MANAGING ENVIRONMENTAL & SOCIAL RISKS IN LAND USE FINANCE: PRACTICE, CHALLENGES AND OPPORTUNITIES

Learnings from the 2021 Knowledge Exchange Event

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Introduction

Catalysing a transition to sustainable land use financing

How we manage land and produce food will be a key pillar to tackle the climate and nature crises. The latest IPCC and IPBES reports showed that we are now in the "code red" territory in terms of our collective failure to hardwire emission reduction, climate adaptation and protection/sustainable use of nature into our economic and financial systems.

Banks and other financial intuitions (FIs) have the potential to help transition land use to become nature positive, by shifting investment to more sustainable projects. However, setting up robust social and environmental frameworks to ensure investments create true impact and avoid harms is a complex matter in the land use space, with the physical scale, often geographically remote nature, and novelty of such deals all providing challenges to FIs.

The UN Environment Programme (UNEP), in collaboration with UNEP-WCMC, is providing support and guidance to funds and facilities who are developing sustainable land use investment portfolios. For the last three years the team has run E&S Knowledge Exchange Events to facilitate open discussions on challenges in this space. Previous events focused on the standardization of positive impact measurement and reporting, informing the development of the *Land Use Financing – Positive Impact Indicators* directory. This year we have pivoted to discussion of the environmental and social risk management facet of land use financing. Currently little guidance is available on the experience and challenges in operationalizing risk management frameworks in the context of land use finance, and this year's event aimed to address this.

Format of the 2021 Knowledge Exchange Event

The 2021 knowledge exchange event consisted of five online events over the course of the week of 29th November. Public webinars opened and closed the week, with three invite-only workshops in between. The workshops worked through the major aspects of a risk management framework: eligibility criteria and exclusion lists, risk screening, and due diligence. This document will reflect on the main learnings from across the week.

- *Opening webinar:* Managing environmental & social risks in land use finance
- *Workshop 1:* Setting the bar: eligibility criteria and exclusion lists
- *Workshop 2:* Risk Screening: practice and challenges
- *Workshop 3:* Due Diligence: defining the scope and addressing challenges
- *Closing webinar:* Reflection and Next Steps. *(Recording here).*

Across the course of the week there were 53 unique attendees – many of whom attended multiple sessions – representing a range of impact funds, asset managers and funders.

Eligibility Criteria and Exclusion Lists

Context

Eligibility criteria and exclusion lists set the tone for what each fund aims to achieve with their investments and form the first element of a framework for screening potential deals against. Eligibility criteria set out minimum requirements for investments to deliver against – including, for land use, cut off dates after which no deforestation/conversion is allowed. Exclusion lists can be used to set out sectors or activities excluded for a fund.

Insights

Reflections on the use of eligibility criteria

From the discussions it became clear that many funds curated their eligibility criteria to assess whether potential deals met with the overall aims of the fund. Depending on the aims of the fund, different elements would be more or less stressed; some were more focused on ensuring sustainable rural livelihoods, with a 'do no harm' approach to biodiversity and/or deforestation issues, whereas other funds reversed the emphasis. Consistent across the discussion, however, was that funds were keen to 'screen in' rather than screen out potential deals, and to engage with potential investees to raise the bar – an issue that we will discuss further in the Risk Screening element.

There was also a common understanding that setting the bar too high for investees may retard progress in the right direction. Funds were conscious of the differing levels of resourcing and capability across small and large players in the target geographies, resulting in varying potential levels of compliance on a number of aspects of eligibility criteria. For example, when it came to IFC Performance Standard 6, it was suggested that smaller businesses could be given more time to reach compliance, or that just the overall principles were applied for smaller businesses, rather than insisting on full compliance which can be very burdensome for smaller organisations. This is considering the backdrop often eligibility criteria are imposed by the providers of concessional funding who support blended finance funds – but with different funders insisting on different criteria this often became burdensome for the blended funds. A staggered approach was also suggested in regard to cut off dates for deforestation – with smallholders potentially held to less ambitious dates and an incremental approach to meeting certain eligibility criteria.

Similarly, when it came to ensuring compliance such as the exclusion of child labour within supply chains, many attendees agreed that it was important to engage with potential investees and understand the drivers of the risk, diagnose the problem and deploy a mutually agreed and practical solution, rather than take a simplistic exclusionary approach which may not bring about any meaningful change on the ground. As with any topic, it was important to heed regional differences, and not expect a 'one size fits all' approach to yield the best outcomes.

