Developing Risk Profiling Methodologies – insights from financial services in the quantification of sustainability risk at different spatial scales

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1. Executive Summary

The ISEAL Alliance is a global membership organisation for credible sustainability standards. ISEAL commissioned Efeca to conduct a piece of research on the methodologies, data sources and decision-making processes used by the financial sector to assess sustainability risks. This synthesis report aims to provide insights from a range of financial sector players in order to strengthen ISEAL members’ understanding of and approaches to sustainability risks.

1.1. Key findings

The financial sector is extremely varied, and the findings of this brief study should therefore be viewed as an overview of themes, trends and emerging issues as opposed to an exhaustive analysis. Nevertheless, both the interviews and the desk-based research demonstrate that interest in sustainability (and associated attention to sustainability risk) is increasing across the financial sector.

1.1.1. Defining sustainability and ‘sustainable’ investment

Sustainability is becoming a mainstream consideration by all financial players. However, as there is no common definition of sustainability adopted by the financial sector as a whole, there is no aligned approach to sustainability risk assessment. In practice, sustainability is defined differently by different players in the market. Nevertheless, financial institutions often use an ESG (Environmental, Social and Governance) framework to assess, and sometimes quantify, sustainability risks. Although, owing to the diversity and fragmentation of the financial sector, a definitive list of ESG issues does not exist, ESG is a common lens in the financial sector, and ESG investing incorporates environmental, social and governance issues into the analysis, selection and management of investments.

‘Responsible investment’ is an increasingly used approach, in some cases used as proxy for ‘sustainable’ investment. In addition, while the majority of financiers see impact as an added benefit to their investment decisions, ‘impact investors’ actively use it as a key performance indicator. Although, so far, achieving positive sustainability impacts has mostly been the remit of impact investors, the ‘sustainable’ or ‘responsible’ investment sector is changing rapidly, driven by regulations and changes in demand.

1.1.2. Risk assessment methodologies and strategies

Identifying and addressing sustainability risks is necessary to minimise negative social and environmental impacts, which have corresponding financial implications. A useful approach, recently presented at the 2019 London Climate Summit on Green Finance, distinguishes three separate categories of investment and operations:

- **A: Avoidance** – where regulations and policies, in addition to ESG screening are mostly considered;
- **B: Benefit** – alignment with the 17 UN Sustainable Development Goals (SDGs) is key;
- **C: Contribution** – broadly take the alignment with SDGs one step further, towards impact investment.

From this perspective, ESG frameworks can provide a means for exclusion, thus for avoiding risks (negative screening), whereas adherence to aligned goals or aims such as the Sustainable Development Goals (SDGs) can be used for positive screening. Impact investment, instead, as mentioned above, goes beyond positive screening as it requires to assess and evaluate positive
impacts beyond the initial client screening in order to really contribute to deliver the desired environmental, social and/or economic impacts.

Of increasing importance is also the assessment of the ‘investment footprint’, for which methodologies are being developed. In particular, carbon / GHG footprint disclosure offers an opportunity for a ‘universal language’. However, GHG emissions are only one aspect among sustainability risks and related impacts.

1.1.3. Data sources and tools used for risk assessments
Organisations are using a wide variety of tools and methods for identifying sustainability issues and to assess and quantifying the risks. Similarly, the financial sector uses different data sources to carry out sustainability risk assessments, ranging from publicly (and freely) available data sources, the use of information acquired from external data providers, to the collection of internally gathered data – or a combination of any of the above. The data collection approach also depends on the sector as well as the type of sustainability risk, while the amount of data required also depends on the additional requirements a financial institution might have. Certification can also play a crucial role, but it needs to be transparent and robust to be used in investment decisions. Technological innovation (e.g. blockchain) could support an increase in transparency and traceability.

When investigating a specific sector or sustainability risk, financial institutions might choose to utilise public data sources (e.g. Global Forest Watch for forest cover data), as well as publicly available audit reports (if available). However, in order to do so, they need to have ‘internal’ technical capacity for this information to be analysed ‘in house’, with the ability to use additional data if required. This additional data could be gathered on the ground (e.g. field data), but is more often collected through third party publicly available sources.

Alternatively, large financial institutions will typically partner with external data providers (on a subscription basis) as they work across a broad and diverse range of sectors and commodities. By working in this way, data can be collected and packaged to clearly show ESG ‘specific’ data, ratings and scores, or, for example, how an applicant may comply with the lender’s internal policies. This allows the data user to combine or cross-check data from a range of sources (and data providers) to make decisions with greater assurance, even if the technical knowledge might not be built into the business.

Finally, when data is gathered internally, due to cost, it is typically tailored to specific contexts. For example, for commodities associated with higher social risks, additional social data can be gathered when conducting sustainability risk assessments.

1.1.4. Risk assessment processes and outcomes
Sustainability risks are increasingly considered as material credit risks (rather than reputational risks as previously) and are thus progressively integrated into credit assessments, due diligence processes and ultimately into decision-making processes. This is also due to a shift in governance, with sustainability functions being integrated within various teams, rather than being seen as a standalone team/process. In some cases, sustainability considerations are clearly embedded into all ‘internal’ systems and processes, and this can be particularly true for
impact investment funds as they have been developed with sustainability principles at their core.

1.2. Key challenges

There is fragmentation across the industry, not only in the understanding and definition of sustainability, but also in methodologies and processes used. There is consequently an increasing need for coordination and alignment.

In addition, regarding data sources, publicly available information, as well as externally gathered data originating from ‘private’ disclosure, often does not include third-party verification, as the latter can be particularly costly. This means there could be questions around data quality and trustworthiness, though this is a wider issue which goes beyond the financial sector. Furthermore, it is important to recognise that most data sources are historic, with any forward-looking analysis being uncommon, and typically conducted by in-house experts. Lack of standardisation in data can also make data collection and analysis challenging.

Moreover, risk quantification, triangulation and mitigation remain challenging, whereas our research has highlighted the need for financial systems to be multidimensional and capture ‘the ripples’ of influence in order to minimise adverse impacts.

1.3. Key opportunities

There are a range of opportunities for collaboration and lessons sharing between financial sector players (especially those with additional sustainability requirements) and ISEAL members. For instance, current and future discussion on due diligence obligations on avoided deforestation, for the financial as well as other sectors, being at national and/or EU level, could represent an opportunity for alignment (e.g. agreeing a set of ‘umbrella’ principles).

From this perspective, it will be crucial for sustainability standards to provide consistent and transparent data and assurance on both environmental and social risks associated with the commodities they certify. This could also include communicating benefits of certified commodities to the financial sector and be achieved through linking to existing areas of interest, such as alignment with the SDGs and GHG emission reductions. Therefore, closer collaboration between financial institutions and ISEAL members could be sought.
2. Introduction and aim of this synthesis report

In response to changing stakeholder expectations and opportunities inherent in new technologies and data availability, a growing number of standards are now beginning to incorporate risk-based approaches into their assurance models.

This development follows the growing demand for increased transparency and traceability of different products and various commodities. Consumers’ awareness is still limited, but there have been a few successful marketing campaigns which have focused attention on specific commodities (e.g. Iceland’s 2018 Christmas advertisement on palm oil in the UK). Some of this information can be misleading, therefore there is a clear need for sustainability standards to be at the forefront of these discussions, being able to provide assurance for the commodities and products they certify, addressing, monitoring and reporting on both environmental and social issues.

To support the improvement of monitoring and assurance programmes of ISEAL members, ISEAL commissioned Efeca to conduct research on the methodologies used by the financial sector to assess sustainability risks (and how financial institutions approach complex sustainability risk profiling), in order to gain insights that can be transferred to ISEAL members to strengthen their understanding of how to use multiple sources of information to detect and verify sustainability risks both of certified entities, and at greater spatial scales.

Identifying and addressing sustainability risks is necessary to minimise negative social and environmental impacts, which have corresponding financial implications. In fact, one cannot manage what is not known. In particular, as illustrated in Figure 1 below, adverse impacts can be caused, contributed to or directly linked to an enterprise, its products or services.

Figure 1: OECD’s mapping on how to address adverse impacts¹.

![OECD’s mapping on how to address adverse impacts](http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf)

Source: OECD.

3. Research approach and methodology

In order to share learnings on how financial institutions inform their understanding of sustainability risk, and therefore make decisions, Efeca conducted interviews with a range of financial actors, supported by desk-based review of relevant material. This research project has been structured around three main research questions:

- What methodologies and strategies are commonly employed by financial services to quantify sustainability risk across multiple levels and spatial scales?
- What sources of information are needed to support those methodologies, particularly in data-poor contexts and regions?
- What processes and decision-making steps are required to ultimately reach robust conclusions from risk assessments on the relative risk of sustainability issues in a given place?

Furthermore, where it was possible to do so, the team highlighted key learnings relating to how methods, data and decision-making processes are used to assess:

- Risk related to a product, species, or sector: Some sectors, products or species are strongly linked to particular sustainability issues (e.g. the production of hazelnuts and cocoa are known to be associated with forced labour);
- Risk related to the geographical area: Due to variation in geophysical, cultural and institutional factors, some areas are more prone to risk than others (e.g. companies operating in areas with high deforestation rates might be more likely implicated in forest clearance); and
- Risk related to producers or supply chain entities: Internal risks associated with certified entities, or their suppliers (e.g. the fact that a factory employs subcontractors, or that a farm employs seasonal workers).

A preliminary desk-based review as well as key informant interviews was conducted. Following the approach in our proposal, the desk review focused on gaining an understanding of the evidence that is publicly available. This was used to inform the interviews. In terms of interviews, we were guided by the team’s experience and network, as well as the recently launched Global Resource Initiative (GRI). ISEAL Alliance also provided further connections. As a result, a sample of stakeholders across the financial sector were interviewed: from commercial banks, to investment funds, to insurance companies and impact investors. Also interviewed were several platforms and initiatives, including CDP and PRI, who validated the approach and directed the research towards various online sources of information.

It is important to note that the financial sector is extremely varied. Hence, this brief study is not aimed at providing an exhaustive analysis of the methodologies, tools and processes used by different sector players, but more an overview of themes, trends and issues emerging from the review and the interviews on how sustainability and its risks are perceived, with the use of case studies and practical examples to showcase the variety of the landscape under exploration.

As such, it also contains broad implications for ISEAL members. Given the diversity of membership and the complexity of the topics covered, there is ample space for additional analysis. In particular, implications can be refined further, adapting them to suit the specific audience and needs. The details of this refinement are out of the scope of this synthesis report.
This synthesis report presents aggregate findings from both the desk-based review and the interviews, with the three key sections on Methodologies, Data and Processes respectively, in addition to a preliminary section on Definitions, and a concluding section with recommendations on ‘Moving Forward’. Please see more details below.

- **Section 4: Defining sustainability and 'sustainable' investment**, where we discuss the understanding and definition of sustainability across the financial sector, and lenses used to assess the 'sustainability' of an investment (focussing primarily on ESG and SDGs), as well as different kinds of 'sustainable' investments, including impact investment.

- **Section 5: Risk assessment methodologies and strategies**, where we explore several approaches used by financiers to assess sustainability risk, including case studies on methodologies used for GHG emissions footprints, as well as those used for screening potential clients on sustainability performance.

- **Section 6: Data sources and tools used for risk assessments**, including some of the challenges faced by financiers, in particular in data-poor countries and regions.

- **Section 7: Risk assessment processes and outcomes**, including various practical case studies, in some of which there is alignment between sustainability risk assessments and due diligence processes.

- **Section 8: Moving Forward**, where we draw concluding remarks and we suggest next steps for the ISEAL Alliance and its members.
4. Defining sustainability and ‘sustainable’ investment

In order to gain an understanding of what sustainability means for the financial sector, and the degree of mainstreaming into decision-making processes, the first step is to look at how the financial sector defines and interprets sustainability, as well as what lenses and frameworks have been developed by different financial sector players to address sustainability issues. Starting from these considerations, we also aim to briefly illustrate different kinds of ‘sustainable’ investments and provide some examples.

4.1. Sustainability and the financial sector: different definitions

Sustainability is becoming a mainstream consideration by all financial players. All stakeholders interviewed highlighted how issues around sustainability have become a key component of their entities’ operations, often through leadership directions from CEOs or boards; through increasing demand-side pressure from the market; and/or because of increasing regulations. Consequently, there is a plethora of definitions, methodologies, and guidelines available. Examples are presented in this report to show the range, but this fragmentation also creates difficulties when seeking to identify synergies, divergences, and drawing out consistent, clear messages for ISEAL members.

As there is no common definition of sustainability, consequently, sustainability risk assessments also vary. For example, sustainability can be linked to a just and equitable socio-economic transition, which needs to include climate change-related risks, and a consequential restructuring of the financial system. This restructuring would balance the desire for economic growth with job creation and increased sustainability across the three pillars (economic, environmental and social). Of the interviews conducted, some interviewees showed a strong understanding of all three sustainability pillars, whereas others interpreted ‘sustainability’ as primarily ‘financial sustainability’. For instance, for Finance in Motion, an impact investor, sustainability needs to be considered across the financial, environmental and social dimensions. On the contrary, an insurance company highlighted how sustainability is considered in a financial sense. For example, their modelling can answer the question: ‘How much insurance do I need?’ or ‘What is the worst possible loss our investment could suffer?’. In other cases, an additional ethical screening is also undertaken, sometimes for addressing reputational and credibility concerns. As awareness towards sustainability issues increases and becomes more mainstream (and perhaps regulated), more comprehensive and robust sustainability screening criteria is likely to be implemented more widely.

In practice, sustainability is defined differently by different players in the market, and also within entities themselves. In fact, sustainability is understood and managed differently within different teams, who deal with different sustainability issues. For example, for some financiers, the financial and reputational risk attributed to coal investment is perceived as too high, so have made a decision not to invest in it, whilst for others, the decision to invest or not in other sectors would depend on international and jurisdictional regulations, in addition to client policies. While many interviewees chose not to discuss differing approaches across geographies, countries such as Russia and China were mentioned as areas in which risks can be more difficult to quantify.

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2 Expert interview (2019).
In other words, investors need to be able to quantify their potential gains or losses before being able to commit to financing activities / infrastructure / projects anywhere in the world, but particularly in countries that might be perceived as high risk. It is also our impression that, in many cases, if the risks are too high or too difficult to quantify (e.g. lack of transparency), then the financier does not invest.

4.2. **Incorporating sustainability concerns into investment decisions: different approaches and lenses**

**ESG is a common lens in the financial sector, and ESG investing incorporates environmental, social and governance issues into the analysis, selection and management of investments**. There is a growing body of evidence on ESG factors being a material credit risk, and ESG investing is becoming part of the mainstream investment process. Most financial actors have in fact used or adapted a framework to suit their needs, integrating ESG in their analysis. Key issues for consideration typically include:

- **E**: climate change, carbon emissions, pollution, resource efficiency, biodiversity;
- **S**: human rights, labour standards, health & safety, diversity policies, community relations, development of human capital (health & education);
- **G**: corporate governance, corruption, rule of law, institutional strength, transparency.

**A definitive list of ESG issues does not exist, owing to the diversity and fragmentation of the financial sector.** For example, some financiers have developed and implemented a comprehensive approach to manage environmental and social (‘E&S’) risks, which include position statements. Interestingly, some have more recently included ‘Environmental’ and ‘Social’ issues, as ‘Governance’ was already more integrated in traditional due diligence as part of the credit assessment. Table 1 and Table 2 below provide some examples of ESG frameworks while Annex 2 provides a more detailed example of an ESG framework (RobecoSAM Country Sustainability Framework), which is then used for calculating ESG scores and ratings.

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### Table 1: Examples of ESG Criteria according to CFA, PRI and IFC.

