CLIMATE CHANGE – SUSTAINABLE FORESTS AND FINANCE

THEMATIC ENGAGEMENT

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This thematic engagement will address climate risk and advocate for reductions in direct and indirect emissions in the context of global forest systems. Sustainalytics' Sustainable Forests and Finance thematic engagement focuses on three key groups of actors: companies directly driving forest-related emissions, their customers, and their financiers. Building on insights gained from Sustainalytics' Climate Transition engagement (2018 to 2021), this theme targets companies throughout forestry-linked value chains to promote science-based emissions reduction strategies, transparent climate-related disclosure and sustainable practices to mitigate impacts from climate change.

While we have seen positive developments since the signing of the Paris Agreement, active ownership on climate change has historically focused on direct emissions from highly exposed sectors such as fossil fuel and utility companies. At the same time, the less comprehensively addressed aspects of climate risk, including financial, have seen little progress. One such risk is increasing emissions originating in forest value chains.

Throughout this three-year engagement, Sustainalytics will promote corporate awareness and advocate for alignment with the latest developments in legislation globally, working to identify and catalyze cross-sectoral approaches to achieve positive change. The engagement is related to several UN Sustainable Development Goals (SDGs), in particular Climate Action (13), Responsible Consumption and Production (12), Life on Land (15) and Partnerships (17).

WHY?

Economic activity relating to forest systems has a significant impact on climate change. IPCC claims that AFOLU (Agriculture, Forestry & Other Land Use) is responsible for 23 percent of total net anthropogenic emissions. These emissions mean substantial transitional and physical climate risks for companies operating in this area. They are likely to result in financially material impacts, such as supply chain disruption, cost volatility, increasing legislation and litigation, pressures on natural resources, and additional costs and reputational damage to the directly and indirectly involved sectors. Also, as climatic changes materialise, the physical risks and vulnerability of forest biomes will be compounded. This compounding of impacts will in turn lead to an increase in financial risks for investors, not to mention reputational risks and the impact of changing consumer demands on addressing climate and other issues.

Beyond these risks, the scientific community is warning that we may be approaching some climate tipping points[1] in the Earth system – for example, relating to the loss of tropical rainforests. A tipping point is a threshold of change in a system which, when exceeded, can lead to extensive and irreversible changes to that system, with the potential for domino effects on other systems. The risk of reaching a tipping point in forest biomes is growing through rising temperatures, forest fires, sprawling deforestation and forest mismanagement. It is estimated that a tipping point caused by deforestation of the Amazon could be reached at a forest-cover loss of between 20 and 40 percent. The current loss stands at 17 percent, and the year-on-year rate of loss increased by 134 percent in 2019[2]. Irreversible changes to natural systems are expected if a tipping point is reached and will lead to severe consequences for society.

The Climate Change – Sustainable Forests and Finance engagement aims to ensure financiers, companies using forest resources and their customers improve on several aspects that are financially material and include:

- Building an understanding of materiality and reducing operational, transition and physical risks from climate change in their business models
- Highlighting best practice in terms of sustainable value chains, contributing to the development of more resilient, long-term value chains, thus preventing widespread business disruptions
- Encouraging the establishment of long-term carbon strategies underpinned by science-based targets
- Facilitating better understanding and collaboration between key industries across the value chain on global challenges to forest biomes
- Driving action in opportunities for companies leading the way, highlighting potential competitive advantages in new regulatory playing fields, securing supply chains and catering to developing customer expectations.

WHAT?

By engaging with key actors throughout the forest value chain, this engagement will strive to bring about cross-sectoral dialogue and to identify, propagate and enable strategies for production and consumption within planetary boundaries. We see collaboration as a key part of achieving this. These challenges require entire value chains to work together to reduce risks, produce long-lasting sustainability and achieve transformative systemic change. We will be engaging with three interconnected parts of this value chain:

- For **companies directly involved in producing forest commodities,** potential instability of these systems is a direct risk to business models. Disruption and negative impacts from heat and drought, reduced biodiversity, reduced carbon cycling and reduced water cycling lead to a lack of stability and resilience of forest biomes. This will affect the availability and cost of forest resources and

1 https://www.nature.com/articles/d41586-019-03595-0
2 http:/forestsandfinance.org/wp-content/uploads/2020/08/FF_Briefing_Sep_2020-EN.pdf

contribute further to climatic imbalance. Companies producing and trading in forest commodities, such as biomass, rubber, soy, timber, beef, or palm oil, face a high-risk future. Accordingly, the Climate Change - Sustainable Forests and Finance engagement will highlight the risks and impacts, due diligence on sourcing and management of resources and practical actions to address damaging practices.