Valid points were raised on the need for a standardised measure of biodiversity which could be integrated into eligibility criteria. It was recognised by the team that this is indeed needed. It was noted that there are ongoing initiatives in this sense, like the *Aligning Accounting Approaches for Nature* project, which is currently working on recommendations for a standard on biodiversity measurement – a first draft is expected to be published in 2022. The *Finance for Biodiversity Guide on Biodiversity Measurement Approaches* was also recommended as a useful resource.

Finally, the issue of upcoming regulatory requirements was raised. The EU Taxonomy, alongside the Sustainable Finance Disclosure Regulations (SFDR), was referred as a key regulatory development. Those regulations will apply to any fund based in the EU, regardless of where investments are made. Disclosure requirements start applying on 1 January 2022 in relation to the two climate objectives, and on 1 January 2023 in relation to the other four environmental objectives. It was recognised that this will be a burden to many of the smaller funds and facilities, but it is important that eligibility criteria are amended to align with the Taxonomy to ease future reporting needs.

Common eligibility criteria for sustainable land use investments

Common eligibility criteria discussed included:

- **Deforestation and conversion free**[1] – no deforestation or conversion of natural habitats allowed within the portfolio area from the start of the project, or from a point prior to the project start which is called the 'cut-off date'. The cut off date suggested by AFi is 1st January 2020[2].
    - There was some discussion taking an incremental approach to meeting eligibility criteria for smallholders compared to larger commercial farms.
- **Compliance with national and international laws** – as a minimum standard, investees should already be able to show evidence of compliance with all relevant national and international laws which apply to their remit
    - This applied in particular to labour laws and workers rights – compliance with national and International Labour Organisation standards expected
- **Land tenure established** – the ownership of the land on which the project is proposed should be clearly delineated, should have been achieved with free, prior, and informed consent, and must not have any overlapping claims or conflicts.

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[1] The Accountability Framework Initiative define this as: '**No-deforestation.** (Synonym: **deforestation-free**): Commodity production, sourcing, or financial investments that do not cause or contribute to deforestation (as defined by the Accountability Framework). No-deforestation refers to no gross deforestation of natural forests, which the Accountability Framework specifies as the appropriate policy and goal on this topic for companies and supply chains. In the context of the Accountability Framework, deforestation refers to the loss of natural forest (see definition of deforestation). The AFi recognises the High Carbon Stock Approach (HCSA) as a practical tool to implement no-deforestation in the tropics, in contexts where the tool has been validated. The terms "no-deforestation" and "deforestation-free" are used in favour of "zero deforestation" because "zero" can imply an absolutist approach that may be at odds with the need sometimes to accommodate minimal levels of conversion at the site level in the interest of facilitating optimal conservation and production outcomes (see definition for minimal level [of deforestation or conversion]).' https://accountability-framework.org/the-framework/contents/definitions/

[2] https://accountability-framework.org/operational-guidance/cutoff-dates/

- **No negative impact on and/or improved management of protected areas** – protected areas (As defined by national or international mapping) should not be damaged by the actions of the project
- Investment in **fragile, conflict intense, and volatile (FCV) countries**[3] was a red line for some funds - but some others considered investments in these countries important to mitigate social and environmental issues
- **Avoidance of impacts on protected species** – a measure to ensure that project interventions do not have a negative impact on biodiversity and ecological processes underpinning biodiversity

Reflections on exclusion lists

The funds had varying approaches to their use of exclusion lists. Some funds indicated they use lists which had been required by providers of concessional funds (in the case of blended finance), others had developed their own exclusion lists, and others indicated preference for a 'positive' bar based on eligibility criteria, eschewing the more 'negative' filter provided by an exclusion list. Currently, most funds use fairly generic exclusions lists, not tailored particularly to the land use sector. It is not rare to see "weapons", "asbestos", "gambling", and other aspects unrelated to land use included in such lists. The IFC Exclusion List is a common source of such "generic" exclusion lists.

Where exclusion lists had been required by providers of concessional funds, there was a perception that they were more used for 'avoiding headaches' than adding real value to the process. It was also emphasised, as in the previous conversation, that it is vital to understand the context of issues that were being excluded and engage with potential investees on such topics rather than outright excluding them.

The potential development of a specialised land use investment exclusion list by UNEP and UNEP-WCMC (inspired by UNEP-FI's recommended exclusions for the blue economy, *Turning the Tide*) had a mixed reaction from attendees, with the overall feeling being that needs varied too much between funds and funders for such a tool to be particularly helpful.

Proposed topics to explore further

Based on the discussions during the 2021 KEE, the following topics are proposed as ones that could help addressing some of the challenges linked to eligibility criteria and exclusion lists:

- Development of factsheets on **recommended eligibility criteria** (e.g., deforestation cut-off dates), tailored to priority geographies and types of investment.
- **Guidance for client engagement on key eligibility criteria**, including roadmaps to allow transition towards compliance.
- **Engagement with providers of concessional funds** on the E&S requirements they impose on funds, seeking greater standardization of requirements.