<table>
<thead>
<tr>
<th>Institution</th>
<th>E</th>
<th>S</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFA (2015)</td>
<td>Climate change and carbon emissions</td>
<td>Customer satisfaction</td>
<td>Board composition</td>
</tr>
<tr>
<td></td>
<td>Air and water pollution</td>
<td>Data protection and privacy</td>
<td>Audit committee structure</td>
</tr>
<tr>
<td></td>
<td>Biodiversity</td>
<td>Gender diversity</td>
<td>Bribery and corruption</td>
</tr>
<tr>
<td></td>
<td>Deforestation</td>
<td>Employee engagement</td>
<td>Executive compensation</td>
</tr>
<tr>
<td></td>
<td>Energy efficiency</td>
<td>Community relations</td>
<td>Lobbying</td>
</tr>
<tr>
<td></td>
<td>Waste management</td>
<td>Human rights</td>
<td>Political contributions</td>
</tr>
<tr>
<td></td>
<td>Water scarcity</td>
<td>Labour standards</td>
<td>Whistleblower schemes</td>
</tr>
<tr>
<td>PRI (2014) (Sovereign issuers)</td>
<td>Carbon intensity</td>
<td>Demographics</td>
<td>Institutional strength</td>
</tr>
<tr>
<td></td>
<td>Water stress</td>
<td>Education and human capital</td>
<td>Corruption</td>
</tr>
<tr>
<td></td>
<td>Energy resources and management</td>
<td>Health levels</td>
<td>Regime stability</td>
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<tr>
<td></td>
<td>Natural disasters</td>
<td>Political and press freedoms</td>
<td>Rule of law</td>
</tr>
<tr>
<td></td>
<td>Biocapacity and ecosystem quality</td>
<td>Human rights</td>
<td>Financial reporting</td>
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<tr>
<td></td>
<td>Pollution</td>
<td>Labour standards</td>
<td>Regulatory effectiveness</td>
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<tr>
<td></td>
<td>Biodiversity</td>
<td>Social exclusion</td>
<td>Adherence to conventions</td>
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<tr>
<td></td>
<td>Agriculture</td>
<td>Income equality</td>
<td>International relations</td>
</tr>
<tr>
<td>PRI (2014) (Corporate issuers)</td>
<td>Environmental</td>
<td>Demographics</td>
<td>Business integrity</td>
</tr>
<tr>
<td></td>
<td>Climate change</td>
<td>Human rights</td>
<td>Shareholder rights</td>
</tr>
<tr>
<td></td>
<td>Biodiversity</td>
<td>Employee relations</td>
<td>Incentive structure</td>
</tr>
<tr>
<td></td>
<td>Energy resources and management</td>
<td>Health and safety</td>
<td>Audit practices</td>
</tr>
<tr>
<td></td>
<td>Biocapacity and ecosystem quality</td>
<td>Diversity</td>
<td>Board independence &amp; expertise</td>
</tr>
<tr>
<td></td>
<td>Air pollution</td>
<td>Customer relations</td>
<td>Fiduciary duty</td>
</tr>
<tr>
<td></td>
<td>Water scarcity and pollution</td>
<td>Product responsibility</td>
<td>Transparency/accountability</td>
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<tr>
<td></td>
<td>Resource efficiency</td>
<td>Community health and safety</td>
<td>Board structure</td>
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<tr>
<td></td>
<td>Pollution prevention</td>
<td>Resettlement</td>
<td>Control environment</td>
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<tr>
<td></td>
<td>Emergency preparedness and response</td>
<td>Indigenous people</td>
<td>Transparency and disclosure</td>
</tr>
<tr>
<td></td>
<td>Biodiversity</td>
<td>Cultural heritage</td>
<td>Minority shareholders</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Stakeholder engagement</td>
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</tbody>
</table>

### Table 2: MSCI ESG Key Issues for Companies

<table>
<thead>
<tr>
<th>3 Pillars</th>
<th>10 Themes</th>
<th>37 Key Issues</th>
</tr>
</thead>
</table>
| **Environment** | Climate Change | • Carbon Emissions  
• Product Carbon Footprint  
• Financing Environmental Impact  
• Climate Change Vulnerability |
| | Natural Capital | • Water Stress  
• Biodiversity & Land Use  
• Raw Material Sourcing |
| | Pollution & Waste | • Toxic Emissions & Waste  
• Packaging Material & Waste  
• Electronic Waste |
| | Environmental Opportunities | • Opp’s in Clean Tech  
• Opp’s in Green Building  
• Opp’s in Renewable Energy |
| **Social** | Human Capital | • Labour Management  
• Health & Safety  
• Human Capital Development  
• Supply Chain Labour Standards |
| | Product Liability | • Product Safety & Quality  
• Chemical Safety  
• Financial Product Safety  
• Privacy & Data Security  
• Responsible Investment  
• Health & Demographic Risk |
| | Stakeholder Opposition | • Controversial Sourcing |
| | Social Opportunities | • Access to Communications  
• Access to Finance  
• Access to Health Care  
• Opp’s in Nutrition & Health |
| **Governance** | Corporate Governance | • Board  
• Pay  
• Ownership  
• Accounting |
| | Corporate Behaviour | • Business Ethics  
• Anti-Competitive Practices  
• Tax Transparency  
• Corruption & Instability  
• Financial System Instability |


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'Responsible investment' is an increasingly used approach, in some cases used as proxy for 'sustainable' investment, and subject to increasing regulations. For example, members of the Investment Association, an asset management trade body, were consulted on approaches to sustainability and responsible investment. 'Responsible investment' was adopted as an appropriate term to encompass the full suite of approaches within this space, replacing 'sustainability'. This supports the findings above that the finance sector is increasingly seeking to consider the ‘ethical’ implications of their actions. This is of particular importance for ISEAL members, as the term ‘responsible’ does not always equate to ‘sustainable’ in some commodity level discussions, whereas in the finance sector ‘responsible investment’ can be taken to mean ‘sustainable’ or ‘green’ investment, indicating a different approach to decision making.

Using SDGs to go beyond ‘responsible investment’. In some cases, financiers might decide to actively contribute to deliver positive impacts. In order to do so, the 17 Sustainable Development Goals (SDGs), developed and promoted by the United Nations, are increasingly being used as a framework to show these positive contributions. Additionally, if positive impacts are carefully assessed and considered as the key, necessary outcomes of the investment itself, then the investments are increasingly referred to as ‘impact investment’. More information on the SDGs can be found in Annex 2, and on impact investment in Section 4.3.

4.3. Lessons from impact investors

While the majority of financiers see impact as an added benefit to their investment decisions, impact investors actively use it as a key performance indicator. In fact, ‘sustainability’ itself can also be understood to refer to certain goals to which responsible investment approaches can contribute. For instance, the 17 Sustainable Development Goals (SDGs) can be used as a framework for positive contributions, thus mapping the impact of the investment. From this perspective, sustainability could be interpreted to refer to environmentally, socially or economic sustainable goals, including the resilience of financial systems. Box 1 provides a specific case study on the Agri3Fund, which is used for financing impact investments.

Box 1: Agri3Fund (further information provided in Box 13 in Annex 2)
The Agri3Fund is a flagship programme on impact lending developed in collaboration with the United Nations Environment Programme (UNEP), the Dutch Development Bank FMO, IDH and Rabobank. The three main objectives of this fund are:

1. Forest protection and reforestation (including forest landscape restoration, transition of agricultural lands to agroforestry, and protection of high conservation value (HCV) areas and high carbon stock (HCS) forests).
2. Improved rural livelihoods (including local farmers and smallholders in order to reach sustainable inclusive growth, with particular attention paid to gender equality, eradicating child labour, promoting fair labour and wages, and alleviating poverty).
3. Sustainable agriculture (including implementing innovative agricultural solutions such as Integrated Crop-Livestock-Forestry (ICLF) systems that have an impact on lowering GHG emissions, restoring degraded land, enhancing water management, improving soil fertility, sequestering carbon, building climate change resilience and protecting biodiversity while maintaining or substantially increasing yield for local farmers and smallholders).

Box 1: Agri3Fund (further information provided in Box 13 in Annex 2)
The Agri3Fund is a flagship programme on impact lending developed in collaboration with the United Nations Environment Programme (UNEP), the Dutch Development Bank FMO, IDH and Rabobank. The three main objectives of this fund are:

1. Forest protection and reforestation (including forest landscape restoration, transition of agricultural lands to agroforestry, and protection of high conservation value (HCV) areas and high carbon stock (HCS) forests).
2. Improved rural livelihoods (including local farmers and smallholders in order to reach sustainable inclusive growth, with particular attention paid to gender equality, eradicating child labour, promoting fair labour and wages, and alleviating poverty).
3. Sustainable agriculture (including implementing innovative agricultural solutions such as Integrated Crop-Livestock-Forestry (ICLF) systems that have an impact on lowering GHG emissions, restoring degraded land, enhancing water management, improving soil fertility, sequestering carbon, building climate change resilience and protecting biodiversity while maintaining or substantially increasing yield for local farmers and smallholders).

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8 Agri3Fund brochure.
Agri3Fund advisor is Althelia Funds by Mirova – a leading asset management company for responsible investment\(^9\). Mirova have also developed a ‘natural capital investing platform’. The Fund’s E&S impact framework comprises a hierarchical structure of objectives, impacts, key performance indicators (KPIs) and methods of monitoring progress towards KPIs. Fund-level E&S KPIs have been developed per objective to reflect and contribute to the global goals and indicators of the SDGs, wherever relevant and possible\(^{10}\). Certification standards and sustainable land use management are also taken into account.

*Source: Agri3Fund brochure.*

So far, achieving positive sustainability impacts has mostly been the remit of impact investors, but the sustainable or responsible investment sector is changing rapidly, driven by regulations and changes in demand. It was highlighted that many financiers are already working in the responsible investment space, without knowing it or labelling it so, with consequent strong opportunity for growth in the sector. In addition, soon more stringent disclosure on sustainable investment will no longer be a choice as it is instead becoming mandatory by regulators, also driven by market demand\(^{11}\). There is general agreement that those best prepared will be able to forge a space in the market and survive. Box 2 below contains another example of impact investment fund.

**Box 2: eco.business Fund, advised by Finance in Motion\(^{12}\)**

The eco.business Fund aims to promote business and consumption practices that contribute to biodiversity conservation, to the sustainable use of natural resources, and to climate change mitigation and adaptation.

The fund operates in Latin America and the Caribbean, and has an embedded sustainability focus at its core. In fact, it is a debt fund which supports sustainable operations in four sectors, namely agriculture, fishery (including aquaculture), forestry and (sustainable) tourism. As well as providing financing in commercial terms for sustainable business practices (not subsidies), the fund also provides technical assistance and research, seeking to improve the way of assessing environmental and social risks (thus helping banks to develop their own risk profiling methodologies and processes) and, as a consequence, increasing sustainable / responsible / impact investment in these sectors, aiming to achieve both environmental, social, and financial returns.

In practice, the fund mainly provides loans to qualified, regulated financial institutions (primarily commercial banks) that then on-lend the money to eligible borrowers, which need to meet eligibility criteria:

1. Being certified by a recognised sustainability standard (approximately 30 standards are eligible, many of which are ISEAL members); and/or
2. Adhering to the so called ‘green list’, which is a list of investment opportunities which are believed to have a positive impact on the environment (e.g. irrigation systems, agroforestry measures for coffee and cocoa, etc.).

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\(^{10}\) Agri3Fund brochure.


Beneficiaries also need to report their 'positive' impacts through the eco.business Fund impact framework.\footnote{https://www.ecobusiness.fund/fileadmin/user_upload/impact/the_pathway_to_impact/ecobusiness_Fund_Impact_Framework_Growing_Impact_2019.pdf}

\textit{Source: Finance in Motion and eco.business Fund (Impact Report, 2018).}

Impact investment and the growth of nature-based finance solutions could provide interesting opportunities. In fact, uptake could grow, potentially also supporting REDD+ initiatives. This highlights the role that certification of natural resources and carbon could play in providing the required assurance. More information on the role of certification can be found in Section 6.6.1.

4.4. Analysis of research findings related to definitions

In order to draw out key lessons from this section, the summary table below focuses on commonalities and differences around definitions of sustainability and 'sustainable' investment.

\textbf{Table 3: Key commonalities and differences related to definitions of sustainability and 'sustainable' investment.}

<table>
<thead>
<tr>
<th>Topic</th>
<th>Commonalities</th>
<th>Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainability and the financial sector:</td>
<td>• Momentum is currently growing as sustainability concerns are becoming</td>
<td>• Sustainability (and its definition) is interpreted differently by different financial sector players.</td>
</tr>
<tr>
<td>different definitions</td>
<td>mainstream.</td>
<td>• Alignment is lacking.</td>
</tr>
<tr>
<td>Incorporating sustainability concerns into</td>
<td>• Although definitions are not aligned, interest in greener, more</td>
<td>• There are no clear, comprehensive and standardised definitions of responsible / green investment, which can cause</td>
</tr>
<tr>
<td>investment decisions: different approaches</td>
<td>responsible and more impactful investments is growing.</td>
<td>confusion / misunderstanding.</td>
</tr>
<tr>
<td>and lenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lessons from impact investments</td>
<td>• Sustainability is embedded at the core through robust risk assessments,</td>
<td>• No common framework for screening, monitoring and reporting.</td>
</tr>
<tr>
<td></td>
<td>as well as comprehensive impact frameworks (e.g. Agri3Fund, eco.business</td>
<td>• Some link impact investment achievements to SDGs (sometimes referred to as SDGs investing – please see Annex 2 for</td>
</tr>
<tr>
<td></td>
<td>Fund, etc.).</td>
<td>additional information on SDGs investing).</td>
</tr>
</tbody>
</table>

To conclude, sustainability is becoming mainstream in lending and investment decisions, but there are numerous different definitions and interpretations of sustainability adopted by the financial sector. As it is clear that there is currently very little or no alignment in the understanding and definition of sustainability, the market is seeking to become less fragmented, potentially also driven by regulations and market demand.

In the next section we explore several examples of methodologies used by the financial sector to address sustainability risks.
5. Risk assessment methodologies and strategies

In this section we present different methodologies and strategies used by financiers to assess sustainability risk. Case studies throughout the section explore these methodologies, in particular those used for carbon and GHG footprints, as well as their related disclosure initiatives. In addition, further information on and examples of clients’ screenings, including on sustainability concerns/performance, are provided. Comparative analysis is also used to draw out commonalities, differences, learnings and opportunities, where possible.

5.1. Looking at examples of carbon / GHG footprints: key disclosure initiatives

In the more traditional sustainability sense, a key focus of financial institutions has been on (carbon) footprints, with varied levels of disclosure. CDP, Task Force on Climate-related Financial Disclosures (TCFD), Principles for Responsible Investment (PRI) have been at the forefront of facilitating a shift in this sense. It has been highlighted that larger financiers, such as large commercial banks, have more advanced public disclosure approaches available, with some also aiming to become carbon neutral, including compliance with the RE100 targets\(^\text{14}\) of committing to 100% renewable energy power. It is much more challenging for smaller banks and funds to comply with higher scrutiny over their operations. For more details on the outputs of the TCFD, refer to Section 6.8.1.1.

Meanwhile, of increasing importance is the assessment of the ‘investment footprint’, for which methodologies are being developed. For example, some financial institutions are piloting ‘Science-Based Targets’\(^\text{15}\) (refer below for more details on the Science-Based Targets Initiative for Financial Institutions), and the 2\(^\circ\) Investing Initiative, a multi-stakeholder think tank, is working to align the financial sector with 2°C climate goals. This initiative is supported by PRI and has developed the 2°C Scenario Analysis website\(^\text{16}\) as well as the PACTA (Paris Agreement Capital Transition Assessment) tool, a free software that calculates the extent to which corporate capital expenditures and industrial assets behind a given equity, bond, or lending portfolio are aligned with various climate scenarios\(^\text{17}\).

The PACTA framework includes climate scenario analysis (also known as climate compatibility tests), climate stress-tests, and qualitative analysis of climate actions\(^\text{18}\). In order to achieve carbon neutrality, different approaches for different sectors have been developed (e.g. oil and gas, coal, power, automotive, cement, steel, and shipping)\(^\text{19}\). For instance, it will show the need to divest from coal as well as that of enabling the transition to electric and hybrid vehicles. However, the first seven sectors covered in the methodology (as mentioned above) show that while there has been good progress in the energy and transport sectors, to date, less has been achieved in other sectors, such as agriculture. For more information on climate scenario analysis, refer to Box 8 in Section 6.8.1.1.

