

# Land Use Finance Programme BRIEF

# #1

## Standardising Procedures for Environmental & Social Impacts to Stimulate Sustainable Land-Use Finance

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### Executive summary

Financial institutions, including institutional investors, banks and impact investors, as well as companies across the agricultural value chain, all play a vital role in making the transition to more sustainable food and commodity supply chains. Financing deforestation-free commodity production, forest and landscape restoration and other forms of sustainable land use require a shift from business as usual towards best practices in the finance sector to ensure that land-use finance delivers positive environmental and social (E&S) impacts.

In order to achieve this, E&S risks associated with the projects financed or clients' activities must be assessed and managed, and the E&S impacts that result from financing sustainable land use must be framed and demonstrated. However, managing E&S risks and demonstrating E&S impacts present challenges, such as navigating multiple guidelines and

standards, avoiding the risk of displaced negative impacts outside of projects' boundaries, designing key performance indicators (KPIs) that appropriately measure E&S impacts, and cost-effectively accessing data to measure these KPIs, to name but a few.

For finance institutions to take on these challenges, appropriately manage E&S risks and ensure that positive E&S impacts are achieved, best practices must be identified and shared among land-use finance stakeholders. Ultimately, the emergence of standardised E&S risk management procedures, and sets of E&S KPIs, should facilitate broader uptake of sustainable land-use finance practices and the evolution of a novel asset class of deforestation-free commodities.

## Introduction

In 2020, for the 3rd year running, the World Economic Forum's [Global Risks Report](#) identified all environmental risks as five of the seven global business risks that are most impactful and likely to occur throughout the year ahead. Agriculture as a key driver of land-use change, including deforestation, represents a clear and present danger in mitigating climate change. Halting the annual loss of more than seven million hectares of tropical forests while ensuring growth in agricultural production to feed nine billion people by 2050 is one of the defining challenges of the 21st century.

Mainstream private finance to the agricultural sector contributes, directly and indirectly, to large-scale deforestation. However, more sustainable business models are often deemed risky or untested and farmers are rarely offered viable financing alternatives, given the absence of a credit history. As a consequence, smallholder farmers and cooperatives struggle to access capital that does not lock them into perpetuating deforestation and land degradation. Redirecting private capital towards deforestation-free commodity production, restoration of degraded land and other forms of sustainable land use is critical to staying within planetary boundaries and meeting the goals of international agreements such as the Paris Climate Agreement and the Sustainable Development Goals.

Shifting “business as usual” and redirecting private capital towards financing sustainable land use is critical for all stakeholders across the agricultural and financial value chains. As a result, pioneering impact investors, commercial banks, debts managers, fund managers and donors have introduced funds and facilities that use blended finance to unlock, leverage and scale up funding that promotes deforestation-free commodity production, forest and landscape restoration, and other forms of sustainable land use.

Framing, identifying and demonstrating the environmental and social (E&S) risks and impacts associated with the project or client (i.e. asset) that is financed is key. It contributes to creating public and private investor confidence, attracting diverse sources of concessional finance and mainstreaming private capital. This brief presents some of the main challenges and emerging good

practices for (1) managing environmental and social risks and (2) demonstrating environmental and social impact associated with sustainable land-use financing.

## 1. Managing environmental and social risks

There are a range of environmental and social risks that financial institutions can be exposed to. These risks can have material impact on the financial viability and performance of investments. Poorly or unmanaged E&S risks can lead to inefficiencies, operational disruption, litigation, reputational damage, diminished returns on investments or (partial) default of loans. Integrating comprehensive E&S risk management practices into business processes and financial analysis is therefore key to guiding investment decisions and optimising investor returns.