- **Companies using forest resources in their supply chain** are more removed from the problem but still face significant risks. Industries where greenhouse gas (GHG) emissions from supply chains are on average four times as high as those from direct operations (Scope 1 & 2) include forestry. Companies may be subject to sourcing disruptions, increased costs or customer demands for sustainably sourced products. However, due to their indirect exposure, these companies can be better positioned to take a proactive approach to address risks – for example, by substituting at-risk materials or implementing responsible sourcing. These companies can be critical agents for change. The engagement is intended to help companies understand the impact that their supply chains have on forest systems and the corresponding physical and transition risks, and reduce emissions.
- **Financiers** are another critical agent. Since 2015, global banks have committed USD 154 billion in loans and underwriting into the production and trade of commodities driving deforestation and land degradation in the three major tropical forest regions.[3] With the launch of UNEP Finance Initiative Principles for Responsible Banking[4] amongst other initiatives, there is an increasing expectation of transparency on the banking sectors' sustainability credentials. The engagement dialogue aims to harness this momentum focusing on credit and loan portfolios to explore the policies and actions banks are taking to address exposure to business practices degrading forest biomes.

With this approach to engagement, we aim to support participating investors by

- Ensuring portfolio companies are working to mitigate transition risk and build resilience.
- Proactively addressing deforestation and other threats to forest resources from companies throughout the financial system.
- Increasing the availability of relevant corporate data, including physical risk and the financial impacts of climate change.
- Enabling greater alignment with incoming legislation, such as the EU Sustainable Finance Disclosure Regulation, the UK Stewardship Code, the TCFD and the IIGCC Net Zero framework.
- Engaging in more effective and accurate reporting of scope 3 emissions within portfolio companies.

HOW?

The three-year engagement will target approximately 20 companies across three categories driving climate change within the forest value chain:

- Producers and traders in forest risk commodities (for example timber, palm oil, rubber & soy).
- Banks financing these operations, with a focus on the lending arm.
- End-users of forest commodities

Since the engagement will address structural challenges across sectors, the aim is to create a ripple effect that extends beyond targeted companies to the trading system more widely.

To measure progress and engagement impact, a set of KPIs and sub-indicators will be applied, reflecting the key topics where more forward-looking action is required:

- Financing of forestry and other industries heavily linked to deforestation and forest management.
- Increased transparency & disclosure
- Long-term science-based targets
- Innovation
- Mapping of physical risk throughout supply chains

The company selection will take into account participating investors' interests and priorities, and the synergies and interlinkages throughout the value chain. Given the need for holistic and collaborative responses, Sustainalytics will also engage with other relevant stakeholders, institutions and experts.

12 RESPONSIBLE CONSUMPTION & PRODUCTION

13 CLIMATE ACTION

15 LIFE ON LAND

17 PARTNERSHIPS FOR THE GOALS

3 https://www.banktrack.org/article/banks_funnelled_over_usd_150_billion_into_companies_driving_deforestation_since_paris_agreement_new_data_analyses_shows
4 https://www.unepfi.org/banking/bankingprinciples/

FOR FURTHER INFORMATION PLEASE CONTACT:

Henry Pallister-Dixon
Manager, Engagement
henry.pallister-dixon@sustainalytics.com

Emma Henningsson
Associate Director, Engagement
emma.henningsson@sustainalytics.com

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Sustainalytics, a Morningstar Company, is a leading ESG research, ratings and data firm that supports investors around the world with the development and implementation of responsible investment strategies. For more than 25 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. Sustainalytics also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices and capital projects. With 17 offices globally, Sustainalytics has more than 800 staff members, including more than 300 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.

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contact@sustainalytics.com | www.sustainalytics.com

Europe: Amsterdam (+31) 20 205 00 00 | Copenhagen (+45) 32 72 52 81 | London (+44) 20 3514 3123
Frankfurt (+49) 69 3329 6555 | Paris (+33) 1 184880642 | Stockholm (+46) 8 505 323 33

Americas: Boston (+1) 617 603 3321 | New York (+1) 212 500 6468 | Toronto (+1) 416 861 0403

Asia Pacific: Sydney (+61) 2 8320 9436 | Tokyo (+81) 3 4510 7979

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