\(^{14}\) [http://there100.org](http://there100.org)
\(^{16}\) [https://www.transitionmonitor.com/](https://www.transitionmonitor.com/)
\(^{19}\) [https://2degrees-investing.org/pacta/](https://2degrees-investing.org/pacta/)
The Science-Based Targets Initiative for Financial Institutions (SBTI FI) was launched in 2018 to develop science-based target setting methodologies, tools, and implementation guidelines for key asset classes covering financial institutions. While the Science-Based Target initiative (looking at GHG emissions) is well advanced for corporates, with over 800 companies having already submitted their targets, of which 330 have already been approved, the SBTI-FI is only currently developing its own methodology (which is ‘work in progress’ under discussion). It is interesting to note that big multi-national corporations (especially those with greater reputational risks linked to their public-facing brands) seem to have taken the lead (as a sector), with the financial sector as a whole (but again starting from the ‘biggest’ players) now starting to actively engage in these discussions. Therefore, although there has been great progress and the ‘momentum’ is currently growing, there are still more questions than answers. The SBTI FI final framework, a collaboration between CDP, the United Nations Global Compact (UNGC), the World Resources Institute (WRI) and WWF, will be published in 2021. This could be an opportunity for ISEAL to collaborate with the financial sector on terminology alignment and GHG emissions reductions.

In fact, carbon / GHG footprint disclosure offers an opportunity for a ‘universal language’. While it is recognised that sustainably produced commodities are likely (but not necessarily) to have a better carbon footprint than ‘business as usual’ production due to different agricultural practices, etc, it can be challenging to assign specific values to this. By exploring the carbon benefits of sustainable commodity production, there may be potential to use a ‘universal language’ that could strengthen links between standards, supply chain actors and financial investors / institutions. In addition, carbon footprint metrics are generally easier to quantify than other sustainability metrics, offering great potential for cross-sector alignment.

5.1.1. Challenges related to carbon / GHG footprints and their disclosure initiatives

Numerous challenges still remain to be faced and addressed. This is despite, as illustrated above, progress that has been made in the development of initiatives and frameworks that provide methodologies and metrics to assess and report on carbon / GHG emissions in the context of climate change mitigation measures.

For instance, according to the Greenhouse Gas Protocol (GHGP), a partnership between the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD), scope 3 emissions (also known as value chain emissions) often represent the largest source of greenhouse gas emissions and in some cases can account for up to 90% of the total carbon impact. However, due to the complexities involved in assessing and estimating GHG emissions, targets are usually less ambitious / demanding on those scope 3 emissions compared to scope 1 (direct GHG emissions) and scope 2 (electricity indirect GHG emissions), which are generally pretty small for financial institutions. In fact, category 15 – investments (under scope 3 emissions) is by far the greatest source of financial institutions’ GHG emissions.

Nevertheless, the GHGP provides both accounting and reporting standards. It thus establishes a comprehensive, global, standardised framework for measuring and managing emissions from private and public sector operations, value chains, products, cities, and policies. This provides a strong common basis for all the different initiatives illustrated above.

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20 [https://2degrees-investing.org/science-based-targets-initiative-for-financial-institutions-sbti-fi/]
However, GHG emissions are only one aspect amongst sustainability risks and related impacts. Despite being a crucial one in the context of climate change mitigation measures, sustainability risks are much broader in scope and, as illustrated in Section 4 above, are not consistently and comprehensively understood by the financial sector.

5.2. Beyond carbon / GHG footprints: different approaches to sustainability and responsible investment

Sustainability issues cut across Environmental, Social and Governance (ESG) as well as Sustainable Development Goals (SDGs) themes. A useful approach that was recently presented at the ‘2019 London Climate Summit – Green Finance’ is to distinguish investments and operations between ‘A, B, C’ – with an example from PGGM (Figure 2), the second largest pension fund in the Netherlands, and from the Investment Association (Figure 3) below:

- **A – Avoidance**: where regulations and policies, in addition to ESG screening are mostly considered;
- **B – Benefit**: alignment with SDGs is key;
- **C – Contribution**: broadly takes the alignment with SDGs one step further, towards impact investment.

*Figure 2: PGGM approach to responsible investment*\(^\text{21,22}\).

<table>
<thead>
<tr>
<th>NO</th>
<th>CHANGE</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>What We Do Not Want</td>
<td>Making companies and markets more sustainable through ESG integration, active ownership and collaboration with financial service providers</td>
<td>Creating social returns in the areas of:</td>
</tr>
<tr>
<td>Direct exclusions:</td>
<td>• Controversial weapons</td>
<td>• Climate and environment</td>
</tr>
<tr>
<td></td>
<td>• Tobacco</td>
<td>• Water</td>
</tr>
<tr>
<td>Exclusions after engagement on:</td>
<td>• Human rights and social circumstances</td>
<td>• Health</td>
</tr>
<tr>
<td></td>
<td>• Environment</td>
<td>• Food</td>
</tr>
<tr>
<td></td>
<td>• Corporate governance</td>
<td>Instrument:</td>
</tr>
<tr>
<td>Instrument:</td>
<td>• Exclusions</td>
<td>• Investing in solutions</td>
</tr>
</tbody>
</table>

Source: PGGM.

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\(^{22}\) Inderst, G. and Stewart, F., Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment. World Bank Group publication, April 2018 (page 37).
Similarly, Blackrock, the world’s largest asset manager, has recently proclaimed to have become a market leader in sustainability. Blackrock has recently stated that definitions of sustainability must move beyond the ‘binary’ approach of the EU Sustainable Finance Taxonomy\textsuperscript{24}, as they pressed policy makers to promote convergence of sustainability standards. Additionally, they manage a broad suite of dedicated sustainable investment solutions ranging from green bonds and renewable infrastructure to thematic strategies that allow clients to align their capital with specific outcomes, such as the UN Sustainable Development Goals (SDGs)\textsuperscript{25}.

Blackrock currently categorises investments in:

- ‘Avoid’ strategies, which involve minimising or eliminating exposure to certain companies or sectors associated with negative ESG characteristics that could pose reputational or other related risks, or which violate the asset owner’s values; and
- ‘Advance’ strategies, which focus on increasing or targeting exposure to positive ESG characteristics. This might include using ESG scores as an additional layer in portfolio / index construction or focusing on a specific social or environmental theme or outcome\textsuperscript{26}.

\textsuperscript{23} \url{https://www.theia.org/sites/default/files/2019-11/20191118-iaresponsibleinvestmentframework.pdf}
\textsuperscript{25} \url{https://www.blackrock.com/us/individual/investment-ideas/sustainable-investing/sustainable-solutions}
\textsuperscript{26} \url{https://www.blackrock.com/us/individual/investment-ideas/sustainable-investing}
ISEAL members can learn from some of the market leaders’ approaches. The approaches taken by the Investment Association, PGGM and Blackrock could be transferred and adapted for ISEAL members, supporting them to engage with those in most need of support (therefore delivering greatest impact) and encourage existing compliant members to ‘advance’ to become thought leaders and share lessons across supply chains.

In practice, ESG is usually used to provide a means for exclusion. This involves excluding securities of specific activities or industries (e.g. controversial weapons, tobacco, fossil fuels) deemed unacceptable. Reasons may be ethical, legal or due to other norms and standards (e.g. human rights, labour conditions, corruption)\(^{27}\). See for example Standard Chartered and Swiss Re’s position statements in Section 7. It should also be noted that while a financial actor may choose to exclude, these same criteria could be used by an ISEAL member as part of a method to identify risk of non-compliance and/or prioritise engagement with members to maximise impact on the ground.

**Table 4: Screening Criteria for Different Types of Issuers\(^ {28} \).**

<table>
<thead>
<tr>
<th>Screening Approach</th>
<th>Corporate Criteria</th>
<th>Government Criteria</th>
<th>Financial Sector Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethical/reputation screens</td>
<td>Revenue derived from: • Tobacco • Controversial weapons • Nuclear energy • Pornography • Arms • Gambling • Alcohol • Animal testing</td>
<td>• Adherence to international standards on human rights and environmental issues (see below) • Use of capital punishment</td>
<td>• Financing or ownership of business activities listed under corporate criteria (on left) • Origination of ABS financing business activities listed under corporate criteria (on left) • Predatory lending • Aggressive tax avoidance schemes or consultancy</td>
</tr>
<tr>
<td>Norms, standards and international laws</td>
<td>• Illegal activities • Export controls • International Labour Organisation conventions • UN Global Compact Standards</td>
<td>• Trade embargoes • US, EU, UN sanctions • ILO conventions • Human rights conventions • Montreal Treaty • Kyoto Protocol • World Governance Indicators • Ottawa Treaty (antipersonnel mines) • Convention on Cluster Munitions (CCM)</td>
<td>• Export controls • Whistle-blower policy • Regulatory compliance • Community Reinvestment Act (US) • IFC Performance Standards • Equator Principles • International sanctions</td>
</tr>
</tbody>
</table>


Furthermore, a growing body of research shows that ESG factors are material credit risks, for example for fixed income investors. Evidence increasingly suggests that incorporating ESG into fixed income investing contributes to more stable financial returns. Consequently, ESG investing is increasingly becoming part of the mainstream investment process for fixed income investors – an approach that used to be more confined to specialist bonds, such as green bonds. This dispels the myth that incorporating ESG means having to sacrifice financial returns.

**ESG can also be used for positive screening, or ‘best in class’ selection, with related risks.** This is a positive selection or overweighting of companies or countries with better or improving ESG performance relative to sector peers. It can be implemented on either the level of ESG measures or their potential for change (ESG momentum – see Box 10 in Annex 2 for more information on this). An immediate concern with exclusions or best-in-class is the potential reduction of the investment universe. Also, screening may lead to unintended sector and factor biases in portfolios, so these risks need to be well managed.

**ESG can also be used for active ownership, voting, engagement or stewardship.** This refers to the practice of entering into a dialogue with companies or countries on ESG issues and exercising both ownership rights (including voting) and ‘voice’ (especially relevant in cases where investors do not have voting rights, such as bondholders) to effect change. This is an alternative to ‘exit’ (i.e. selling off the investments with questionable practices) or divesting based on specific issues (e.g. removing exposure to fossil fuels as ‘stranded assets’). Some investors may also lobby for ESG themes more widely in politics.

Alternatively, ‘green tagging’ is also used by financial sector players, especially in energy efficiency. Green tagging refers to a systematic process whereby banks identify the environmental attributes of their loans and underlying asset collateral as a tool for scaling up sustainable finance. The green tagging of bank assets allows for easier access to green bond markets, better tracking of green loan performance, and provides greater transparency of climate risks and portfolio resilience. Green tagging for energy efficiency has started to be applied to commercial real estate lending and residential mortgages, particularly in Europe thanks to the now required provision of an Energy Performance Certificate (EPC) on all advertisements for the sale or rental of buildings.

**5.3. Sustainability assessment as part of credit rating and potential loss analysis**

Ultimately, the focus of lenders is assessing the creditworthiness of a client or potential client and, especially in challenging and data-poor environments, picking the right client is essential. Depending on the financier, clients vary from multilaterals, to commercial banks, to Export Credit Agencies (ECAs) and would come with their own set of characteristics, in


In more challenging countries, for example, insurance companies would show a preference to work with multilateral banks, who have leverage and resources to resolve political and economic issues. Having large commercial banks as clients also provides a higher level of assurance due to more sophisticated due diligence processes and longstanding relationships. The client relationship with other businesses, such as supermarket chains or mining companies, may carry higher risks of information asymmetry, so higher and more diversified coverage would be sought (for example, cover against confiscation would be recommended in operating in the mining sector). Box 3 below contains an example of sustainability assessment methodology, Rabobank’s ‘Client Photo’.

**Box 3: Rabobank’s ‘Client Photo’**

Rabobank’s sustainability risk assessment methodology focuses on the so called ‘Client Photo’, which is an integrated assessment of customers’ sustainability performance. Rabobank’s customers are divided into three main groups: wholesale, rural and Dutch (as Rabobank was originally established in the Netherlands).

When conducting clients’ assessments, Rabobank evaluates compliance with their Sustainable Development Policy, which includes core, theme and sector policies. The four core policies are related to core environmental, social and governance issues (including Human Rights, Labour Standards and Anti-corruption) and are applicable for all their products and services. Theme policies are related to thematic issues such as Animal Welfare, Biodiversity and Land Governance; whereas sector policies are related to specific socially and environmentally sensitive industries and supply chains such as Aquaculture, fisheries and seafood processing; Armaments industry; Biofuels; Cocoa, Coffee & Cotton; Extractive Industries; Forestry; Livestock Farming; Palm Oil; Soy; Sugarcane. Therefore, they do both positive and negative screening, as well as engaging with stakeholders for continuous improvement and with clients to improve their sustainable performance.33

In particular, any commercial client over € 1 million is analysed on sustainability performance and categorised as it follows:

- **A** – frontrunner (5-10%);
- **B** – average performer (80%);
- **C** – laggard (10%);
- **D** – non compliant (1%);
- Non-compliance can be further subdivided in D and D+ (D being exit strategy, with reports on anonymised basis, whereas D+ being currently non-compliant, but with a timeline and an approach to become compliant through further engagement with the client).

This methodology has been developed over a number of years, starting from the creation of the sustainability department in 1998 driven by strong CEO level leadership, to a position where sustainability is a core part of all operations and departments within this financial institution.

*Source: Rabobank interview, January 2020.*

**Insurance companies, on the other hand, need to describe the potential losses to be able to insure.** For example, ForestRe34, which is part of Globe Underwriting35, considers forests

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more as an opportunity than a risk. They collect data at the local level, and model the potential loss, considering the frequency and severity of catastrophic events, commodities / products, and the environment in which the potential client is in, including socio-political processes and behaviours. They then charge an appropriate premium. They do not operate in all countries, excluding those that are considered riskier, especially where it is more challenging to collect data. More details on the ForestRe's approach to data can be found in Section 6.

5.4. Lessons related to methodologies

This sub-section aims to draw out lessons on how financial institutions have developed and use sustainability risk assessment methodologies and strategies, building on their understanding and definition of sustainability (as previously analysed in Section 4), focussing in particular on commonalities, differences, learnings and opportunities, where possible.

Table 5: Key commonalities and differences related to risk assessment methodologies and strategies.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Commonalities</th>
<th>Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Looking at examples of carbon / GHG footprints: key disclosure initiatives and related challenges</td>
<td>Opportunity for a 'universal language' beyond sector specific definitions (e.g. Greenhouse Gas Protocol).</td>
<td>There are already numerous different initiatives, frameworks and tools in this space (e.g. TCFD, RE100, SBTI FI, PACTA, etc.).</td>
</tr>
<tr>
<td>Beyond carbon / GHG footprints: different approaches to sustainability and responsible investment</td>
<td>ESG screening (both positive and negative) could be part of an overall A – B – C strategy (Avoidance – Benefit – Contribution). An example of A – B – C strategy could be the following: 1. preliminary negative ESG screening (A); 2. positive ESG and/or SDGs screening (B); 3. impact requirements to be measured, monitored and reported (C).</td>
<td>• ESG is a very common term for the financial sector as a whole. • However, there is not one clear, comprehensive and standardised framework that defines a 'fixed' set of environmental, social and governance metrics (although several different examples have been provided in Section 4). • Therefore, each financial institution uses its own set of ESG metrics, often depending on the specific sectors in which they operate, as well as the particular services they provide.</td>
</tr>
<tr>
<td>Sustainability assessment as part of credit rating and potential loss analysis</td>
<td>ESG screening is increasingly becoming more integrated into traditional due diligence, which means that sustainability risk assessments are starting to be carried out as an integral part of the checks undertaken on potential new clients (e.g. Rabobank Client Photo). Sometimes these assessments are also regularly undertaken on existing clients (e.g. every year).</td>
<td>• Although sustainability risk assessments are becoming more and more common, they are not currently carried out by all financial institutions for all clients (e.g. it might depend on the size of the investment), and they can also be more or less integrated. • In addition, depending on the length and/or kind of the investment, sustainability assessments might be more focused on risk, impact and/or performance.</td>
</tr>
</tbody>
</table>
5.4.1. Key learnings and opportunities

As momentum is growing, so are opportunities for financial institutions to be at the forefront of this shift towards more sustainable investments. Nevertheless, structural changes would be needed to put sustainability at their core (including integrating sustainability assessments into traditional due diligence processes). In addition, alignment should be sought, both within and beyond the financial sector. For instance, alignment towards using the SDGs as a common framework could present a great opportunity for inter-sector collaboration.