[3] https://www.worldbank.org/en/topic/fragilityconflictviolence/brief/harmonized-list-of-fragile-situations

- Create a shared understanding of the **EU Taxonomy requirements and implications for setting eligibility criteria** that are aligned with the Taxonomy's technical screening criteria.
- Explore further the idea of a **standardized exclusion list for funds and facilities focused on land use finance**.

Risk Screening

Context

The process of risk screening allows funds to assess a deal's alignment with their own risk appetite and check what risk mitigation processes might need to be put in place for a deal. Risk screening is done after the deal has been shown to meet the fund's eligibility criteria. The risk screening process can be seen as a 'light touch' first run through of due diligence, allowing the fund to highlight areas where more work is needed by the investee, or where technical assistance should be provided, in advance of the more detailed and costly due diligence process.

Insights

Aims of risk screening

From our discussions, it became clear that funds are keen to use the risk screening process to identify opportunities for improvement rather than to 'screen out' potential deals. Where deals were found to be lacking, it was more likely that funds would support potential investees to put an Environmental and Social Action Plan (ESAP) or other risk mitigation plan in place, rather than ruling out a deal. Additionally, some funds looked purposely to engage with investees or geographies which could be seen as riskier – and the risk screening process allowed these funds to assess whether a potential deal aligns with their greater risk appetite.

The risk screening process is increasingly seen as an opportunity to identify and leverage areas for capacity building of potential investees, ensuring they are able to comply with developing the necessary procedures (e.g., Gender policy or action plans for the protection of biodiversity) and are able to gather and process necessary data to track their progress.

Challenges

Data availability and variability was a major challenge mentioned by almost all funds. Many land use investments are in remote areas, and some in countries with low levels of public data available. Different definitions of key habitats – e.g., forest – on a national level can further complicate this. Remote sensing data is one way to get around the large areas to be monitored – but some mentioned that ground-truthing and surveys are still vital to ascertain the true quality of forest or biodiversity on the ground. Proxies can be used to ground-truth remote sensing to some extent, and it is certainly an important part of a wider combination of data sources. Global screening data layers available thought IBAT relevant to biodiversity are also important data sources for screening purposes – these include the World Database on Protected Areas (WDPA), Key Biodiversity Areas (KBAs), the IUCN Red List, and the STAR metric.

Most funds used a mix of internal and external tools to carry out risk screening, with some funds outsourcing elements. It was noted that the costs of commercial licences for databases such as IBAT and Global Forest Watch Pro should be worked into a budget for risk screening. Other sources of information for risk screening mentioned included Global Forest Watch, MapBiomas (mostly for Brazil, but expanding coverage), Agroideal (Brazil

only), , Refinitiv, RepRisk, governmental data, IFC GMAP, and the WWF Environmental and Social Safeguards Framework.

Proposed topics to explore further

Based on the discussions during the 2021 KEE, the following topics are proposed as ones that can help addressing some of the challenges linked to risk screening:

- Create country or subnational jurisdiction profiles to highlight potential risks linked to land use finance.
- Mapping of relevant tools to aid the selection of tools funds can use to support risk screening, by topic (e.g., deforestation cut-off dates)
- Facility access to service providers that can support risk screening on topics relevant to land use finance, e.g., through a service provider directory.
- Develop a catalogue of webinars and trainings on different tools that can support risk screening by financial institutions investing in land use finance

Due Diligence

Context

Due diligence is the final step before an investment decision is made. This process is all about ensuring that risks are sufficiently assessed and the investors have confidence in the investees' ability to manage risks and deliver positive impact. If improvements have been requested as part of the earlier risk screening process, these should usually be in place by this stage, and the investors should be confident that all the necessary environmental and social safeguards are present, or will be present by implementation, for the project to manage risks, deliver real impact, as well as financial returns.

Insights

From speaking with a range of funds, it was clear that there was no one approach to due diligence. The process is highly tailored to the funds aims and even the deal at hand. However, the overall aims remained similar – to identify drivers of high risks and investigate partners' ability to manage those risks while delivering impact.

Risks assessed during this process included both the tangible – for example, project financing driving deforestation, or poor worker protection – and wider reputational risks for investors themselves – for example, supporting a company who has a poor history on social or environmental issues. The outcomes of the risk screening process were used by some funds to target due diligence to areas already highlighted as more risky.

