputational risks— that could potentially be more material to financial institutions.

In recent years, there has been an array of international and national frameworks and initiatives looking at how financial institutions need to assess, report and disclose their impacts on nature and people. For example, commodity sourcing companies are increasingly asked to disclose information on their supply chain impacts on land use. Failure to do so will entail charges and other legal sanctions. In the case of the UK, forest commodities in commercial activities must establish a due diligence system[1].

The regulatory landscape includes upcoming and on-going regulation[2]. There has been increasing developments for reporting operations and investments through an impact lens, including biodiversity loss and deforestation. According to a survey conducted by CDP[3], half of the financial institutions disclosing data were not assessing forest-related risks in their portfolios, putting them at risk from growing liabilities as incoming regulation on deforestation is being developed. In the case of land-use investing and forest-risk commodities, financial institutions have a great part to play in shaping business activities toward more sustainable and deforestation-free investments.

[1] UK Environment Act 2021. https://www.legislation.gov.uk/ukpga/2021/30/contents
[2] For further information on upcoming regulations see slide 27 of the webinar's slide deck. Available here.
[3] CDP (2021). CDP Forests Analysis Report 2020. The Collective Effort to end Deforestation: A pathway for companies to raise their ambitions https://de.scribd.com/document/500302418/CDP-Forests-Analysis-Report-2020

Under the increasing awareness of the drastic impact of deforestation, 141 countries have signed the 2021 Glasgow Leaders' Declaration on Forests and Land Use worldwide, and various regulatory institutions also started to respond. The European Union is in the process of finalising its regulation to curb the flow of deforestation-related commodities. It is an ambitious initiative, sitting within a wider goal to promote sustainable production and consumption patterns and policy. In 2023, it will be one of the pioneer regulatory advances on the matter.

Webinar Summary

The webinar discussed emerging regulations and disclosure frameworks that are likely to place obligations on financial institutions operating in the land use finance space. It included examples from the EU and a country-specific example from Brazil. Additionally, the webinar touched upon how approaches to measuring the impact on land-use can prepare financial institutions to anticipate mandatory regulations and thus mitigate regulatory risks. During this webinar, guest speakers shared their insights and recommendations.

Introducing EU Deforestation-free Products Regulation

Satu Glaser, from UNEP-WCMC, who is providing technical support to the EU Commission in the context of the EU deforestation-free products regulation proposal, provided a brief history of the draft regulation, which is a pioneer regulatory response on deforestation brought forward by consumer countries. The origin of the proposed regulation can be tracked back to the *EU Communication on Stepping up EU Action to Protect and Restore the World's Forests in 2019.* It pointed out a range of key actions for the European Commission and includes an assessment of additional demand side regulatory measures, as well as recommendations for actions by industry. In 2021, the draft regulation was proposed by the European Commission, and it went through different stages. On Dec 6th, 2022, the Commission has welcomed the provisional political agreement just reached between the European Parliament. The next step is for the Council and the Parliament to formally adopt the new Regulation before it can enter into force.

The regulation focuses on bulk commodities of cattle, swine, sheep and goats, poultry, cocoa, coffee, palm oil, soya, maize, wood, and rubber[4]. In the case of the meat products above, animals cannot have been fed with deforestation-associated fodder of products within the scope of the regulation. The proposal covers import, placing on EU market and export. The key provisions for operators[5] and traders[6] encompass a due diligence obligation, such as information collection, record-keeping and submitting due diligence statement in a register, including a risk-assessment to ensure that the commodities comply with the regulation. The proposed cut-off date is set so that no commodities produced on deforested land after 31 December 2019 can be imported into, placed on, or exported from the EU market.

One of the points that Satu emphasised was that the most recent Parliament version[7] of the draft released in September 2022, extends the obligations to financial institutions headquartered or operating in the European Union. These mainly involves collecting information about the production, supply, placing and/or exporting of commodities, as well as assessing the risk and submitting due diligence statements. It is specified that financial institutions can only provide services if there is a

[4] The speaker noted to please see Annex I.
[5] For the purpose of this Regulation, an operator is the one that places on the (EU) market and exports from it. Please refer to this draft.
[6] For the purpose of this Regulation, like in the EUTR a trader can be defined as "any natural or legal person who, in the course of a commercial activity, makes available on the Union market relevant commodities and products". Please refer to this draft.
[7] The speaker noted that this version only includes the elements where they propose changes/additions, therefore do assess it together with the Council version.

negligible risk that these are directly or indirectly linked to activities leading to deforestation, forest degradation or forest conversion.

Investor-led Initiatives in Latin America

Fernanda Gimenes, from the Tropical Forest Alliance - TFA, initiative hosted by the World Economic Forum (WEF) –, presented on the rising pressure on countries to establish regulatory frameworks that help reduce deforestation. Following a presentation on regulatory responses emerging in different geographies, both in commodity producer and commodity consumer countries, she also spoke on how institutional investors can mitigate risks by halting deforestation in Brazil. She too flagged finance opportunities for sustainable land use in three Latin American countries.