Additionally, as ESG frameworks are very diverse, there is the opportunity for further integration. The financial sector can create, develop and use a sector-wide 'common' ESG framework, in a collaborative approach, although currently there are not incentives for the financial sector to encourage this collaborative alignment, due to ‘competition’ amongst other reasons. However, as regulation (including for example, possible due diligence obligations for reducing risk associated with deforestation) is currently being explored (both nationally and at the EU level), regulation could represent a great opportunity for alignment.

Alternatively, different financial institutions could still develop, use and improve their own ESG frameworks and align to SDGs. If ESG frameworks could be somehow aligned with the SDGs, this could provide a common ‘umbrella’ beyond the financial sector itself as the SDGs are increasingly being referred to in other contexts, including for monitoring and reporting impacts achieved on the ground by development projects as well as sustainability standards (including carbon standards).

However, in many cases, this would represent qualitative rather than quantitative information. Therefore, the quantification of SDGs related impacts would still constitute a gap to overcome. Nonetheless, if this cross-sector challenge could be collectively and collaboratively addressed, and an overarching SDGs methodology established, including key quantifiable metrics, potentially linking up with the different sector and/or commodity specific initiatives, then cross-sector alignment could be achieved.

To conclude, the lack of a common holistic approach to sustainability as well as the variety of ESG frameworks that have been developed and are currently used (as illustrated in Section 4), presents difficulties for the identification of commonalities across methodologies used by the financial sector to address sustainability risks. In fact, in most cases these seem to depend firstly on the kind of financial institution (e.g. commercial bank versus insurance company), secondly on the sectors, commodities and geographies in which they operate (e.g. forestry specific versus wide range of sectors), and thirdly on the understanding and interpretation of sustainability and ‘sustainable’ investment (e.g. PGGM approach and Blackrock strategy).

In the next section data sources and tools used across the financial sector for assessing sustainability risks and making decisions in this respect are explored.
6. Data sources and tools used for risk assessments

Data sources and tools vary across the sector, accounting for different kinds of risks, such as commodity and/or sector specific risks, but also ‘global’ risks such as climate change related negative impacts. Challenges relating to the sources of information in addition to the means for assessing (and at least potentially verifying) such information are particularly pertinent in data poor countries. This section presents an array of examples, aimed at depicting the variety of data sources and tools used for sustainability risk assessments. The role of innovation and that of certification are also explored, along with challenges, learnings and opportunities. However, before focusing on data sources and tools used for sustainability risk assessments, preliminary information on the types of risks themselves is provided.

6.1. Risk identification, assessment and evaluation

Whether a standards body, an investment bank or a global food manufacturer, organisations broadly consider three types of risk:

- Risk related to the product, species or sector;
- Risk related to the geographical area where the commodity is produced or sourced (geographical risk); and
- Risk related to the individual producer or certificate holder.

Exposure to these risks may depend on the supply chain itself as well as on the level of transparency and traceability, as the latter provide assurance to buyers throughout the supply chain.

However, the challenge is considering sustainability more broadly, across all issues and sectors. It is currently more common to explore risk on a relatively small scale and scope (e.g. water risk). However, interviewees highlighted how frameworks should be multidimensional, capture the ‘ripples’ and impacts beyond one specific sector, and be linked to geographies, sectors, commodities (e.g. palm oil, cocoa, pulp and paper, etc.) and companies. For example, water risk is very local and specific to one region, whereas a multisector approach is better to identify energy-related risks (see Box 4 below on climate change related risks and data). For instance, deforestation is also linked to climate and food security, therefore there is a need for a regulatory and risk framework to identify high risk companies and cross check with financial exposure. In brief, how to explore risk in a multidimensional approach remains a challenge for everyone.

### Box 4: Climate change related risks and data

Disclosing carbon emissions is not enough in order to understand the material climate risk to the portfolio, which is much more complex and challenging.

Investors are increasingly concerned about both the transition needs and the physical risks related to climate change, but these risks cannot be easily managed as the necessary data and tools are not currently available. In addition, although the Task Force on Climate-related Financial Disclosures (TCFD) has suggested a set of metrics (included in Figure 14 in Annex 2) for reporting physical risks, the lack of standard measurement methods and available data to account for them makes them very

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36 The first two types of risk are sometimes also referred to as ‘external risks’, while the last category is also known as ‘internal risk’.

37 Expert interview (2019).
hard, if not impossible, to implement. Given these limitations, it is challenging for investors to assess vulnerability to risks such as extreme weather events, and to then convert them into financial terms.

There are some exceptions including managing risks related to water stress, floods, wildfires and sea level rise. This is mainly undertaken by insurance companies, but also by investors that manage or directly invest in fixed income assets like municipal bonds, or real assets like real estate or farmland, primarily because the data is more accessible for them than for other sector players. In this report we provide an example of this, namely ForestRe. However, this reinsurance perspective is to be considered as an exception in the financial sector as a whole.

In addition, for some issues, data is still incomplete or of poor quality, leading to data gaps. Examples of this include data on carbon emissions, methane emissions, energy consumption, water management and climate scenario analysis disclosure. Furthermore, contextualising the data can be quite challenging regarding, amongst other issues, local water stress, global carbon prices by region and jurisdictional environmental regulations. Therefore, this information should be interpreted and evaluated, starting from company disclosures, and towards the assessment of performance on relevant metrics.

Sources: Expert interviews (2019-2020); and WRI (2019)\textsuperscript{38}.  

6.2. Sustainability risk assessment tools, methods and approaches
Organisations are using a wide variety of tools and methods for identifying sustainability issues among suppliers and certificate holders, thus assessing and quantifying the risks\textsuperscript{39}. Based on their characteristics, processes and the data sources they make use of, the following approaches are commonly used for risk assessments:

- Increased or more varied audits and site assessments (by the scheme owner for example);
- Desk-based risk assessments;
- Complaints and incidents assessment;
- Stakeholder consultations;
- Producer self-assessments and internal audits;
- Supplier engagement;
- Geospatial assessments; and
- Alignment with principles such as the Equator principles.

There are numerous sustainability assessment approaches used to evaluate different kinds of risks – economic, environmental and social. Examples include\textsuperscript{40}:

- Economic risk assessments: cost / benefit analysis, modelling, regressions, scenarios;
- Environmental risk assessments: life-cycle analysis, material flows, resource accounting, NAMEA, ecological footprint; and
- Social risk assessments: sustainable livelihoods, human and social capital measurement, participatory processes.

\textsuperscript{38} https://www.wri.org/news/what-investors-want-sustainability-data
\textsuperscript{40} https://www.oecd.org/greengrowth/39925248.pdf
6.2.1. Challenges related to sustainability risk assessments

Overall, there are numerous challenges identified with sustainability risk assessments. OECD include the following 41:

- Giving equal attention to the three spheres of ESG and adequate attention to the longer-term (for long-term sustainability – e.g. building climate change resilience);
- Assigning monetary values to environmental and social assets for comparisons (including all the challenges linked to the quantification of sustainability risks, issues and opportunities);
- Identifying trade-offs and presenting positive versus negative assessments in the three spheres on a comparable basis (aiming to minimise adverse impacts); and
- Reconciling conflicts between economic, environmental and social goals and providing the basis for establishing company-wide policies and processes which integrate sustainability assessments into 'standard' due diligence processes.

6.3. Lack of integration and alignment

Risk profiling is multifaceted. For example, CDP’s Forests reporting framework covers the key commodities that drive deforestation globally (namely cattle products, palm oil, soya, timber products, rubber, coffee and cocoa). CDP Forests provides a standardised method and common platform through which companies can report on their exposure to deforestation risk and on the actions they are taking to minimise and address that risk. However, unlike the Climate Change reporting framework, there is no single metric such greenhouse gas emissions. Nonetheless, investors can use company scores as one single metric, while service providers have already started to use CDP Forests data to develop products that help investors avoid deforestation-related risks. For example, CDP Forests data is used by Exchange operator Euronext in an equity index, the EUROnext CDP Environment France EW Decrement 5%, which includes the 40 French-listed companies that score highest based on their CDP disclosures, including on deforestation risks 42.

Nevertheless, if there was one sustainability metric, lenders and investors would be able to incorporate that one sustainability criterion in their lending / investment approach more easily. As land use changes, such as deforestation, can negatively impact biodiversity, water, and other services, land use could potentially, in some circumstances, be used as a proxy for sustainability risks more generally, through a more systemic consideration of both environmental and social impacts, including indigenous rights 43.

There is consequently an increasing need for integration and alignment. As various sustainability standards already include requirements on deforestation and/or conversion free (providing cut off dates, etc.), in some cases, sustainability standards can have an intermediary role between the producers and the companies which, through certification channels, can be transferred to investors as well. However, there is high fragmentation among different sustainability standards depending on the commodities, regions and sectors they operate in, so it can be hard for investors to rely on them (in aggregation). Nonetheless, potential further alignment among different sustainability standards, at least on a set of core principles, could

43 Expert interview (2019).
provide a strong basis for investors to rely more on sustainability standards when assessing sustainability risks. Box 5 below provides an example of how the financial sector can come together to influence change.

**Box 5: Investor statement on deforestation and forest fires in the Amazon**

As of May 2020, the statement below is endorsed by over 250 investors representing approximately US $17 trillion in assets.

‘As investors, we see deforestation and the associated impacts on biodiversity and climate change as systemic risks to our portfolios and see the reduction of deforestation as a key solution to managing these risks and contributing to efficient and sustainable financial markets in the longer term. Considering the growing risks due to increased deforestation in Brazil, Bolivia and other Amazonian countries, we therefore urgently request companies to redouble their efforts and demonstrate clear commitment to eliminating deforestation within their operations and supply chains, including by:

1. Publicly disclosing and implementing a commodity-specific no deforestation policy with quantifiable, time-bound commitments covering the entire supply chain and sourcing geographies.
2. Assessing operations and supply chains for deforestation risk and reduce this risk to the lowest possible level, disclosing this information to the public.
3. Establishing a transparent monitoring and verification system for supplier compliance with the company’s no deforestation policy.
4. Reporting annually on deforestation risk exposure and management, including progress towards the company’s no deforestation policy.’

*Source: PRI (2019-2020).*

### 6.4. Differences in data sources

#### A large amount of ESG data, used by the finance sector, comes from individual companies’ public disclosures.

Companies disseminate this information through a number of outlets, including annual reports, social responsibility reports and ESG disclosure surveys from data providers like CDP. This focus highlights the importance of mutual disclosures (e.g. schemes also publicly reporting and sharing data to build trust).

#### Third-party data providers also collect and aggregate these data, along with data from other sources.

These providers can serve as a centralised access point for data, offered through fee-based subscriptions. Some offer a specialised focus, or others cover a broad range of ESG issues. Providers use their own proprietary methods to process and standardise the data into a suite of metrics, scores, ratings, rankings and indexes to enable easier comparisons among companies. The diagram below (Figure 4) illustrates an example of the flow of sustainability data across market players.

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44 [https://www.unpri.org/Uploads/c/k/h/investorstatementondeforestationandforestfiresintheamazon_502487.pdf](https://www.unpri.org/Uploads/c/k/h/investorstatementondeforestationandforestfiresintheamazon_502487.pdf)

45 (pers. comms)
Some institutions interviewed also carry out their own data collection, and the approach depends on what is being assessed and on internal capacity. For example, the assessment of mergers and acquisitions (M&A) or project finance is carried out not so much at the entity level, but at the asset level – so, for example, the assessment is carried out on how construction of a project is done, and on the alignment with the lending criteria. Those new to sustainable investing often use ESG scores as an entry point. More sophisticated investors may construct their own metrics or analysis using raw ESG data. Additionally, findings from the interviews suggest that external data is more frequently used for screening reputation-related risks and ‘do no harm’, whilst positive/contribution assessments are generally more internally led – in most cases because of the more limited information available in the latter case.

6.5. Data sources: tools and platforms
Currently there are a number of external data sources used by financiers. These include those presented in the following table (Table 6). This is not an exhaustive list and further research would be required for a comprehensive analysis.

<table>
<thead>
<tr>
<th>Data Source</th>
<th>Comments</th>
<th>Benefits</th>
<th>Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Forest Watch (GFW)</td>
<td>Useful for maps which include forest change, land cover, land use, climate and biodiversity data. It can also show data on carbon emissions, density and gains, as well as on commodities, including data on logging, mining, oil palm, wood fibre, oil and gas concessions, palm oil mills, RTRS Guides for</td>
<td>It covers historical data on a wide range of environmental data and is publicly available and free to use. As it uses satellite data, it covers different geographies, but it does also show data on specific commodities (e.g. RSPO oil palm concessions) and</td>
<td>It does not cover social data.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Data Source</th>
<th>Comments</th>
<th>Benefits</th>
<th>Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDP</td>
<td>Responsible Soy Expansion and RSPO oil palm concessions.</td>
<td>CDP collects data on corporate management of climate change, deforestation and water security, through three specific questionnaires. Investors can then access the companies' responses and can use the data and insights in their own investment process. It is therefore based on voluntary disclosure.</td>
<td>Being based on voluntary disclosure, data quality could vary depending on the level of detail of the answers themselves.</td>
</tr>
<tr>
<td>SCRIPT (the Soft Commodity Risk Platform by Global Canopy)</td>
<td>SCRIPT hosts two tools. The Policy Benchmarking Tool assesses the strength of policies against peers, and includes a tool to benchmark the policies of regional banks in Latin America and South East Asia. The Portfolio Risk Tool screens for highest risk clients and issue areas, and offers suggestions for company engagement.</td>
<td>It is quite specific, focussing on policy benchmarking and on portfolio risk respectively. Both tools are also free to use, and provide practical, customised advice on how to move towards greater sustainability, effectively engaging companies on unsustainable practices.</td>
<td>It seems to be more useful for financial institutions than for sustainability standards. In addition, as CDP data powers SCRIPT, this tool is also based on voluntary disclosure.</td>
</tr>
<tr>
<td>PRI</td>
<td>PRI works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The PRI website offers a Collaboration Platform, a Data Portal and a Reporting Tool, as well as</td>
<td>Offering a Collaboration Platform, a Data Portal and a Reporting Tool, PRI can be very useful for financial institutions, also towards increasing alignment.</td>
<td>Nevertheless, it does not seem as useful for sustainability standards.</td>
</tr>
</tbody>
</table>

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47 [https://www.globalforestwatch.org/](https://www.globalforestwatch.org/)
48 [https://www.cdp.net/en](https://www.cdp.net/en)
49 Please note that from 1st May 2020 the SCRIPT tools will no longer be available on [www.script.finance](http://www.script.finance).
<table>
<thead>
<tr>
<th>Data Source</th>
<th>Comments</th>
<th>Benefits</th>
<th>Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trase</td>
<td>Trase offers both national and subnational data across Latin America for different commodities (primarily soya) as well as palm oil data in Indonesia. It mainly focuses on trade volumes, but it also covers financial flows, land use, deforestation risk and CO2 emissions.52</td>
<td>Trase offers primarily trade data, but also data on environmental issues such as deforestation risk. It is also publicly and freely available.</td>
<td>It does not currently cover social data.</td>
</tr>
<tr>
<td>Google Maps</td>
<td>Used worldwide as free satellite imagery data (including for forest coverage).</td>
<td>It provides free satellite data.</td>
<td>It does not currently cover social data.</td>
</tr>
<tr>
<td>UN Global Compact</td>
<td>Materials and reports with a particular focus on the SDGs.53</td>
<td>It focuses on the SDGs.</td>
<td>It seems to offer more qualitative than quantitative information.</td>
</tr>
<tr>
<td>RepRisk</td>
<td>It claims to be the world's largest due diligence database on ESG and business conduct risks.54</td>
<td>It offers comprehensive data on the full ESG spectrum.</td>
<td>It is only accessible under subscription.</td>
</tr>
<tr>
<td>Bloomberg</td>
<td>Bloomberg provides financial software tools and enterprise applications such as analytics and equity trading platform, data services, and news to financial companies and organisations, including data on ESG.55</td>
<td>It also offers comprehensive data on the full ESG spectrum.</td>
<td>It offers bespoke support and designs tools for financial companies (too expensive for sustainability standards).</td>
</tr>
<tr>
<td>RobecoSAM (their Country Sustainability Framework is included in Annex 2)</td>
<td>Based on their collaboration with S&amp;P Dow Jones Indices, the DJSI provide asset managers with a range of reliable and objective benchmarks for managing sustainability portfolios.56</td>
<td>It offers data on sustainability risks.</td>
<td>Services under subscription.</td>
</tr>
</tbody>
</table>