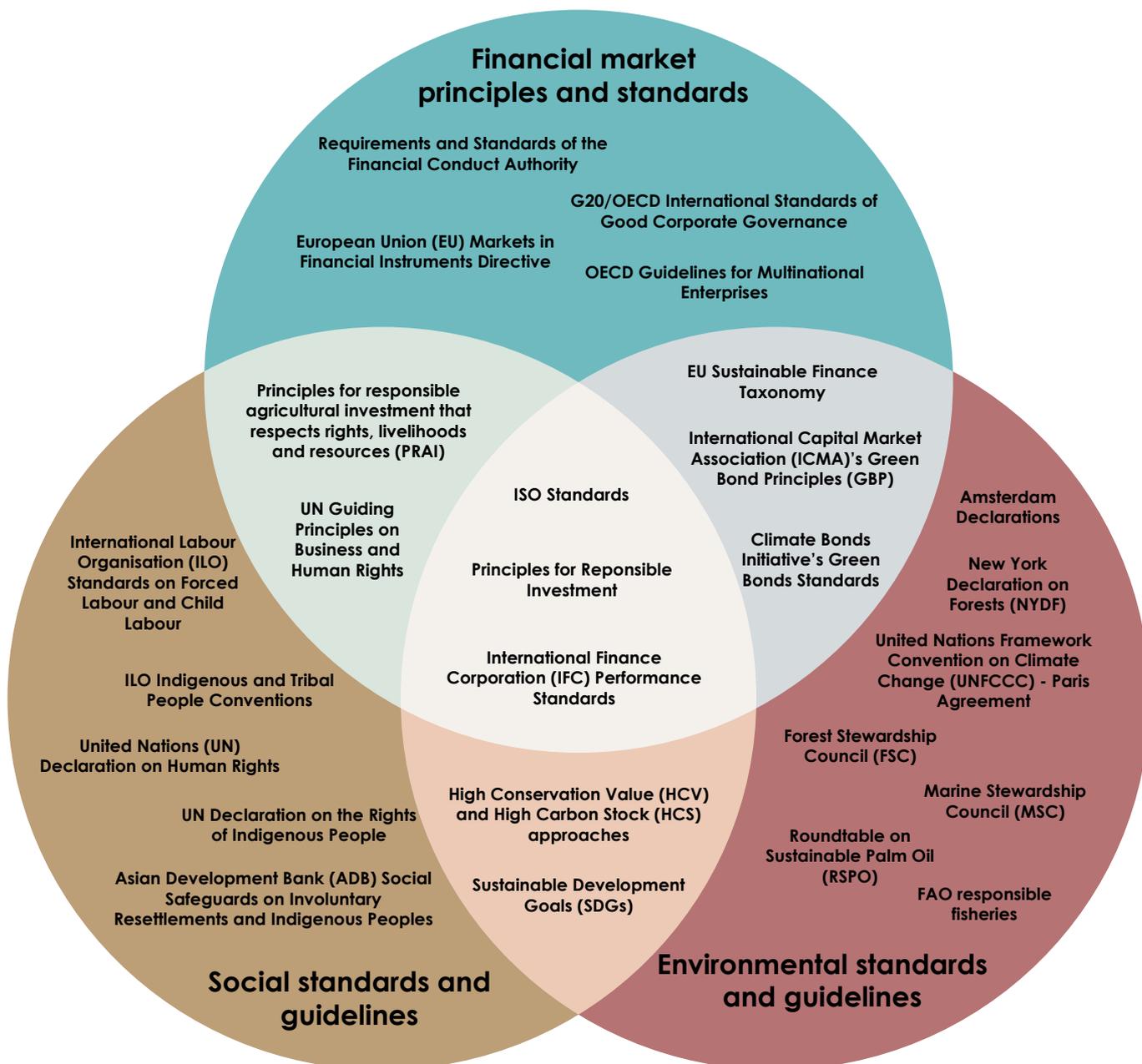
### 1.1. Environmental and social standards for risk management

E&S risk management processes need to be underpinned by robust standards and indicators. The International Finance Corporation's (IFC) [Performance Standards](#) (PS) have been adopted by sustainable land-use facilities and funds that are at the forefront of redirecting private capital towards financing sustainable land use. These have supported the design of E&S frameworks for managing risks associated with their funding. Still, several IFC PS elements do not yet make an explicit appearance in sustainable land-use finance E&S frameworks, including emergency preparedness and response, stakeholder engagement, and grievance redress mechanisms.

While the main approach to E&S risk management in sustainable land-use financing has been based on the tried-and-tested IFC PS, several other good-practice guidelines and standards exist (Figure 1). However, frequent overlap between guidelines and regular changes still pose a challenge to many businesses. Some blended finance facilities and funds that invest in sustainable land use, such as the [Tropical Landscape Finance Facility](#) (TLFF) and [Agri3 Fund](#), have conducted an assessment of the equivalences and gaps between good-practice guidelines and standards and the baseline IFC PS to design the most appropriate

E&S frameworks. Standard operational procedures for their due diligence have then been developed by adding (not duplicating) E&S risk management elements found in other standards. Operational standards should be consistent and detailed enough to allow for effective measurement while at the same time providing a level of flexibility to meet different needs.

**Figure 1: Good-practice guidelines and standards adopted by some sustainable land-use finance facilities and funds.**



## 1.2. Managing environmental and social risks: the case of leakage

While E&S safeguards can assist in managing risks within the boundaries of the project funded or land bank of the client (on-site), these risks, especially deforestation, can be displaced or leaked to areas outside these boundaries (off-site). Leakage refers to the risk of land-use change impacts being shifted locally or even globally, when the underlying drivers of deforestation are unaddressed. Leakage reduces the net positive impact generated by robust on-site E&S management and could eventually lead to an increase in total land-use change impacts, thus undermining the original goal of reducing E&S impacts of a project. Consequently, it is important to identify and account for any potential leakage within E&S frameworks. Nevertheless, quantifying and managing the indirect environmental impact of land-use change is challenging because of the difficulty of tracing the cause-effect relationship between land-use changes made on-site as part of a project or contract with a client and land-use changes that result from the demand for agricultural commodities being transferred to other lands. Some of the identified leakage risks management measures include:

