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Biodiversity, the next challenge for financial institutions?

A scoping study to assess exposure of financial institutions to biodiversity business risks and identifying options for business opportunities

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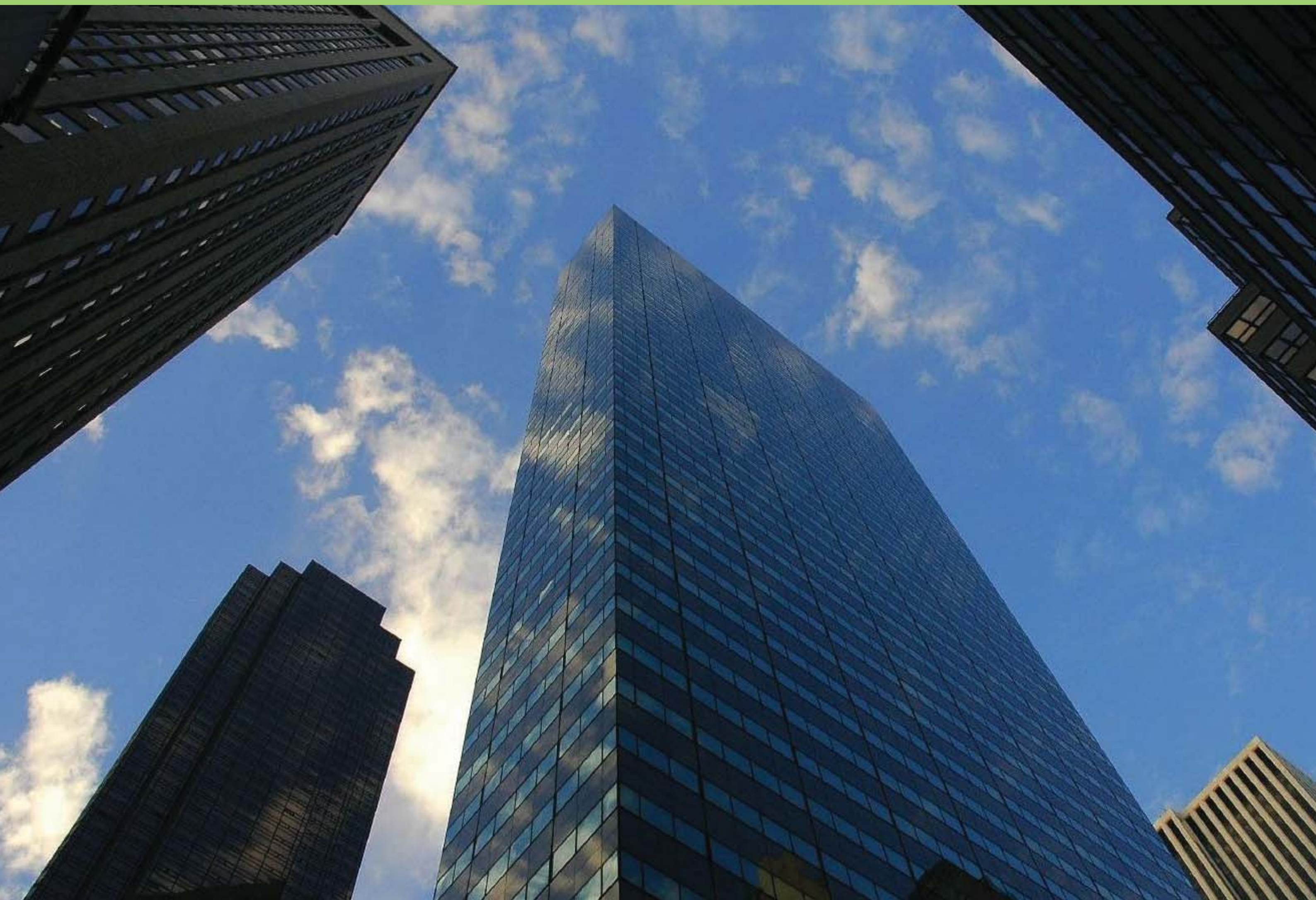
Executive summary



Business and Biodiversity Programme

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Executive summary

Climate change is now recognized as an important business challenge for a wide range of private sectors. The business case for financial institutions (FIs) to focus on greenhouse gas emissions (GHG) is also getting stronger. FIs that do not understand the business rationale may be at risk when they have invested in, or provided loans, advisory services or insurance products to companies with significant carbon footprints. On the other hand, FIs that understand the issue can capture business opportunities, for example by increasing investments in clean energy technologies or by brokering deals through the European Emissions Trading (ETS) scheme or the voluntary Chicago Climate Exchange (CCX). As an example, Bank of America (BoA) announced on 6 March 2007 a US$20 billion initiative to support the growth of environmentally sustainable business activity to address global climate change. And in January 2007 Goldman Sachs announced they have made investments in of US$1.5 billion in alternative energy/clean technology.