51 [https://www.unpri.org/](https://www.unpri.org/)
52 [https://trase.earth/](https://trase.earth/)
53 [https://www.unglobalcompact.org/](https://www.unglobalcompact.org/)
54 [https://www.reprisk.com/](https://www.reprisk.com/)
55 [https://www.bloomberg.com/europe](https://www.bloomberg.com/europe)
### Data Source

<table>
<thead>
<tr>
<th>Data Source</th>
<th>Comments</th>
<th>Benefits</th>
<th>Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainalytics</td>
<td>Sustainalytics is a company that rates the sustainability of listed companies based on their environmental, social and corporate governance (ESG) performance.(^{57})</td>
<td>It offers ESG risk ratings as well as ESG data to financial institutions.</td>
<td>Services under subscription.</td>
</tr>
<tr>
<td>MorningStar</td>
<td>Morningstar is a global financial services firm which provides an array of investment-research and investment-management services.(^{58})</td>
<td>It offers various services to financial institutions.</td>
<td>Services under subscription.</td>
</tr>
<tr>
<td>Standard &amp; Poor's</td>
<td>Standard &amp; Poor's (S&amp;P) publishes financial research and analysis on stocks, bonds, and commodities.(^{59})</td>
<td>It offers ESG evaluations.</td>
<td>Services under subscription.</td>
</tr>
<tr>
<td>MSCI (formerly Morgan Stanley Capital International)</td>
<td>MSCI is a global provider of equity, fixed income, hedge fund stock market indexes, and multi-asset portfolio analysis tools. It publishes the MSCI BRIC, MSCI World and MSCI EAFE Indexes.(^{60})</td>
<td>At least some MSCI ESG ratings should now be publicly available.</td>
<td>ESG ratings are more useful for financial institutions than for sustainability standards. Other services remain under subscription.</td>
</tr>
</tbody>
</table>

### 6.6. Different approaches to collect, analyse and use data

The data collection approach also depends on the type of sustainability risk. For example, assessing against the Equator Principles requires a phased due diligence process, which is more qualitative than quantitative, and the data is client-based, entirely owned, without the use of external data. Free, Prior, Informed Consent (FPIC) approaches are also used in the application of the Equator Principles on project finance. In contrast to this, for the assessment of climate risk (where uncertainty around the timeframe and severity of impacts is high), data is usually externally acquired and more quantitative than qualitative. Also, emissions data is usually externally acquired. For instance, the PACTA climate scenario analysis tool for listed equity and corporate bonds portfolios (previously described in Section 5.1) has already been applied by over 1,000 financial institutions around the world on over 7,000 portfolios to date\(^{61}\). It provides free and confidential assessment of how listed equity and corporate bonds portfolios compare to a 2°C transition (as defined by the IEA), as well as a better understanding of potential capital misallocation and potential associated financial risk under 2°C transition, and the ability to implement supervisory stress-tests\(^{62}\).

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\(^{57}\) [https://www.sustainalytics.com/](https://www.sustainalytics.com/)

\(^{58}\) [https://www.morningstar.co.uk/uk/](https://www.morningstar.co.uk/uk/)


\(^{60}\) [https://www.msci.com/](https://www.msci.com/)

\(^{61}\) [https://www.transitionmonitor.com/](https://www.transitionmonitor.com/)

\(^{62}\) [https://www.transitionmonitor.com/](https://www.transitionmonitor.com/)
Additionally, the approach followed also depends on the sector. For instance, FPIC approaches are used in the agro-industry sector on plantation management. For Rabobank, for example, sustainability is a key indicator for some specific sectors, such as agriculture, but also oil and gas. For some commodities such as ‘coffee’, which are perceived to carry a higher ‘social’ risk, more data is gathered compared to other sectors / commodities because the risk of human rights violations (e.g. child labour) needs to be assessed more carefully. Interestingly, Rabobank has also collaborated with IBM on the development of a blockchain-based application allowing consumers to support the farmers who grow the beans that make their cups of coffee, thus increasing transparency\textsuperscript{63} (blockchain’s role in traceability is illustrated further in this section).

Business development is also assessed, by asking 10 questions to each client (the questions are standardised to enable comparison). Scores are then assigned based on outputs. Further to that, more client-specific questions are also asked, for instance around participation to certification schemes and standards (more information on certification can be found in Section 6.6.1 below).

Furthermore, the amount of data required also depends on the additional requirements a financial institution might have. For example, Standard Chartered have developed sector specific position papers which clearly outline several exclusionary requirements. In particular, regarding investments in agro-industries, amongst other requirements, they have committed to not providing financial services to agribusiness clients who develop new plantations or livestock ranches which convert or degrade High Conservation Value (HCV) or High Carbon Stock (HCS) primary forests, peatlands or designated legally protected areas. Moreover, they will not provide financial services directly towards operations which use fire, including for land clearance, and/or in the preparation of land for planting, as well as any operations that grow, process or trade soya from the Brazilian Amazon or Brazilian Cerrado\textsuperscript{64} (additional information provided in Box 11 in Annex 2). Therefore, in order to be financed, agribusiness clients need to be able to provide data to show and demonstrate compliance with the above requirements.

6.6.1. The role played by certification

Certification can be crucial for investment decisions. Financial institutions use data on certification, for example, knowing that there is a deforestation-free supply chain is key, while ISO standards are under discussion in green bonds. For Rabobank, for example, as they operate in different market segments, their approach to certification varies. For the whole portfolio certification is widely used as a confirmation and extension of the internal sustainability analysis.

Similarly, Standard Chartered’s agro-industry sector approach also includes commodity specific criteria and exclusionary requirements which clearly reference certification schemes (Box 11 in Annex 2 for more details). For instance, for palm oil (amongst other palm oil specific requirements), they only provide financial services to clients who have Roundtable on Sustainable Palm Oil (RSPO) membership at the parent or subsidiary level, and publicly commit to No Deforestation, No Peat and No Exploitation (NDPE) – verified by credible


\textsuperscript{64}https://www.sc.com/en/sustainability/position-statements/agro-industries/
assessors when developing new plantations. Likewise, for forestry, they will only provide financial services to clients who have Forest Stewardship Council (FSC) or Programme for the Endorsement of Forest Certification (PEFC) certification for their production sites; or have an agreed time-bound plan to achieve certification. For more details on Standard Chartered’s agro-industry sector approach refer to Box 11 in Annex 2.

**However, certification needs to be transparent and robust to be used in investment decisions.** One interviewee thought that forest sustainability standards would have been a good proxy for good plantation management and employment processes but has found that it was not always the case.

Reasons for this may include (non-exhaustive):

- Traceability is not always readily available from all certificates or across commodities, therefore back-to-source traceability is very difficult to establish.
- Limited data disclosure – another interviewee highlighted that certification schemes do not always provide public information, naming the Roundtable on Sustainable Palm Oil (RSPO) as an example in which data disclosure could be further improved.
- The occurrence of false claims (or confusing claims, such as buying certified material without being certified themselves) that can discredit schemes.
- Interpretation of certificates and evidence requires a level of technical knowledge of the commodity / sector / geography, which is not typically available in-house.
- Blockchain, while relatively new, is gaining traction as a tool that can be used to overcome problems with in-house capability as the end user does not have to have the technical knowledge to interpret the evidence, as discussed further in Box 7 in Section 6.6.2 below.

### 6.6.2. The role played by innovation

**Methods and tools have changed over time, in line with increase in technological innovation.** For example, ForestRe started modelling scenarios in the 1980s-90s and over time progressed from using physical maps to Google Earth, including data on elevation, burning, etc. Since 2007 their approach has become more quantitative, combining remote sensing and on the ground forest monitoring. For instance, visiting the forests and talking to managers to understand how they handled fire used to be quite common. In some cases, relatively elementary local practices led to losses caused by burning for pastures and/or by honey gatherers who used smoke to manage bees. Therefore, field visits provided a better understanding of on the ground aptitude to risk, particularly as at middle latitude fires are generally mainly caused by people. In order to calculate potential losses, including those due to fire risk, different methods can be used. Box 6 below contains an illustration of a complex tool used in the insurance sector, the Monte Carlo method.

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**Box 6: The Monte Carlo Method and ForestRe’s approach to assessing extreme events**

The Monte Carlo method has been highlighted as a key tool for the insurance industry and, amongst others, it is used by ForestRe. The modelling tool pre-prepares half a dozen typical data distributions and lists the results according to the characteristics of each of the distributions. This is used to generate losses for each account being priced (loss cost % x value exposed).

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Then the benefits of any given excess (deductible) retained by the insured can be tested, to see what proportion of expected losses are not to the account / liability of an insurer. Similarly, one can do this for any limit of cover (a ‘limit’ is the maximum the insurer will pay out. For example, US$20m maximum coverage required on an account worth say US$1 bn). The same process shows how many losses lie outside (bigger than) the requested limit. The losses that are bigger than the deductible and less than the ‘limit’ is the liability of the insurer.

The main challenge highlighted by ForestRe is not around the mean loss cost, that is more or less known, but the extreme events (‘Fat-Tail event’). Extreme events have no known mathematical relationship with the last largest event for any particular account, region or country. A premium therefore will be charged for the possibility of an extreme event, that may only occur 1 in 250 or 1:500 years (typically hurricanes in US South of any significance will be about 1:30, but the extremes could be far higher). For this, the following is needed:

- as good a data set as can be found or constructed,
- a loss data distribution that reflects how the losses are spread out, multiplied by frequency in real life.

In time, ForestRe has developed a strong sense of the probability of impact of disasters, based on historical data.

*Source: ForestRe interview, December 2019.*

**Blockchain is another good example of technological innovation.** In fact, while the uptake of blockchain tools varies across different sectors, particularly due to cost, it has great potential. For instance, amongst other opportunities, it can allow to show traceability and demonstrate transparency throughout the supply chain, as illustrated further in Box 7 below.

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**Box 7: The transformative role of blockchain in increasing supply chain transparency**

Supply chain traceability is one of the main applications for blockchain technology. Along with the use of smart contracts, blockchain enables the following:

- Transparency into the provenance of consumer goods – from the source point to end consumption;
- Accurate asset tracking;
- Enhanced licensing of services, products, and software.

Blockchain has the potential to drive cost-saving efficiencies and to enhance the consumer experience through traceability, transparency, and tradeability.

- Traceability improves operational efficiency by mapping and visualising enterprise supply chains. Blockchain helps organisations understand their supply chain and engage consumers with real, verifiable, and immutable data.
- Transparency builds trust by capturing key data points, such as certifications and claims, and then provides open access to this data publicly. Once registered on the blockchain, its authenticity can be verified by third-party attestors. The information can be updated and validated in real-time.
- Tradeability – using blockchain, one may “tokenise” an asset by splitting an object into shares that digitally represent ownership. These tokens are tradeable, and users can transfer ownership without the physical asset changing hands.

As an example, the company “Tracr” established traceability across the diamond value chain.

*Source: Consensys website*[^consensys]

[^consensys]: https://consensys.net/blockchain-use-cases/supply-chain-management/
6.7. Different financiers have different challenges

The overall resilience of a portfolio is starting to be assessed. The approach to assessment of resilience is twofold, considering how exposed to the transitioning economy the portfolio is, and whether there will be a negative impact on it. Consequently, financiers would identify business with whom to work in a more purpose-led approach than before, shifting the focus from ‘risk’ to ‘opportunity’. Insurance companies for instance assess clients’ exposure based on their annual accounts and on how much funding they are providing to vulnerable businesses (for example, in Nigeria, on oil and gas). Financiers can struggle with trade-offs between long- and short-term perspectives. For example, the integration of development and climate change considerations in risk assessments is critical: even with the most sophisticated modelling, the scenarios do not align with the life of most financial assets. When a bond’s lifetime is 10-20 years, disinvestment before the expiration is not possible.

The availability and sophistication of tools depends on the type of financier, and thus the length of timeframe for the investment. The insurance market operates on longer timeframes and will have the most sophisticated tools and modelling techniques, developed long before climate change risks were as prevalent. For pension funds this consideration is slightly different. Whilst their client horizon is very long term, their investments are short term – i.e. they can invest or disinvest in shorter timeframes and are assessed through short term targets.

There are numerous challenges identified in using risk-identification strategies with regard to data for companies, which would impact on financiers. These include the fact that companies are still not doing robust risk assessment and are not always able to report on financial risks or opportunities (there are in fact low disclosure response rates for some sectors, such as forests, compared to others, such as water and climate change). These findings are supported by the findings of Proforest’s study in 2017 for ISEAL Alliance⁶⁹, that reported data accessibility and availability, real-time and accurate data, in addition to inaccessible audit data, as key challenges. Additional sustainability challenges for investors are presented below, in Figure 5, per region.

Figure 5: Sustainability Challenges for Investors\textsuperscript{70}.

<table>
<thead>
<tr>
<th>Performance concerns</th>
<th>North America</th>
<th>Europe</th>
<th>Latin America</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>44%</td>
<td>42%</td>
<td>47%</td>
<td>37%</td>
</tr>
<tr>
<td>Lack of transparency and reported data</td>
<td>41%</td>
<td>33%</td>
<td>44%</td>
<td>34%</td>
</tr>
<tr>
<td>Difficulty measuring and managing risk</td>
<td>26%</td>
<td>29%</td>
<td>26%</td>
<td>26%</td>
</tr>
<tr>
<td>Cost</td>
<td>23%</td>
<td>28%</td>
<td>22%</td>
<td>26%</td>
</tr>
<tr>
<td>Investment committee is not comfortable making sustainable investments</td>
<td>14%</td>
<td>6%</td>
<td>14%</td>
<td>23%</td>
</tr>
<tr>
<td>Other</td>
<td>11%</td>
<td>12%</td>
<td>9%</td>
<td>6%</td>
</tr>
<tr>
<td>I do not believe in sustainable investments</td>
<td>20%</td>
<td>22%</td>
<td>15%</td>
<td>29%</td>
</tr>
</tbody>
</table>


6.8. Common challenges

From the research conducted, while not exhaustive, some common challenges have been identified and grouped around three themes: fragmentation and lack of standardisation; data quality: assurance and proxies; and risk quantification, triangulation and mitigation.

6.8.1. Fragmentation and lack of standardisation

Firstly, as discussed in detail in Sections 4 and 5, there is fragmentation across the sector in both the understanding of, and definition of, sustainability and its related risks. In addition, across ESG data and frameworks, different metrics and ‘weights’ are used by different entities (e.g. data providers) in developing ESG ratings and scores, making comparison very hard to do. Furthermore, as some financial institutions gather their own data (and have developed their own ‘internal’ methodologies and processes to do so), they tend to have different data points and exclusionary requirements (as well as different organisational structures, etc.). Moreover, data quality and availability differ across sectors and geographies, including data acquired from and/or publicly disclosed by sustainability standards and certification schemes.

This lack of standardisation in data can make data collection and analysis challenging, and simplification is needed. As different players in the financial sector use different ratings and related data to quantify value at risk, this diversity impacts on the quality of disclosure information: rating agencies receive responses that vary in terms of depth and scope, making comparability challenging. In addition, it is also not clear to disclosure entities how investors use the data generated in lending or investment decisions, making it difficult to generate lessons learnt and to improve the systems, in addition to carrying out monitoring and evaluation. There

is a widespread desire for a more simplified process, including, for example, a flagging system of 'hot spot' risk areas.

6.8.1.1. TCFD recommendations

A positive progress towards standardisation is represented by the work carried out by the Task Force on Climate-related Financial Disclosures (TCFD)\(^1\). The TCFD (previously mentioned in Section 5.1) aims to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. The Task Force considers the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries. The work and recommendations of the Task Force aims to help companies understand what financial markets want from disclosure in order to measure and respond to climate change risks and encourage firms to align their disclosures with investors’ needs. The TCFD published its second Status Report in 2019, which provides an overview of disclosure practices that are aligned with the Task Force’s recommendations over a three-year period from 2016 to 2018. At the same time, the number of supporters continues to grow and reached 785 in 2019. Box 8 below describes one of the key recommendations developed by the TCFD.