- Making investments in national or subnational jurisdictions that have developed landscape-level policies for green growth, jurisdictional approaches to sustainability, low-emissions development plans or similar policies. Prioritising projects in these geographies presents limited opportunities for deforestation to be displaced locally, as well as reduced operational risks of project failure.
- Maintaining or enhancing yield intensity of deforestation-free commodity production in relation to jurisdictional averages. A reduction in productivity as part of a funded project or as a result of a client's activities could increase pressure to convert forests outside of the project boundaries to compensate for low yields. Maintaining or enhancing production intensity on-site, by applying best practices, can therefore reduce the risk of leakage.
- Giving priority to investing in low-value lands where funding impacts will be high, thereby reducing the amount of offsetting needed to account for leakage. Investing in abandoned land that was previously outside of the market results in increased productivity compared to previous yields, even when current yields are

low. Prioritising investments in such lands leads to higher productivity, and potentially other positive effects, that can be discounted to account for leakage.

## 2. Demonstrating environmental and social impact

Using key performance indicators (KPIs) is a good way of framing what (positive) impact is achieved (e.g. in terms of forest protected, improvement of farm income, or CO<sub>2</sub>eq avoided/sequestered) or what negative impacts are avoided. Demonstrating E&S impacts requires an answer to two main questions: what metrics can be used to measure E&S performance (Section 2.1) and how to monitor KPIs using available methods and data (Section 2.2).

### 2.1. Environmental and social key performance indicators

A converging set of KPIs for forests, climate and sustainable agricultural production is emerging among impact investors, banks, and blended finance facilities that are pioneering in (re)directing private capital towards deforestation-free commodity production and other forms of sustainable land use. These KPIs are explicitly aligned to the [UN Sustainable Development Goals](#), and other international policy commitments such as the [New York Declaration on Forests](#) and the [Bonn Challenge](#) on Forest Landscape Restoration. KPIs that apply to a single geography also communicate with and contribute to targets set in national policy commitments, including Nationally Determined Contributions to the Paris Climate Agreement and National Biodiversity Strategies and Action Plans. The integration of such standards into investment decisions can be supported by the [EU Taxonomy for sustainable activity](#) which provides a common language to integrate environmental sustainability into economic activities.

Priority environmental KPIs can easily be set as hectares of forest or tones of CO<sub>2</sub> equivalent, as long as a definition of forest and units for greenhouse gases (GHG) accounting are agreed upon. Several standards and approaches exist which can be applied to environmental KPIs specific design. [High Conservation Value](#) (HCV) and [High Carbon Stock](#) (HCS) approaches are among the most commonly adopted methods when designing environmental KPIs. While priority KPIs

measuring forest extent are relatively straightforward, measuring KPIs for biodiversity, which requires multiple indicators and proxies, is less so. This is most notable in the empty forests effect, whereby a forest is intact vis-a-vis its extent, but is devoid of the biodiversity which underpins and forms an integral part of forest ecosystems.

Consensus on social KPIs is more difficult to achieve as finding metrics to measure impacts on livelihoods, rural resilience or farmer capacity is challenging. Several reasons attribute to this challenge, including the greater variety within categories (e.g. work and labour conditions, health, safety and security, indigenous peoples etc.), the difficulty in finding metrics that are replicable among crops, geographies or production systems and a lack of standardisation and universal acceptance.

However, in order to stimulate more banks and impact or institutional investors to direct private capital to sustainable land use, it is important to converge on a few KPIs that all stakeholders across the financial value chain can use. This creates the foundation for what – in the near future – could become an alternative asset class for deforestation-free and sustainable land-use assets on the books of banks and investors.

## 2.2. Accessing and interpreting data

Monitoring E&S impacts requires to gather data through accessing and interpreting satellite imagery or remote sensing data to monitor indicators such as forest cover change and other environmental metrics, and aggregating statistical data submitted by borrowers on social metrics such as agricultural practices or farmers' incomes.

Continual technological advances and increases in available data present a critical opportunity for the cost efficiency of monitoring and evaluation methods. However, the profusion of, and confusion surrounding, rapidly evolving remote sensing technology and tools can pose as a challenge for E&S impact monitoring. In addition, social impacts remain harder to measure, due to the lack of low-cost technological monitoring solutions, automated methods such as remote sensing, and the higher costs of carrying out field surveys.

The increasing number of platforms, data and services offered have given rise to a complex and fast-moving space that requires standardised methodologies, expert knowledge and time investment. Costs of accessing usable data could be reduced by collecting and aggregating baseline data across funding portfolios and pipelines. Although environmental and social data is extremely dependent on the context and geographies it is measured for, data that is already available can further be adapted to specific contexts and used to reduce collection costs. For example, general data collection implemented at the national or local government level can be considered during KPI identification in order to facilitate on-going monitoring.

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