Fernanda introduced Tropical Forest Alliance (TFA), a global network that brings together partners around the common goal of implementing solutions to tackle deforestation resulting from commercial activities in tropical forest areas. The pressure to end deforestation is rising. She highlighted that forests are at the centre of key societal crisis today, such as biodiversity, climate change, food security and more. An example of how financial institutions can respond to that pressure is for instance if regulation states that banks could request physical asset-location data from counterparts and companies to enhance supply chain traceability and to ensure nature-positive activities.

Fernanda took the opportunity to talk about the Investor Policy Dialogue on Deforestation (IPDD), an investor-led initiative. TFA aims at coordinating several policy dialogues on halting deforestation in a handful of countries, including Brazil. This is because deforestation is already posing a systemic risk for investors' portfolios and even sovereign and corporate debt. In terms of regulation, this initiative is looking to enforce Brazil's Forest Code and avoid any changes that could negatively impact forests and land use. As an example, there are currently proposed changes to regulation in Brazil that might affect indigenous lands and land tenure that could be worth looking into while investing in the country.

Fernanda also highlighted the Innovative Finance for the Amazon, Cerrado, and Chaco (IFACC) initiative as an investment opportunity for sustainable production of cattle and soy in Brazil, Paraguay and Argentina. IFACC is an initiative from the United Nations Environment Programme (UNEP), the Nature Conservancy (TNC) and the Tropical Forest Alliance (TFA). It supports banks, companies and investors seeking to expand innovative finance for deforestation/conversion-free beef and soy in these regions. It does so through farm loan products, farmland investment funds, corporate debt instruments and capital markets offerings—and help farmers implement proven business models to supply the global market without further conversion of the Amazon, Cerrado and Chaco ecosystems. IFACC goal is to rapidly scale up private finance into sustainable land use, they are seeking US$3 and $10 billion in commitments by 2023 and 2025 respectively, and $200 million and $1 billion in disbursements by 2023 and 2025 respectively.

TNFD and more: Voluntary tools and frameworks

Romie Goedicke, from UNEP-FI, who is involved in the Taskforce on Nature-related Disclosure (TNFD) discussions, shared how voluntary approaches to measuring the impacts and dependencies on nature can prepare financial institutions to anticipate mandatory regulations on public reporting and disclosures.

She mentioned that there is a huge gap that needs to be closed since biodiversity loss has been identified as one of the top five risks to the global economy. Thus, biodiversity is the fastest-developing ESG theme in global capital markets.

Romie pointed out that public and private sector are interconnected, and so one follows the other. Legislative developments should be placed in the context of what happens in the markets. She shared how major frameworks such as the Task Force on Climate-Related Financial Disclosures (TCFD) are influencing regulation regarding climate investments. For instance, there are already constituencies that are considering legislation aligned with the TCFD[8]. Similarly, the upcoming TNFD can be expected to have a comparable influence for nature investments regulations.

There is a drive by business and financial institutions to level the playing field by means of regulations. And in order for financial institutions to anticipate risks, they need to raise awareness, build capacity within their organisations, and adopt recommendations that will most likely later become regulations and thus mandatory obligations. For instance, implementing the TNFD risk and disclosure beta-framework could help financial institutions to be prepared for the upcoming regulations.

Key takeaways for fund managers to consider

- **The regulatory responses to deforestation that are emerging globally, both in commodity-producer and consumer countries, pose compliance risks for financial institutions.** The EU regulation is an example of the global awareness at the legislation level, and there will be more governments and regulators following this trend, especially driven by a market-interest in levelling the field for all players.
- **Financial institutions can benefit from actively participating in collaborations and opportunities for engagement with legislators and other stakeholders**. Examples of these are IFACC and the IPDD, investor-led initiatives that seek to expand innovative finance for deforestation-free commodities in producing countries. We encourage financial institutions to engage in the EU policy-making consultation, give feedback and to publish or discuss opinions in the right fora.

- **Having a start on preparing for nature-related disclosures and actively engaging with the initiatives driving this agenda —in particular TNFD— can brace financial institutions to anticipate mandatory regulations.** It is expected that voluntary frameworks on nature-related disclosure currently in development will influence the future mandatory requirements, similar to what is already happening in the climate change space. Some regulatory requirements are already emerging, such as the SFDR and the Corporate Sustainable Reporting Directive (CSRD) in the EU. Financial institutions can join the TNFD piloting program, provide feedback, develop their capacities, and engage with disclosing information to be prepared and minimize risks for regulatory frameworks.

References

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[8] For example, Switzerland made TCFD mandatory for large companies from 2024 onwards. https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-91859.html

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