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**Box 8: Forward-looking analysis and climate-related scenario analysis**

‘One of the key TCFD recommendations is for organizations to *disclose forward-looking analysis* of how climate change will impact business operations. These so-called climate-related scenario analyses test businesses, strategies and financial performance against a set of potential climate-related scenarios, each based on a series of assumptions about climate impacts and market shifts. For most companies, climate-related scenario analysis is a new exercise. While numerous reference scenarios are available, there is no standard method for completing the analyses. Companies must therefore make a number of assumptions to inform the analysis. This leads to concerns about the quality of the results. Without the use of consistent assumptions and metrics, or at least greater transparency into those used, the analyses will not be comparable across companies, greatly limiting the utility in informing decisions’.

*Sources: TCFD; and WRI (2019)*\(^2\).

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6.8.2. Data quality: assurance and proxies

There are challenges related to the fact that a large proportion of data used comes from public disclosure sources. These sources include annual reports, ESG disclosure surveys, etc. with often no third-party verification. Alternatively, external data providers collect and aggregate the data, and then provide this information to financial institutions, subject to subscription. As data verification remains costly, the question around data quality and trustworthiness remains relevant beyond the financial sector. For instance, one interviewee thought that sustainability standards were a good proxy for sustainable production, but over the years found out that this was not always the case. This could have been caused by the following reasons (amongst others): differing levels of transparency across standards; limited data disclosure; and/or confusing claims / challenges in interpreting certification or technical evidence.

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\(^1\) [https://www.fsb-tcfd.org/about/](https://www.fsb-tcfd.org/about/)

6.8.3. Risk quantification, triangulation and mitigation

Generally, the longer the timeframe / length of the investment, the more complex risk quantification becomes. In order to internalise these risks, for example for climate change related risks, GHG emissions reduction targets and sector specific decarbonisation methodologies are being developed through different initiatives (as previously illustrated in Section 5.1). However, the development of decarbonisation approaches and methodologies for some sectors, including for agriculture, seems to be currently ‘lagging behind’ compared to other sectors (e.g. transport).

In addition, some risks, for example social risks and those associated with extreme events, are harder to measure than others. In the case of social risks, closer engagement with the client, may be required as a way to gain greater clarity on the type, scale and frequency of the risk (i.e. need for greater understanding of the business and associated risks). For environmental risks linked to extreme events (such as natural disasters and their impacts), instead, as these risks are particularly hard to quantify, this often results in a premium being charged to account for potential losses. Finally, there is also greater recognition that ‘systems’ need to be multidimensional and capture ‘the ripples’ in order to minimise adverse impacts.

6.9. Analysis of research findings related to data sources

Drawing from the information and examples presented in this section, three categories of data sources have been identified, namely publicly available data sources, external data providers and internally gathered data. For further clarity, these three categories are illustrated and summarised in Table 7 below.

Table 7: Summary table on the three categories of data sources identified through this research.

<table>
<thead>
<tr>
<th>Used by who?</th>
<th>Publicly (and freely) Available Data Sources</th>
<th>External Data Providers (under subscription)</th>
<th>Internally Gathered Data</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Financial institutions focusing on specific sectors.</td>
<td>Large financial institutions working across very diverse sectors.</td>
<td>Large financial institutions or very 'localised' ones.</td>
</tr>
<tr>
<td>Why?</td>
<td>Only assessing specific sustainability risks related to specific commodities and/or regions.</td>
<td>Need to assess many clients across a wide range of very diverse sectors.</td>
<td>They operate in niche sectors in which there is no available data and/or they are very large and resourceful.</td>
</tr>
<tr>
<td>How?</td>
<td>Sometimes integrated with additional data (sometimes gathered on the ground, but more often acquired through desk-based research).</td>
<td>Data collected / gathered and 'packaged' by the external data providers, offering ESG specific data as well as ESG ratings (under subscription).</td>
<td>Through established networks.</td>
</tr>
<tr>
<td>Result?</td>
<td>Analysis of the data in-house (using own methodology).</td>
<td>Potential to combine and/or cross-check data acquired from different data providers for greater assurance.</td>
<td>More tailored data gathered for more precise analysis.</td>
</tr>
</tbody>
</table>
6.9.1. Key learnings and opportunities

**Strengthening alignment across ISEAL members may be beneficial for improving sustainability due diligence.** If sustainability standards could consistently provide data and assurance on both environmental and social risks (if not governance issues) linked to the specific commodities and products they certify, then these could be increasingly used by financial institutions as part of due diligence. In order to achieve this, ISEAL could strengthen alignment across its membership, potentially using ISEAL ‘Code of Good Practice’ (including for monitoring and reporting), which could in turn build trust and increase the use of certification for assurance purposes within risk assessments.

**In particular, GHG emissions reductions could be potential gateways to communicate benefits to the financial sector.** This is because some financial sector players are becoming increasingly interested in assessing their ‘investment footprint’ using methodologies and tools (e.g. stress tests) to calculate the extent to which the activities they finance are aligned with various climate scenarios (especially 2 degrees), and carbon reductions / savings could become a ‘universal language’ across commodities, supporting cross-sector alignment and collaboration due to the potential carbon benefits from producing commodities sustainably. Similarly, in some cases, financial institutions are interested in assessing (and measuring) impacts on the grounds and the SDGs framework offer the potential to link even more closely sustainability standards and certification schemes to impact investment (which was discussed in Section 4.3). Therefore, if sustainability standards could provide (e.g. publicly disclose) data showing and demonstrating carbon savings, as well as SDGs related positive impacts, then this potential for alignment could lead to more opportunities for certification schemes.

**To conclude,** the availability of good data and information is key in investment decision making processes, and the use of technology to improve data quality and availability is increasing. The data and tools used depend greatly on the type and size of the financier, and on the commodities and sectors where they operate. Additionally, the importance of cross-commodity and sectoral considerations are emerging. Rigorous and quantitative data, particularly in riskier sectors, will increase the creditworthiness of a client, and will facilitate decision-making processes. Typically, the finance sector initially relies on company data disclosure or third-party data providers, incorporated with primary data sources according to risk (commodity, geography, sector) and/or internal corporate policy requirements. This can also vary depending on the relationship with the client and the robustness of the initial screening (‘on boarding’ stage) along with existing clients’ reviews, which financiers have identified as an opportunity to leverage their influence on their clients. This is also an opportunity for certification schemes when conducting their audits and/or their standards’ reviews. It is recognised that this is a risk-based approach, and risks can be mitigated through the use of data disclosed by independent certification schemes, if publicly available, as cost of independent audits remain a prohibitive factor.

**In the next section,** we illustrate some trends with regard to processes, including governance systems, with examples from different financial sector players.
7. Risk assessment processes and outcomes

The finance sector uses a diverse range of sustainability risk assessment processes in making investment decisions, with a variety of outcomes. Trends and challenges are explored, including possible alignment with more traditional due diligence processes. Learnings and opportunities are also shared.

‘Complexity’ seems to be the main challenge in the creation of a risk assessment framework. To overcome this, the needs for collaboration, a common ‘method’, policy development, and improvement of the enabling environment for companies to disclose, were highlighted as priorities in the interviews, considering that different stakeholders, not only the private sector, need to work together to address sustainability risks, and that environmental and social issues (and risks) are interlinked.

A shift in governance is increasingly observed, with sustainability functions being more institutionally embedded. Sustainability teams increasingly are starting to work with capital markets, so are not located in one division, such as in the Corporate Social Responsibility or Corporate Strategy teams, but with the market development parts of businesses, and are hence able to influence assets and investments. At Standard Chartered, for example, the Enterprise Risk Team comprises also of the Environmental and Social Risk Team. In fact, environmental and social considerations are more reputational and require credit approval: climate change risks could also change the credit rating itself, resulting in higher vulnerability of the client and the portfolio if mitigation measures are not put in place73.

In particular, depending on the investment objectives, data can inform various stages of the investment process. The stages can include asset allocation, security selection, portfolio construction and risk management. The additional layer of information can reveal material risks and opportunities that are otherwise overlooked in investment decisions, helping to identify investments that may lead to enhanced risk-adjusted returns and reduced downside risk74.

7.1. Integrating risk management into the credit process

In practice, the processes used for sustainability assessments are very diverse. There are however common steps taken in these processes, including, for example, the following:75

1. Identify level and target (e.g. national policy, local project);
2. Establish sustainability relevance;
3. Select quick scan versus more detailed assessment;
4. Identify relevant tools (qualitative, quantitative);
5. Assess impacts, synergies and conflicts;
6. Identify alternative policy paths from least to most sustainable;
7. Present findings to policy-makers and stakeholders.

73 Please also see: Integrated investment teams VS Dedicated ESG team and investment teams. https://www.unpri.org/download?ac=10
In this section we draw on a few examples (e.g. Standard Chartered, Swiss Re, Rabobank, ForestRe, The Private Office), to show the range of processes used and highlight areas of similarities and differences. However, these are just a few financial institutions and their processes should not be interpreted as reflective of the whole industry.

7.1.1. Standard Chartered

Risk management is now an integral part of the credit process for Standard Chartered. There are four distinct stages to their lending and E&S risk management processes, including:

1. Initial risk assessment;
2. Detailed due diligence;
3. Approval; and

Standard Chartered has a set of position statements of sectoral standards with heightened environmental and social risk (additional information provided in Box 11 in Annex 2). The standards are then turned into client due diligence questionnaires which the client has to complete before Standard Charter enters into a business relationship with them. An alignment rating with general and specific standards is then produced, which triggers the credit initiation and the amount of commitment capacity. Escalation in the process of engagement depends on the alignment rating, and the due diligence is revised annually, also through monitoring of media, and, if a misalignment is generated, it could have reputational risks. A tiered due diligence process with screening and triggers is therefore considered crucial, as shown in Figure 6 below.

Figure 6: Standard Chartered’s Environmental and Social Risk Assessment.

Source: Standard Chartered.

7.1.2. Swiss Re

Swiss Re also has a detailed due diligence process as part of their Sustainability Risk Framework. The due diligence process is the central part of their Sustainability Risk

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Framework. It consists of the Sensitive Business Risk (SBR) Assessment Tool, the SBR Referral handled by a dedicated team of analysts, and an appeal process through which disagreements can be addressed. The process allows them to efficiently implement the principles and helps focus on the good risks. It is also embedded in the Group's underwriting guidelines, thus requiring that all of the business is compliant with the human rights and environmental protection guidelines. Please see their Sustainability Risk Referral process illustrated in Figure 7 below.

Figure 7: Swiss Re’s Sustainability Risk Referral process.

7.1.3. Rabobank

Rabobank’s process has been developed over time and differs per market segment and geography. It started as a disjointed process, with questions more on ‘Avoid’ – ‘Do no harm’, whereas now it is integrated into the core credit processes. For the Retail segment, there is an

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assessment by in-country analysts which is then internally revised, whereas for Wholesale it is more customised.

From a geographic perspective, Rabobank has developed a specific assessment for each country on how clients, for example rural farmers, score on sustainability based on local challenges they face. For instance, in Australia there is a focus on water, but other criteria also include waste management, energy efficiency, employee engagement, animal welfare, etc. Additionally, in Brazil there is a higher proportion of compliance based on regulations, whereas in other countries regulations might be less sophisticated and more dependent on the country itself. Part of the process is also focused on the relationship manager engaging directly with each client, as well as on the assessment which provides a A, B, C, D score, as described in Box 3 in Section 5.3.

7.1.4. ForestRe
ForestRe has developed an internal risk assessment process called 'Forestry Rating Procedure'. This is 'as robust and as non-technical as we can make it. Something one can use (after selection of suitable empirical data) in minutes and not hours' (Interviewee). ForestRe’s rating procedure involves the following elements:
1. Location review;
2. Rating preparation;
3. Simulations;
4. Completing the rating sheet;
5. Completing the submission sheet;
6. Checking the work and ‘four eyes’;
7. Preparing the submission file.
Please note that additional information on ForestRe had already been provided in Section 5.3 and Section 6.6.2, including in Box 6.

7.1.5. eco.business Fund
Finance in Motion has embedded sustainability in all its own internal processes, including for risk and impact assessments. Sustainability is at the core of their operations and systems. The impact investor developed its own Environmental and Social Management System (ESMS), also taking into account the IFC’s ESMS as part of their Performance Standards. Their impact framework is integrated and undertaken since the first engagements with banks, to understand their knowledge, experience, and exposure. It is also followed by those in charge of risk assessment, through to the ones carrying out the due diligence. In addition, the E&S team and the impact team have specific technical assistance projects linked to the framework.

The Fund’s Development Facility also provides support in enhancing the banks’ E&S management systems. The eco.business Fund also supports banks to develop, mainstream, and implement ESMS systems. Their focus is on building systems that go beyond a project by project level and are strongly embedded in the wider financial and company processes and

81 https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards
procedures, to ensure system resilience. Additional information on the eco.business Fund is provided in Box 2 in Section 4.3 above.

7.1.6. The Private Office
The Private Office combines internal and external processes. In fact, they:
1. Consider portfolio composition to ensure assets are adequately liquid;
2. Consider Green Bonds;
3. Conduct detailed due diligence interviews with fund managers; and

Other examples include AXA Investment Manager. Their ESG integration approach is illustrated below, with fails, partial, and full passes across an ESG rating system. Please note that additional examples are provided in Annex 2.

Figure 8: AXA Investment Managers ESG integration approach.82

![AXA Investment Managers ESG integration approach](image)


7.2. Analysis of research findings related to processes
In this subsection we draw together findings related to risk assessment processes and outcomes, linking them with findings from previous sections, in order to show in the following summary table (Table 8) key challenges, trends and opportunities.

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Table 8: Summary table on key challenges, trends and opportunities related to processes.

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Trends</th>
<th>Opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is fragmentation across methodologies and decision-making processes, including in data points, exclusionary requirements, organisational structures, etc. Additionally, 'internal' processes are often 'ad hoc' – different and difficult to align and/or replicate across different financial sector players and sometimes even within the same financial institution across different teams.</td>
<td>Integration is increasing: Environmental and Social (E&amp;S) Risk Teams / Sustainability Teams / ESG Teams used to be 'separate' and almost work in isolation from other teams, but as the processes become increasingly more integrated, financial institutions' organisational structures need to adapt to this fundamental change.</td>
<td>Sustainability standards / certification schemes can be a crucial part of decision-making processes, but this varies across commodities and sectors as robustness of data / reporting and of the scheme itself are fundamental (e.g. for some financial institutions palm oil certification has become a commodity specific requirement).</td>
</tr>
</tbody>
</table>

7.2.1. Key learnings and opportunities

Closer collaboration between financial institutions and ISEAL members could be sought. In fact, the latter have a wealth of experience in identifying and mitigating sustainability risks on the grounds whereas the financial sector is often quite detached from the real sustainability issues producers might be facing on a daily basis, as well as, at least in some cases, from measures and strategies used to mitigate those adverse impacts. Thus, there is the potential of developing partnerships, encouraging alignment between sustainability standards and financial institutions. Creating synergies and working in partnerships could allow different players across different supply chains (particularly those with high sustainability risks) to fruitfully interact with the financial sector, aiming to create a common language, and common definitions (thus improving communications), as well as co-creating and improving decision-making processes to ensure both their fairness and their rigour.

To conclude, in this section we provided some examples of sustainability risk assessment processes in use in the financial sector. We have also noted how many more financiers have embedded sustainability in their due diligence processes and governance systems. ISEAL membership could learn from these processes, but also take note of this trend, as will reflect on the due diligence that will be applied to members.
8. Moving Forward
In this concluding section, in addition to the analysis contained in sections above, learnings from this research are highlighted, along with potential opportunities for ISEAL and its membership, and some recommended next steps.

8.1. Key learnings

8.1.1. Need for standardisation
There is clearly a high degree of fragmentation in the broad sustainability sector. Sustainability cuts across ESG (Environment, Social, Governance) issues, as well as aligns to the Sustainable Development Goals (SDGs). However, despite the fragmentation, sustainability is increasingly becoming a mainstream topic, integrated in other risk assessment processes, with many different definitions based on sectors and entities. In some cases, ‘ethical’ screening suggests that social criteria may be considered before other sustainability pillars, perhaps as a result of current regulation requirements (e.g. Modern Slavery).

A useful way to structure sustainable financing that can be applicable to certification schemes is through the ‘A-B-C’ approach. This approach categorises interventions across: Avoid (A), Benefit (B) and Contribute (C). ‘Contribute’ has so far broadly been the remit of impact investment, which bridges trade-offs and reconciles conflicts between economic, environmental and social goals. Although SDGs investing does not currently seem to be mainstreamed in the financial sector, there is potential for further exploration in the near future as the SDGs would provide a better aligned framework across different sectors and geographies, encompassing the integration of ESG issues as well as climate change related issues.