Biodiversity bears characteristics that can lead to it becoming the next challenge for financial institutions (FIs). Global biological resources have decreased by about 30% since 1970. This has set in motion a number of powerful drivers such as pressure and activism by NGOs, increased regulations such as laws, strengthened liability regimes, scrutiny of a company's supply chain practices and shifting consumer preferences that are leading to a growing relevance of biodiversity to businesses. Certain sectors are more exposed to biodiversity business risks (BBRs) than others. These include:

1. **Companies having (high) *impacts* on ecosystems.** These can be subdivided into companies with *direct footprints* on ecosystems, such as the oil & gas, mining, and construction, as well as sectors that have *significant impacts through their supply chains,* such as the food retail sector.
2. **Companies *depending* on ecosystem services.** These include for example the tourism, fisheries, forestry and the agricultural sector.

FIs, such as retail and commercial banks, asset managers, private and institutional investors, and insurers that provide financial services to these types of companies can be exposed to BBRs, both *directly* and *indirectly*. FIs can be directly exposed to for example reputational risks, liability risk or regulatory scrutiny. As an example, the environment ministers of the G8 countries and the five major newly industrialising countries launched the "Potsdam Initiative – Biological Diversity 2010" on 17 March 2007. The ministers specifically state that they will "*approach the financial sector to effectively integrate biodiversity into its decision making*".

Indirectly, FIs can be exposed to BBRs for loans and investment portfolios in the above mentioned types of companies. As biodiversity will likely increase in relevance for these types of companies in the coming years, some of them may increasingly come under biodiversity-related scrutiny. Goldman Sachs outlined for example that oil & gas companies will increasingly explore offshore oil and gas fields, which are more complex for exploration and production, very likely leading to increased BBRs. FIs that are not positioned to identify which companies are most at risk can be exposed to increased risk for default (credit activities), lower investment returns (investment portfolios) or an increase in insurance claims (insurance activities).

This scoping study assessed: 1) what *types* of BBRs financial institutions can be exposed to; 2) what *evidence* there is of the biodiversity business case from a financial sector's perspective; 3) what opportunities are available for FIs to address and mitigate BBRs; and 4) what biodiversity business opportunities (BBOs) can be captured by FIs. The key findings are provided below.

Biodiversity business case from a risk perspective

An interview survey among financial institutions, other private sectors and NGOs revealed that nineteen out of 26 respondents[a] (> 70%) believed FIs are exposed to reputational risk. In addition, respondents from the financial sector indicated liability risk, social license to operate, credit risk and reduced shareholder value additional types of risk, although they were seen as less important (at present).

Although it is difficult at present to link BBRs to tangible financial metrics, such as market capitalization, asset value or credit risk, the report provides a wide range of case studies expressing evidence of the business case. This includes for example the case of Associated British Ports, which saw GBP155 million wiped off its market value (about 10% of its share price) after the UK government blocked the company's plans for a new container terminal at a site in the south of England in April 2004. The government admitted that one major factor in its decision was the potential environmental impact. Although the share price of the company has recovered since, it provides a clear case to investors that extra-financial issues (*e.g.*, biodiversity) make business senses. Another case concerns upcoming liability regulation in the EU. The new EU directive (2004/35/EC) aims at preventing environmental damage to water resources, soil, fauna, flora and natural habitats and at making the polluters pay whenever damage cannot be avoided. This is something the insurance sector will need to respond to in the coming months.

Biodiversity in the business operations of financial institutions at present

Banking sector. Studies by Oxera and F&C Asset Management revealed that on a sector-wide level, biodiversity is hardly recognized at present. However, an assessment of 11 commercial and investment banks that were chosen for their global reach and/or involvement in the development and adoption of the Equator Principles, revealed that a considerable number of these banks have already started to go beyond the Equator Principles for project finance to develop sector-specific guidelines. The banks apply these new guidelines to an increasing number of credit products and some investment products. Although these sector-guidelines often do not make reference of biodiversity directly, phrases are used such as *tropical moist forest, critical natural habitat or depletion of natural resources,* which capture the value of biodiversity to a certain extent.

- Rabobank appears to be the leader on biodiversity, as they are applying a CSR tool as of the 1st of February 2007 to all their lending activities. Three of the ten guiding principles of their CSR tool refer to biodiversity to some extent: 1) environmental pollution; 2) depletion of natural resources; 3) cruelty against animals. They have also developed five types of sector-guidelines and three more are in the pipeline. The bank's client relation managers and risk analysts, who will be the day-to-day users, are *obliged* to use this tool.
- HSBC and ABN AMRO have also developed multiple sector-specific policies (*e.g.*, for their forestry clients).
- Goldman Sachs, an investment bank, recently adopted the Biodiversity Benchmark (developed by Fauna & Flora International and Insight Investment), which they use in their investment decision-making.