Carrying out a thorough due diligence process for a land use project – which may be in a remote and inaccessible area, cover many thousands of hectares, and involve a coalition of partners – is neither cheap nor straightforward. There was variation between the funds in whether they had an in-country presence near to their project areas, and if they needed to or were able to pay for external consultancies to help with due diligence - some did not have sufficient budget for this. Some funds used larger consultancies to run an initial scan of the project, then employed specialist in-country consultants to investigate further if risks were flagged. Once all the various aspects of the due diligence searches are completed, even compiling and reviewing the final report can be a major time sink for the investor team. All of this adds up to a large sunk cost, which may be lost if the due diligence exposes risks too great for the project to go ahead.

The issue of who bears the cost of due diligence was a controversial one, with no straight answer. In some cases, funds reported being asked to carry out very detailed due diligence procedures by the providers of their concessional funds -- but not receiving any additional funding to cover the cost of such intensive screening. Passing the due diligence cost on to the potential investee would further discourage smaller businesses from coming forward for sustainable financing options. For most impact investments, the cost of impact screening and assessment are covered by the fund, which is often a concessional entity.

Defining the scope of the due diligence process was raised as an important and non-trivial point. For projects wanting to generate impact down the supply chain from the initial

project intervention site, it is important to think through and set boundaries on how far down the supply chain you wish initial due diligence and subsequent monitoring should go.

Due diligence as capacity building

At this stage, again, as during risk screening, an element of capacity building and technical assistance (TA) may be required in order for the potential investee to be able to comply with all necessary information requests. Some funds who have TA resourcing available are actively pivoting from a pure due diligence process to one which is also focused on bringing investees to a level of understanding suitable for investment readiness, or to identify areas where TA will be needed during the course of the project. Building such capacity, whilst necessary, is not a quick fix, and so requires patience from investors.

Trust, as well as capacity, must be built with investees, and so framing the due diligence process as a method of making the project as good as it can be – rather than a way of 'checking up' on the investee – was important to many of the funds. Trust between partners was also raised as being important to reduce risks through achieving greater transparency – both sides need to feel comfortable raising issues and resolving them amicably. Lack of trust on the side of the investee can also result in data hiding or obfuscation, which would be unhelpful for both the project and investor.

The issue of scaling up deal flows – which would require considerable streamlining of current detailed due diligence processes – was a challenge for all funds.

Proposed topics to explore further

Many of the funds in attendance flagged that there is already a proliferation of standards and tools available when it comes to due diligence. However, what would be helpful from UNEP and UNEP-WCMC could be **further guidance and knowledge exchange on how to address particularly difficult topics such as biodiversity and child labour**. Some funds raised that alignment across the impact metrics desired by investors would be helpful – this could perhaps be achieved with greater uptake of the *Positive Impact Indicators Directory*.

Additionally, **country-specific due diligence checklists**, highlighting issues relevant at a country level, could be helpful to streamline deal flows.

Challenges across the sector

As we reflected on the week, it became apparent that some risk management issues were raised again and again, and seem to be crucial stumbling blocks to further growth in the sustainable land use financing sector.

Capacity building of investees, coupled with cultural differences

Given the vast estimates of the needs of capital flows into sustainable land use[4], there should be no shortage of projects for funds to invest in. However, what is lacking is the capacity of investees to comply with the procedural requirements of impact funds – which could also be seen as a mismatch in cultural expectations when it comes to investment needs. Compliance with the needs of many impact and blended finance funds – in the form of written procedures evidenced by comprehensive local datasets – is a high bar for many small to medium sized businesses, who may never have needed to develop such procedures and processes before. We should be conscious of cultural differences, and power imbalances, between investors (often Western) and investees (often in the developing world). Funds have mentioned that they often find investees are very open to receiving technical assistance and capacity building – which is also vital for the long-term success of the sector. However, perhaps funds should also consider working with investees to develop alternative processes that, whilst still robust, are more relevant to their context and geographies.

Physical distance between projects and funds – and lack of travel

Building on the points above, it is also worth remembering that the last two years have been a very hard time to get new projects off the ground and build new international relationships. Rolling travel bans have prohibited many site visits, and pushed much relationship building online, or into the hands of local consultants. Whilst much can be done over video conferencing, there is no substitute for meeting in person in order to build trust and understanding.

Data availability

Lack of data, or standardised data, is an ongoing issue when it comes to all stages of risk screening and due diligence. We would encourage further sharing of local data between funds who are working in overlapping jurisdictions – especially of ecological surveys – to help the whole sector progress. More broadly, greater knowledge exchange in general would be helpful, especially for those operating in the same regions – for example, sharing of approaches, methods and tools for risk screening and due diligence would help prevent them being developed in parallel by multiple organisation working in the same area.

[4] https://www.unep.org/resources/state-finance-nature