8.1.2. Locality issues
Financiers do not operate in all countries. They exclude the ones that are considered riskier, especially where it is more challenging to collect data. Similarly, there is a recognised need to go beyond local laws when they are not sophisticated enough, or there is a perceived transparency or governance risk.

8.1.3. Two priorities for the financial sector: carbon / GHG footprint and governance
The creation of a ‘universal language’ could strengthen links between standards and supply chain actors. This could be created by exploring further the potential carbon benefits of sustainable commodity production, as carbon benefits are commonly used as a metric by the finance sector. Nevertheless, often governance (including transparency) is the first element that is considered in investment decisions, before social and environmental aspects. This may support standards in choosing which areas to prioritise.

8.1.4. Best practice
Larger commercial banks and insurance companies have led the way in integrating sustainability in their due diligence (e.g. Standard Chartered, Rabobank and Swiss Re). The recently published 2019 Forest 500 report identifies both Rabobank and Standard Chartered amongst the top 5 sustainability leaders out of a total of 150 financial institutions assessed, thereby providing scope for the identification of best practice.

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83 [https://forest500.org/sites/default/files/forest500_annualreport2019_final.pdf](https://forest500.org/sites/default/files/forest500_annualreport2019_final.pdf)
8.1.5. Big picture and cross-sectoral thinking

It is important for ISEAL members to consider how the standard is perceived. We have illustrated how the financial sector is increasingly assessing resilience at the portfolio-level, considering how exposed to the transitioning economy the portfolio is, and whether there will be a negative impact on it. In effect they identify businesses with whom to work in a more purpose-led approach than before. A key learning for ISEAL members could be to recognise that assessing risk is not restricted to assessing and supporting non-compliant members but can also be utilised to understand how the standard as a whole is perceived.

Multidimensional approaches are also very much valued. As many sustainability schemes are commodity-led, risk is typically assessed by issue. Considering that many sustainability issues cut across sectors and commodities (such as deforestation or water stress), coordination and cross-sectoral thinking are very much required, something that ISEAL could support through encouraging sharing lessons across commodity specific schemes, particularly those working in similar regions or biomes where data availability may be similar, as well as encouraging collaboration on a larger scale, trying to capture the ‘ripples’ and wider impacts, including food security. However, how to explore risk in a multidimensional approach remains a challenge for everyone, including the finance sector.

8.1.6. Evidence generation

In practice, organisations are already using a wide variety of tools and methods for identifying sustainability issues among suppliers and certificate holders, often quantifying the risks. These include audits and site assessments, desk-based risk assessments, complaints and incident assessments, producer self-assessments and internal audits, geospatial assessments, stakeholder consultations and supplier engagement.

Certifications need to be rigorous to be recognised for sustainability risk assessments. Currently certifications are often used in lending or investment decisions as confirmation or validation of other acquired data as part of due diligence processes. Also, ISO standards are under discussion in green bonds. As the financial sector needs to trust certification to ‘use’ it, it is essential that the scheme in question has a strong reputation – something that the risk approach can ensure and support. The perception of robustness of certification is an area that requires further research, and blockchain technology has the potential to increasingly contribute to making strides in traceability and accountability. Nevertheless, a tiered due diligence process with screening and triggers is still considered fundamental by the financial sector.

8.1.7. Best in class selection and collaboration

Best in class selection could quickly generate ‘winners and losers’, with consequent lessons. For example, an unsustainable business could turn to another investor who has less stringent sustainability requirements. Therefore, in order to achieve impact, it is important to engage with institutions, not only to understand their expectations, but also to collaboratively develop effective risk assessment methodologies and sustainability guidelines. In addition, there are numerous learning opportunities for schemes in the application of best in class selection, where members that achieved the status can share best practices and lessons learnt with other members.
8.2. **Key opportunities**

While a common approach to sustainability and risk would be recommended, due to complexity and specificity, each commodity may need its own commodity-specific methodology. Consequently, an approach may be that ISEAL implements its ‘Code of Good Practice’ to further strengthen alignment across all standards, with each standard then identifying an approach that suits their needs and commodity focus. In practice, the following suggestions could at least potentially represent good opportunities for ISEAL members.

8.2.1. **Further member engagement and support**

For example, standards could utilise (or continue to utilise) a similar approach to Rabobank (and other players) in diversifying the due diligence processes based on the clients’/members’ size and volume (e.g. simplifying processes for smallholders). In addition, ISEAL members (and certified organisations) may need support in answering questions in sustainability risk assessments. An opportunity could be for ISEAL to organise workshops as well as encourage 1-2-1 engagement with respondents in need of help, thus supporting data sharing. In practice, data could also be ‘requested’ as part of a SWOT style analysis that could help ISEAL members to prioritise actions and next steps.

8.2.2. **Lessons sharing and risk evaluation**

Furthermore, Rabobank’s Client Photo offers a useful way to categorise clients that can be expanded to the standards sector. For example, standards could identify their top 10% as front runners and explore lessons sharing with other members. Standards could also learn from the insurance sector, for example on managing risk as a percentage of crop/business affected. For instance, a palm oil scheme could measure fire risk as a percentage of land affected in previous fires and use that data to prioritise engagement. Additionally, standards could also review members on the basis of the resources they are putting towards sustainability, or how proactive they are. For example, a producer who is attending courses/learning could be considered less of a risk than a producer who does not comply with submitting annual verification data, or submits the bare minimum (e.g. RSPO audits could show these differences).

8.2.3. **Monetary evaluation of sustainability risks**

In particular, assigning monetary values to environmental and social risks for comparisons is challenging but extremely valued. For example, it is important to not only understand what part of a value chain can be subject to deforestation risks, but also how much revenue is linked to it. In theory, a standard could use a similar approach to an insurance company that applies a premium to account for potential losses as, for example, it could identify those most at risk and, rather than attributing a financial loss, use this information to advise mitigation practices to reduce the risk of the loss occurring.

8.2.4. ‘Localised’ approach and ‘hot spot’ risk areas

In a similar way to some financial sector players that have ‘localised’ the approach based on the country and/or the client (such as Rabobank, that developed a specific assessment on how rural farmers score on sustainability based on local challenges they face), a scheme could adapt this to a key biome where they will have more targeted knowledge than a bank. Moreover, as there is a widespread desire for a more simplified process, including, for example, a flagging system of ‘hot spot’ risk areas, ISEAL and its membership could help develop the latter alongside the financial sector, making use of their commodity-specific knowledge.
8.2.5. Further alignment with regulations
As regulators are increasingly shifting the attention on quantitative data generation, it is important for standards to have strong, transparent metrics. In practice, sustainability standards could use more metrics and potentially include scenario analysis, as the financial sector is looking ‘more’ forward, in order to understand whether standards can help the business model or not. In a similar way, as discussions on deforestation related due diligence regulations increase, ISEAL members could focus on efforts to develop approaches which can feed into these processes. This would need to include monitoring requirements, potentially following procurement regulation at the national and/or EU level, exploring quantitative data as well as lessons learnt from existing regulations such as the EUTR process.

8.2.6. Transparency and governance
Transparency in processes is very important, so a strong monitoring and evaluation system with indicators on outputs as well as impacts is key. Linked to the above, as public reporting from schemes is varied, ISEAL could further support the implementation of agreed reporting principles and ESMS, going beyond a project-by-project, sector-by-sector, commodity-by-commodity level. In addition, as across the financial sector sustainability functions are less siloed than before and more embedded in key roles (due to a strong shift in governance), similarly, support to the design or restructuring of certification schemes could be beneficial towards stronger transparency, accountability, and effectiveness of their role.

8.3. Recommended next steps
Through our research, we have identified two broad areas of further support that ISEAL may want to consider providing to its members going forward, one around policy and integration, and the second towards capacity building, awareness, partnership creation.

8.3.1. Policy and integration
In order to better understand the current state of play, ISEAL Alliance could undertake a mapping exercise regarding risk assessment methods, data collection and analysis approaches, and processes currently used by ISEAL members. This could potentially be part of a broader mapping exercise looking at risks, opportunities and impacts, linking with ‘Avoid, Benefit, Contribute’ strategies, and including alignment with the SDGs, which could become crucial for sustainability standards.

Regarding certification itself, an assessment of the practices and uses could be undertaken, in particular to better understand the perception of reputational risks and opportunities. This could also highlight best practices to be shared with all members, potentially with a particular focus on data-poor countries and regions (e.g. due to work on the ground), as well as cross-sectoral issues (e.g. comparing sustainability issues faced by different sectors).

In addition, ISEAL could support to the development of ‘integrated’ guidelines, including on governance structures embedding sustainability issues, and where possible and useful of sustainability proxies, as well as commodity and/or sector-specific guidelines, and/or statements of intent, if ISEAL members would be interested.
8.3.2. Capacity building, awareness, partnership creation

Furthermore, ISEAL could organise more webinars and/or workshops, potentially by sector and/or commodity, to present key findings and discuss opportunities for further engagement with the financial sector, including presenting sustainability risks / issues from an ISEAL member’s perspective to financiers, as well as developing partnerships between ISEAL members and financial sector players to support more in-depth sharing of information and data. Creating awareness material on sustainability risk assessments would also be beneficial.
Developing Risk Profiling Methodologies – insights from financial services in the quantification of sustainability risk at different spatial scales

Prepared for ISEAL

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Signed ____________________________

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Efeca Project Number: P128

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Annex 1 – Interview Questions

1. Introduction
   1.1. What sort of financial services provider are you?
       a. Commercial / Wholesale bank
       b. Insurance
       c. Rating agency
       d. Pension fund
       e. Asset / Investment bank
       f. Association
       g. Think tank / Information provider
       h. Other
   1.2. What is your role and how does it fit into the quantification of sustainability risks?

2. Sustainability risk assessment methodology
   2.1. Does your entity assess sustainability risk in investment decisions?
   2.2. If so, what definition of sustainability do you use?
   2.3. What methodology do you use to assess sustainability risk in investment decisions?
   2.4. Has the methodology been externally developed (including Principles of Responsible Investment (PRI)), developed by yourselves, or developed externally and adapted to your needs?
   2.5. What are the main challenges that you have found (e.g. development of methodology, practical use, capacity, knowledge, etc.)?
   2.6. Can you provide an indication of cost for the assessment of sustainability risks (e.g. capital costs for software, data collection, etc.)?

3. Information and data
   3.1. Are your sustainability risks quantified?
   3.2. What data / information is needed to support the methodology? Can you mention at least three different examples of internal and/or external data sources and why you have chosen them amongst all the others?
       a. Are they qualitative or quantitative?
       b. Do they encompass data integration, validation protocols and/or data needs identification?
       c. Do they vary depending on the spatial context of the sustainability risk assessment?
   3.3. Do you have an ‘ad hoc’ software / system for the quantification of sustainability risks?
       a. If yes, does it enable you to map sustainability risks at different spatial scales? And if so how? What is the underlying methodology?
       b. If not, how do you map sustainability risks at different spatial scales? What methodology do you / your company use?
   3.4. Does your system / software aggregate potentially disparate sources of data to create risk profiles for a given commodity, sector or region? If so, what is the methodology behind it?
       a. Commodity examples (e.g. palm oil, soya, beef and leather, timber, pulp and paper, rubber, cocoa, coffee, etc.)
       b. Sector examples (e.g. social issues linked to workers’ rights in specific supply chains)
c. Region examples (e.g. issues at the jurisdictional and/or landscape level and/or country specific sustainability risks)

3.5. (How) do you assess risk in data-poor countries (if you operate in these)? Can you provide a couple of practical examples please?

4. Assessment process and outcomes

4.1. What process do you go through in order to reach a conclusion on the level of sustainability risk of an investment?

4.2. What internal processes?

4.3. Do you make use of external validation?

4.4. Does the sustainability risk assessment process align with your other due diligence processes, and if so, how?

4.5. What kinds of operational decision-making tools, checks and balances and good practices do you use in order to verify that model outputs meet business needs? Could you summarise them in a sort of check list (e.g. 10 fundamental rules)?

4.6. Are they publicly available?
   a. If yes, please name them.
   b. If not, are their sources (from which they draw data from) published online? If so, where?

4.7. If the assessment is not conclusive, what risk mitigation measures do you use, if any? Or is it a binary decision of invest / not invest?

4.8. Is knowledge and learning incorporated in the risk assessment process, and if so, how?

4.9. Do you think there are best practices / strategies commonly employed by financial services to quantify sustainability risk across multiple levels and spatial scales, and could they be applied by a sustainability standard itself?
   a. If yes, how? What enabling conditions would be needed?
   b. If not, why? What barriers / challenges would prevent this from happening?
Annex 2 – Additional definitions and information

This annex is intended to provide additional information to support the discussion within the main report. This includes definitions of financial terms, case studies and further information on examples given above.

ESG Integration

Amongst others, the Investment Association adopts the definition of “ESG integration” according to the UN-supported PRI, namely “The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”. In fact, ESG Integration alone does not prohibit any investments. Such strategies could be used to invest in any business, sector or geography as long as the ESG risks of such investments are identified and taken into account.84

At the firm level, ESG integration can be adopted as a firm-wide policy and, in such instances, reflects a firm’s commitment to integrate ESG considerations, which will include both risk and opportunities; whereas, at the fund level, the precise ways in which ESG considerations will be taken into account in investment analysis and in the investment decision-making process will differ in practice between different investment funds, mandates and strategies.85

The ESG Integration Model (PRI)

PRI provides an indication of four stages and related activities to the ESG integration model:

- **Stage 1: Qualitative analysis** – Investors will gather relevant information from multiple sources (including but not limited to company reports and third-party investment research) and identify material factors affecting the company.
- **Stage 2: Quantitative analysis** – Investors will assess the impact of material financial factors on securities in their portfolio(s) and investment universe and adjust their financial forecasts and/or valuation models appropriately.
- **Stage 3: Investment decision** – The analysis performed in stage 1 and stage 2 will lead to a decision to buy (or increase weighting), hold (or maintain weighting) or sell (or decrease weighting).
- **Stage 4: Active ownership assessment** – The identification of material financial factors, the investment analysis and an investment decision can initiate or support company engagements and/or inform voting. The additional information gathered and the outcome from engagement and voting activities will feed back into future investment analysis, and hence have an impact of subsequent investment decisions.86

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Box 10: ‘ESG momentum’

ESG momentum is a phrase coined by MSCI (formerly Morgan Stanley Capital International) to describe the improvement of corporate management of ESG risks, measured by changes in ESG scores. Therefore, MSCI defines ESG momentum as ‘the financial value of changes in companies’ ESG profiles’. This directly links ESG ratings with financial returns, while, from a data perspective, this means measuring the ‘year-on-year changes of MSCI industry-adjusted ESG scores’. In fact, in addition to looking at existing ESG ratings, investors seeking positive returns within an ESG framework can consider changes in ESG ratings (ESG momentum), but this is only starting to be implemented into a traditional investment approach.

In practice, companies investing to improve ESG ratings (for example investing in more energy efficient buildings) will lead to improved financials (lower energy costs going forward). Taken altogether, ESG improvement is an exciting new factor that can be integrated into the portfolio construction process to better understand the universe of investments. In fact, ESG momentum not only shows outperformance, but improvement in the companies’ underlying financials. However, the lack of a universal definition of ESG and significant differences in evaluation, lead to significant differences in portfolio construction. Therefore, further research is needed to study the effect that changing ESG methodologies have on ESG momentum as any changes in methodology by a data provider could cause false momentum signals. In order to avoid this, managers should consider using multiple data providers and blending the momentum score. This will help to reduce variation due to changing methodology and give a more complete picture of ESG momentum. Nevertheless, this also has the counteracting effects of reducing alignment and increasing competitiveness as every financial institution (if not every manager) will have a specific and often ‘ad hoc’ process to follow which will guarantee competitive advantages.

Please note that ESG momentum can also highlight the current enthusiasm for investments with strong environmental, social and governance credentials, creating “momentum” for ESG assets, meaning that certain investments are now more highly valued because of this current sentiment. However, this may also mean that non-ESG assets might be so cheap that they could actually outperform in the short-term. Regulation in this space would then have a crucial role to play.

Source: Environmental Finance, ‘ESG momentum is better indicator of return than absolute scores, says investor’.