[a] Though HSBC did not take part in the interview survey, the company clearly states in their Environmental Risk standard (published in June 2003) what types of biodiversity/environmental risk it can be exposed to.

With respect to identifying which types of credit products are most exposed to BBRs, there are a number of characteristics such as 1) timeline of the loan; 2) non-recourse; and 3) loans to companies with high impacts on ecosystems and/or ecosystem dependent sectors, which can all contribute to a greater exposure of credit products to BBRs. This can be the case for project finance or other types of structure finance products, as well as for long term corporate loans. The ability of commercial banks to respond to BBRs would be by means of thorough due diligence work and environmental impact assessment (EIA) that include biodiversity components. Also, constructive dialogues with clients, *engagement*, are an important means to reduce exposure to BBRs, for example by pointing them to sector-specific best management practices (BMPs).

Asset management. Many fundamental or conventional investors have long considered environmental issues to be a topic simply for the Socially Responsible Investment (SRI) market. This, because SRI markets are associated with investors who are putting environmental and social issues at the forefront of investment decision making (in stead of financial ones) and they are therefore presumed to be satisfied with lower investment returns (ROI). Though prior investment results in the SRI area have been mixed, there is some evidence that incorporating environmental issues can lead to superior portfolio performances compared to similar fundamental funds. Just as for other environmental issues, asset managers can also be exposed to BBRs when companies, in which they hold shares or ownership, deliver poor financial results (partly) caused by biodiversity-related scrutiny.

With respect to identify which types of investment funds are most exposed to BBRs, there are a number of characteristics such as 1) timeline of the fund; 2) investments in companies with high impacts on ecosystems and/or ecosystem service dependent companies; 3) climate change leading to less stable natural environments, which can all contribute to a greater exposure of investment portfolios to BBRs. Asset managers have the ability to respond to these risks by means of 1) positive and negative screening during fund initiation; and 2) voting power during shareholder meetings.

(Re)insurance. Traditional types of environmental liability claims included 1) property or liability loss on the basis of sudden or accidental pollution; 2) product liability loss; or 3) property loss during an operational breakdown. However, the (re)insurance sector is facing new types of environmental liability, specifically related to an increase in extreme weather events caused by climate change. Economic losses from crop failure and forest fires alone, for example, accounted for US$ 14 billion. During 2002, major floods across Europe caused total damage of almost US$ 16 billion and insured losses of just over US$ 3 billion. Hurricane Katrina caused prices to rise up to 300 – 400% for oil companies in the Gulf of Mexico seeking insurance and insurers seeking reinsurance to protect against offshore losses.

The most noteworthy development for biodiversity for the insurance sector is new legislation in the EU as of 30 April 2007 to hold operators liable for damage to water resources, soil, fauna, flora and natural habitats and at making the polluters pay whenever damage cannot be avoided. Although biodiversity has characteristics that make it difficult to meet conditions for insurability, insurance and reinsurance firms need to respond to this.

Integrating biodiversity in business operations of financial institutions

For those FIs that understand the materiality of the issue and that want to identify how to integrate biodiversity into their risk management procedures (RMP), thereby mitigating any adverse BBRs, the report outlined a general procedure. The procedure provides an overview of existing tools to:

1) **Identify biodiversity important areas.** A number of NGOs have developed (spatial) tools that identify important biodiversity areas, although most areas are quite broad. Work is underway at present to develop a biodiversity tool for the private sector that identifies much more in detail where biodiversity hotspots are situated.
2) **Identify what tools that have been developed for the private sector that factor-in biodiversity.** These can be used by FIs, both in their own RMP or as indicators for their clients to assess their ability to address biodiversity.
3) **Identify sector-specific industry guidelines and international conventions.** Several FIs indicated during the interview survey that they would greatly benefit by knowing what the best-management practices are sector-by-sector. By knowing this, they can inform their clients, as part of their conditions in issuing contracts or use it in developing sector guidelines.

A number of criteria were identified as well by FIs that would contribute to successfully integrating any biodiversity-related tools in their RMP. These include:
1) It should be easy to use by people working with it on a day-by-day basis, such as client relation managers, risk analysts and fund managers.
2) It needs to be implemented in existing business structures in order not to overburden the credit lending or investment process.
3) It needs to be sector-specific and identify sustainable industry standards (*e.g.*, multilateral conventions, industry guidelines, benchmarks).
4) Ideally any type of tool should be adopted by a wide range of FI thereby creating a level-playing field.