Sustainability Focus

Investment approaches that select and include investments on the basis of their fulfilling certain sustainability criteria and/or delivering on specific and measurable sustainability outcome(s) present this remit. Therefore, sustainable investments are chosen on the basis of both their economic activities (what they produce / what services they deliver) and on their business conduct (how they deliver their products and services). 87

Examples include:
- Sustainability Themed Investing: An investment approach that specifies investments on the basis of a sustainability theme / themes. Examples might include climate change mitigation, pollution prevention, sustainability solutions and approaches that relate to one or more of the UN Sustainable Development Goals (SDGs).

• Best in Class: An investment approach that includes investments based on certain sustainability criteria to focus exposure on sector-leading companies. Best in Class approaches can vary from selecting from amongst the best performing companies (e.g. the lowest carbon / most energy efficient energy producers) to excluding the worst performing companies relative to peers.
• Positive Tilt: A portfolio that over-weights investments that fulfil certain sustainability criteria and/or deliver on a specific and measurable sustainability outcome(s), relative to a benchmark (e.g. FTSE 100, S&P 500), for example, half the carbon intensity of the benchmark.  

Box 11: Standard Chartered’s agro-industries sector approach

Standard Chartered recognises that the agro-industries sector faces potential environmental and social challenges, some of which may include: biodiversity degradation through clearance of forests and other habitats; water pollution from sediment run-off from forest cover removal; poor labour and working conditions; and conflict associated with land use and customary rights of local and indigenous communities.

The challenges of population growth and the demand for rising living standards is leading to greater risks of food security and resource scarcity. As a result, there is increasing pressure to intensify production on existing agricultural land and to expand into previously untouched natural areas, which can lead to deforestation.

Standard Chartered has published several Position Statements outlining how they will seek to limit the negative impacts in the agro-industries sector. They are guided by their Position Statements which outline the minimum criteria they require from their clients to achieve the goal of zero net deforestation in soft commodity supply chains by 2020.

For instance, they will not provide financial services to agribusiness clients who:
• Develop new plantations or livestock ranches which convert or degrade:
  • High Conservation Value forests (“HCV”);
  • High Carbon Stock forests (“HCS”);
  • Peatlands; or
  • Designated legally protected areas.
• Use fire in their plantation operations, including in the clearance and preparation of land for planting.

Palm Oil additional criteria – they will only provide financial services to clients who:
• Have Roundtable on Sustainable Palm Oil (“RSPO”) membership at the parent or subsidiary level, and achieve 100% RSPO certification of owned or managed units of production, within 5 years – applicable to Producers;
• Publicly commit to No Deforestation, No Peat and No Exploitation (“NDPE”), verified by credible assessors when developing new plantations – applicable to Producers; and
• Have RSPO membership at the parent or subsidiary level and have a time-bound plan to achieve RSPO Supply Chain Certification of owned facilities, and/or obtain a Traders License – applicable to Refiners and Traders with direct linkages to units of production (plantations).

Soy additional criteria – they will not provide financial services directly towards:

- Operations that grow, process or trade soy from the Brazilian Amazon or Brazilian Cerrado.

And they expect clients to:

- Implement a Sustainable Sourcing Policy, and/or operate a Chain of Custody system under a recognised industry certification scheme – applicable to processors, traders and wholesalers.

Forestry additional criteria – they will only provide financial services to clients who:

- Have Forest Stewardship Council ("FSC") or Programme for the Endorsement of Forest Certification ("PEFC") certification for their production sites; or have an agreed time-bound plan to achieve certification – applicable to Producers.

Fisheries additional criteria – they will not provide financial services to clients who:

- Practice shark finning or trade shark fin.
- Use drift net fishing, deep sea bottom trawling or fishing with the use of explosives or cyanide.
- Conduct Illegal Unreported and Unregulated (IUU) fishing, or use vessels known to have conducted IUU fishing.

And they will only provide financial services to clients who:

- Hold Marine Stewardship Council (MSC) certification, or equivalent national or international certifications, or have in place a time-bound plan to achieve certification – applicable to Wild Capture Fisheries clients.
- Implement policies and develop products aligned to the Food and Agriculture Organization of the United Nations (FAO) Code of Conduct for Responsible Fisheries – applicable to Wild Capture Fisheries clients.
- Hold Aquaculture Stewardship Council (ASC) or Best Aquaculture Practice (BAP) certification, or can demonstrate alignment to these requirements – applicable to Aquaculture clients.

They also expect clients to:

- Adhere to FAO guidelines for the marking of fishing gear, or guidelines for the application of a system on the marking of fishing gear.
- Adhere to the code of best practice to reduce lost and abandoned fishing gear at sea.
- Implement a Sustainable Sourcing Policy to source from companies operating under a recognised catch certification scheme, or are aligned to the FAO’s Code of Conduct for Responsible Fisheries – applicable to processors and traders.

Of the total transactions reviewed by Standard Chartered in 2018, 0.4% were Forestry related, 1.6% were Palm Oil related and 7.4% were Agribusiness related\(^90\).

Source: Standard Chartered\(^{91,92}\).

**Sustainability Risk**

According to the World Business Council for Sustainable Development's (WBCSD) definition, a sustainability risk is an uncertain social or environmental event or condition that, if it occurs, can cause a significant negative impact on the company. It includes the opportunities that may be available to an organization because of changing social or environmental factors.\(^93\)


Box 12: Financial Institution Guidance: soft commodity company strategy

In collaboration with Global Canopy, CDP produced a guidance to support financial institution engagement on deforestation risk. It stems from the acknowledgement that over the last decade, two-thirds of tropical deforestation has been caused by the production of a handful of globally traded soft commodities, not only contributing to climate change but also leading to negative impacts on biodiversity and local peoples’ rights and livelihoods. In turn, these environmental and social impacts create reputational, regulatory, market and operational risk for companies exposed to these commodities.

To ensure robust and resilient business strategies, the report sets out expectations and guiding questions for financial institutions to raise in their discussions with the board and management teams of companies in soft commodity supply chains. These expectations are intended as parameters under which to ‘stress test’ business strategies to prepare for future business conditions.

The guidance includes questions on transparency and disclosure; board oversight and management of risk and opportunity; company policies and strength of mitigation strategy; and strategy implementation.

Source: Global Canopy and CDP (2017).94

Understanding and Quantifying Sustainability Risk

According to the World Business Council for Sustainable Development's (WBCSD), scientific tools and techniques necessary for the quantification of risk (such as those mentioned in the main report – e.g. Monte Carlo) often require a certain ‘art’ (as defined in Figure 9 below), meaning that a combination of intuition and experience is crucial for a deep understanding of risk (sustainability risk in particular).

*Figure 9: ‘Art’ and ‘Science’ for the quantification, understanding and analysis of risk*[^1]

An Example of Sustainability Framework

Figure 10: Structure of RobecoSAM Country Sustainability Framework\(^{96}\).

![Structure of RobecoSAM Country Sustainability Framework](image)

Impact Investing

Amongst others, the Investment Association endorses the Global Impact Investing Network’s (GIIN) definition of Impact Investments, namely “Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.”\(^{97}\)


Examples include:

- Social bond fund: A fund that invests in bonds, whose funding is ring-fenced for projects or initiatives that have the intention to generate positive, measurable social and environmental impact alongside a financial return, for example, one or more of the Sustainable Development Goals (an “SDG fund”).

- Private impact investing: Investing directly in unlisted projects, companies or initiatives that have the intention to generate positive, measurable social and environmental impact alongside a financial return, for example, one or more of the Sustainable Development Goals (an “SDG fund”).

- SDG Impact Funds: Funds where impact is measured against the UN Sustainable Development Goals (SDGs). This can be achieved, for example, through listed equities, a social bond fund or private impact investing.98

According to GIIN, there are four key elements:

- Intentionality: Impact investments intentionally contribute to social and environmental solutions. This differentiates them from other strategies such as ESG investing, Responsible Investing, and screening strategies.

- Financial Returns: Impact investments seek a financial return on capital that can range from below market rate to risk-adjusted market rate. This distinguishes them from philanthropy.

- Range of Asset Classes: Impact investments can be made across asset classes.

- Impact Measurement: A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance of underlying investments.99

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Box 13: Agri3Fund financial flows and guarantees
The Agri3Fund was introduced and illustrated in Box 1 in Section 4.3, but please also see its financial flows and guarantees as depicted in the diagram below.

Financial flows and guarantees:
1. Donors & Investors contribute with grants in a Technical Assistance facility and junior capital in the Finance Fund.
2. Commercial and Development Banks contribute to the senior debt of the Finance Fund.
3. Technical Assistance is provided to the ultimate beneficiaries (directly or indirectly).
4. Soft Loans are provided.
5. De-risking guarantees and loans are provided to Banks and execution partners.
6. Commercial debt is provided to either execution partners or ultimate beneficiaries.\(^\text{100}\)

Source: Agri3Fund brochure.

Impact Investing and the SDGs
The second major driver for impact investing has been the publishing of the SDGs. In 2015, the United Nations approved the 17 SDGs and 169 individual targets. The SDGs were not primarily made for investors, but achievement of the Goals recognises the necessary contribution of all, including the private sector and investors. It is less clear what these contributions look like for such a broad range of targets.

SDG-related investment is still in its infancy. The analysis currently focuses on mapping investors corporate holdings to a selection of the SDG. Several investors such as the Dutch APG and PGGM, or the Swedish AP2 are trying to work out investment possibilities associated with SDGs. One of the commonly stated obstacles is the challenge surrounding impact measurement. Some organizations are working on investor-relevant SDG impact indicators and metrics, while

\(^{100}\) Agri3Fund brochure.
The Investment Integration Project (TIIP) is a further initiative looking to help investors map the link between the investments in their portfolio and the SDGs.\(^{101}\)

**Screening towards SDGs Investing**

In screening strategies, investors choose a set of criteria against which they want to measure performance, compliance or impacts (e.g. a particular development goal or target associated with it). This may focus on policies, systems or specific quantitative results. Portfolios are then screened either on an absolute basis (eliminating companies that have a specific feature, such as alcohol products) or on a relative basis (creating a ranking and eliminating those with the lowest rankings).

Institutions that screen investments in this manner can also focus on whether investee companies are contributing to the SDGs (thus seen as targets), which may or may not feature a short-term, material link to financial performance.

Using PRI’s framework for SDG’s integration, there are three main types of screening:

1. **Negative/exclusionary screening**: The exclusion from a fund or portfolio of certain sectors, companies or practices that are perceived as being in conflict or in contradiction with the spirit of a specific SDG ambition.
2. **Positive/best-in-class screening**: Investment in sectors, companies or projects selected for positive SDGs contributions relative to industry peers.
3. **Norms-based screening**: Screening of investments against minimum standards of business practice based on international norms. Norms-based screening involves either:
   a. defining the investment universe based on investees’ performance on international norms related to responsible investment / SDG contributions, or
   b. excluding investees from portfolios after investment if they are found to contravene these norms. Such norms include, but are not limited to, issuance of a sustainability report based on the GRI Standards, the Ten Principles of the UN Global Compact, the UN Guiding Principles for Business and Human Rights, the Universal Declaration of Human Rights, International Labor Organization standards, the UN Convention Against Corruption, the OECD Guidelines for Multinational Enterprises, and the 2015 Paris Agreement. Some investors will seek to encourage companies to outright adopt adherence to norms prior to the screening process.\(^{102}\)

**The SPICE model used by Sycomore Asset Management**

At Sycomore Asset Management have integrated opportunities and risks into a model called the SPICE model. In fact, as a proxy for gauging the sustainability of a company’s business model, they look at whether it creates value for its stakeholders (meaning suppliers / society / states), people, investors, clients and the environment (SPICE). The SPICE model structures their financial and ESG research work and is fully integrated into their proprietary research and valuation tool.


Figure 11: Sycomore Asset Management SPICE model¹⁰³.

Two Additional Examples of ESG Integration Processes

Figure 12: bcIMC – *ESG integration throughout the investment process, combining analysis from dedicated ESG and fundamental teams*¹⁰⁴.

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Figure 13: VietNam Holding Ltd – Integrating ESG factors into investment process, engagements affecting portfolio construction.

Box 14: Basel III – the Liquidity Coverage Ratio and implications for ISEAL members

‘The objective of the LCR is to promote the short-term resilience of the liquidity risk profile of banks. It does this by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30 calendar day liquidity stress scenario. The LCR will improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy’.

This requirement has strong implications on producers – the stocks that will be favoured more are the ones that can be sold the quickest.

Source: https://www.bis.org/publ/bcbs238.pdf

Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

TCFD’s Principles for Effective Disclosures:
1. Disclosures should represent relevant information.
2. Disclosures should be specific and complete.
3. Disclosures should be clear, balanced, and understandable.
4. Disclosures should be consistent over time.
5. Disclosures should be comparable among companies within a sector, industry, or portfolio.
6. Disclosures should be reliable, verifiable, and objective.
7. Disclosures should be provided on a timely basis.

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**Box 15: CDP's Forests Questionnaire**

CDP’s work on forests involves acting on behalf of over 515 investor signatories with assets of US $106 trillion as well large purchasing companies, who wish to understand how companies are addressing their exposure to forests-related risks.

CDP’s Forests Questionnaire seeks to:

- Provide a logical structure that guides companies through the journey of removing commodity-driven deforestation from their value chain and improve their understanding of deforestation-related risks.
- Facilitate greater and more robust disclosure while reducing reporting burden, where possible.
- Produce responses that lend themselves to effective engagement between external stakeholders and companies, allow companies to demonstrate progress and good practice, and allow stakeholders to identify and engage with companies that do not take action.
- Gather data on deforestation and forest conservation, as well as on conversion and conservation of other natural ecosystems that provide important ecosystem services, e.g. natural grasslands, savannas and wetlands.

The questionnaire modules cover the following:

**F0 Introduction** – This module requests information about an organization’s disclosure to CDP and helps data users to interpret responses in the context of business operations, timeframe and reporting boundary.

**F1 Current state** – provides a snapshot of how forests-related issues are associated with the business and how aware a company is of these issues throughout its value chain, including: a business’s links to
and dependency on forest risk commodities; a business’s use of land resources to produce forest risk commodities; and whether a business has been impacted by any forests-related issues so far.

**F2 Procedures** - requests information about the procedures that organizations have in place to manage issues salient to their sector and to understand inherent risk exposure.

**F3 Risks and opportunities** - allows organizations to show that they have a clear awareness of the extent to which they are exposed to inherent forests-related risks in their direct operations and other parts of their value chain. Companies can also report on any forests-related operational or market opportunities being realized that could substantively benefit their business.

**F4 Governance** - captures the governance structure of the company and its governance mechanisms with regards to forests-related issues including policies, commitments, and board-level oversight of forests-related issues. This module also presents a question on the use of performance incentives for senior employees linked to forests-related issues.

**F5 Business strategy** - companies can explain if and how they have considered and acted upon forests-related issues at a high level. Investors and other data users are interested in forward-looking strategic innovations and financial decisions that have been driven by market opportunities, public policy objectives, and corporate responsibility commitments related to forests issues.

**F6 Implementation** - This module is critical as it requests information on how organizations plan to implement, or are already implementing, their policies and commitments associated with forests-related issues. Questions in this module ask details on specific targets for improving sustainability, traceability systems in place, certification schemes adopted, mechanisms to ensure legal compliance and compliance with commitments, engagement within and beyond the company’s supply chain.

**F7 Verification** - This question gathers data on whether the company currently verifies the data and/or other information disclosed in this response. This provides assurance to the credibility / quality of the information provided and meets the expectations of data users. CDP supports third-party verification and assurance as good practice in environmental reporting since it ensures the accuracy of the data and processes disclosed.

CDP Forests Questionnaire is aligned with the Accountability Framework as the Accountability Framework initiative (AFI) and CDP Forests have collaborated to align the CDP Forests 2020 questionnaire and guidance with the Accountability Framework Core Principles and Definitions that are germane to the scope of CDP Forests. Due to this alignment, companies that report through CDP Forests will be reporting consistently with the Accountability Framework for those themes covered by CDP Forests.

*Source: CDP (2019-2020).*

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108 Please see [https://www.cdp.net/en/research/global-reports/the-money-trees](https://www.cdp.net/en/research/global-reports/the-money-trees) for more information.

109 (pers. comms)