Biodiversity business opportunities

Although BBRs are likely to be more significant in terms of market value, there are a number of biodiversity business opportunities (BBO) that FIs can capture, especially those that have already started to recognize the materiality of it. These include, but are not limited to:
1) **Growing markets for certified sustainable produced commodities**, such as for wild fish, aquaculture or agricultural products. Estimates suggest a potential market size of about US$60 billion annually by 2010. There are also market opportunities for biodiversity offsets, biocarbon, NTFPs, PES and biofuels among others. Estimates for potential market sizes range widely from US$ 35 million – 10 billion annually by 2010.
2) **Due diligence or advisory services** to clients that need assistance in biodiversity sensitive projects and transactions.
3) **Biodiversity-related insurance cover.** For example, around 65% of the insurance premium of the shipping companies using the Panama Canal is environment-related, such as covering for too little water or delays because of regular dredging. Reforestation along the slopes of the canal will drastically cut insurers' exposure to BBRs.
4) **Government-induced opportunities**. The Dutch government for example triggered demand by private investors to invest in green funds. Total capital invested in 2005 amounted to € 1.5 billion, of which € 282 million has been allocated to the project category "nature, forests and landscapes".
5) **Conservation land as a result of default or debt work-out**. Should a bank acquire a significant amount of biodiversity-sensitive land as a result of default or debt work-out situations, collaborations with NGOs, local conservation organizations, or the government might be helpful in finding suitable (conservation) purposes for the land. While the bank remains owner of the land, it could use the situation to bolster its reputation or for other marketing purposes.

Moving Ahead.....

Despite the fact that there is undoubtedly greater interest in biodiversity issues in the financial sector, there is clearly a huge effort needed to continue to build the biodiversity business case and increase the awareness of biodiversity as a significant business factor within the financial sector. The following recommendations can contribute to this:

Continue to build the biodiversity business case for FIs

1) A Stern-like review[b] of the economic costs of biodiversity loss and benefits of biodiversity conservation can lift the issue up the international political and business agenda. The need for such a study was also highlighted during the G8 meeting of environment ministers in Potsdam, March 2007. There is a big role to play here for government agencies, research institutes, as well as for the NGO community.
2) Greater focus on quantifying the business case from a risk perspective. Though this project provided a wide-range of case studies expressing evidence of the business case, it is important to link biodiversity business risks (BBRs) as much as possible to tangible financial metrics, such as default risk, shareholder value or market capitalization, in a systematic way.
3) With respect to biodiversity business opportunities (BBOs), a stronger effort should be undertaken from the NGO community (in collaboration with FIs that are recognizing potential business opportunities) towards identifying BBOs, as well as start pilot projects to assess their financial viability.

Diversify communication & raise awareness of the materiality of biodiversity to FIs

4) Diversify the communication channels about the business case for biodiversity to FIs. Governments, multilateral institutions and NGOs as well as those FIs that have already started to address biodiversity are examples of stakeholders that can participate in such a process.
5) Building capacity within FIs to mitigate BBRs and identify BBOs. As this issue is rather new for the sector there is a need for FIs to build capacity to deal with this emerging issue. This can for example be achieved through training of staff, engaging in partnerships with NGOs and multilateral organizations or by hiring consultancies that possess the technical capacity. UNEP FI has already initiated a working stream on the issue.

Develop tools that day-to-day users can use

6) Biodiversity should be integrated in such a way that it becomes *practical* by people using such tools on a day-by-day basis. This includes, for example, client relation managers, credit analysts, and fund mangers.

Focus on the entire financial sector

7) Focus on other segments of the financial sector. This project focused on commercial banking, asset managers/investors and insurance. In an effort to increase awareness throughout the entire sector, there is a business rationale to include other segments of the financial sector as well.
   - Though this study focused on **(institutional) investors** to a certain extent, there is a clear need to increase the focus on this segment of the financial sector. Due to the long term horizons of their investments, pension funds, insurance firms, and other institutional investors have a clear business rationale to incorporate biodiversity into their risk management procedures and investment decision-making.
   - Similar efforts should be made to engage **credit rating agencies** in this process, by identifying possibilities to incorporate biodiversity into the "credit-worthiness" assessments for projects, companies, and countries.
   - Since biodiversity is often still regarded as a public good, **governments**, which control huge amounts of public bonds and public pensions, even have a special obligation to assess possibilities to integrate biodiversity into their risk management procedures and investment decision-making.

[b] The Stern review outlined that future loss of GDP as a result of climate change is projected to be in the range of 5% to even 20% each year, whereas the costs of action now is estimated to cost about 1% GDP per year.