# "Sustainable Finance for Agricultural Commodities"

## Non paper for the Multi-Stakeholder Meeting
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This paper has been prepared for discussion at the multi-stakeholder meeting for the Amsterdam Declarations Partnership. The target audience are non-financial experts. Because of the added value and potential size of the commercial investment portfolio, this thought paper focuses on commercial investors and blended finance with an important role for multi-lateral financial institutions and development banks. This paper does not provide detail on finance structures and does not draw specific conclusions on financial gaps or next steps.

## Sustainable finance for agricultural commodities

Global population is estimated to exceed 9 billion people by 2050 as global population growth is reaching 80 million people per year. Together with climate risks and the need to preserve ecosystems for resource security and our well-being this puts enormous pressure on the Earth's ecosystem and our food production systems. The global demand for food is expected to increase with 70% by 2050.[i] The increase in production will have to be achieved with less land and water available per person, and considerably more sustainable use of inputs as pesticides and fertilizers. Investments in sustainable agriculture play a crucial role in meeting this challenge. However, investments in activities are usually outweighing total ODA and domestic finance for the conservation and sustainable management of forests (CPF, February 2018[ii]).

"Sustainable finance" generally refers to the process of taking due account of Environmental, Social and Governance (ESG) considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities.[iii] Multinational companies from OECD countries (plus Argentina, Brazil and Chile) are expected to conduct their business responsibly (due diligence).[iv] In addition the UN has its Principles for Responsible Investment.

According to the World Bank[v] the transition toward a sustainable finance system includes:

- *Market based initiatives*: public and private finance institutions work together to integrate environmental and social risk and opportunities into their business and approaches;
- *National Initiatives*: country-led finance initiatives arising from national planning processes to implement climate change and other long-term strategic development processes;
- *International initiatives*: Cooperative efforts by G20, G7, UN and Financial Stability Board as well as actions by multilateral development banks and international finance institutions.

# Global investments

The investment required for the Sustainable Development Goals is estimated at more than $4 trillion annually with a current deficit of $3.1 trillion.[vi] `The GEF estimates $400-600 billion is needed per year to finance conservation of land, forests and water.[vii] The global capital markets are valued at an estimated $218 trillion. The G20 Green Finance Study group stated that only 1% of global bonds are labelled green and less than 1% of holdings by global institutional investors are green infrastructure assets. In 2017, 440 investment funds specialized in food & agriculture investment managed $73 billion in assets[viii]. International development finance initiatives also provide important financial support, such as the BioCarbon Fund for Sustainable Forest Landscapes ($340m), the Forest Investment Program ($780m) and climate finance (Green Climate Fund, REDD+). However, in many (developing) countries public expenditure is still the main source of funding for agriculture compared to Official Development Assistance and commercial finance. Finance options for small farmers in developing countries ("financial inclusion") are very limited.

Important financial stakeholders are commercial banks and institutional investors (pension funds, insurance companies); Development Finance Institutions (such as The World Bank including the Internal Finance Corporation (IFC), European Investment Bank (EIB), national development banks); government finance entities such as regulators; and non-governmental financial institutions mostly set up by NGOs and Foundations to provide finance to farmers and small and medium enterprises. Commercial investors often manage risk by using guarantees from public finance institutions to protect them against defaults on their loans. In general, public institutions currently consider options to strategically leverage private finance often using grants, equity, guarantees and subordinated debt as catalytic 'first-loss' capital ('blended finance'). No considerations are known on how public institutions could further facilitate greener investments.

# Main challenges and example financial initiatives

Many banks, pension funds and insurances companies have signed commitments related to climate change, forests and sustainability. International collective action is needed because of existing interdependencies. Meaningful global action requires global principles and alignment. Information relevant for sustainable finance is critical to ensure alignment and assessment of incentives, results management, proper valuation of assets and effective risk management. Consensus is building around methodologies for disclosure of information such as level of agricultural investment and their carbon footprint. For example, no information could be found in annual reports on how much an individual bank, pension fund or insurance company invests in (sustainable) agriculture. Below, the main challenges are presented that can be discussed at the multi-stakeholder meeting, plus some example initiatives:

**1. Disinvestment in agricultural commodities responsible for deforestation (climate emissions, ecosystem stability), at high climate risks, and associated with social issues (e.g. land rights).**

Some examples that aim to trigger a shift in investments by enhanced understanding:

***Forests & Finance initiative****:* A NGO initiative that assesses the financial services received by over 180 companies involved in palm oil, pulp & paper, rubber and tropical timber supply chain, whose operations impact natural tropical forests in the Asia-Pacific region. By disclosing this information the initiative probably hopes to promote shifts in investments. The website provides information on

deals from 2010 onwards, a risk scorecard on bank policies; and case studies on deforestation and rights abuses. The initiative states that between 2010 and 2015 at least US$38 billion worth of corporate loans and underwriting facilities were provided to the 50 companies studied. The forest operations of the 50 forest-sector companies were supported by an additional US$14 billion worth of bond and shareholdings as of the start of 2016.

**IFC Sustainable Banking Network (SBN)**: SBN includes financial sector regulatory agencies and banking associations from emerging markets committed to advancing sustainable finance in line with international good practice. The Network facilitates the collective learning of members and supports them in policy development and related initiatives to create drivers for sustainable finance in their home countries.

***Natural capital Declaration & Natural Capital Finance Alliance (2012):*** The declaration has been signed by more than 40 financial institutions committing to the eventual integration of natural capital considerations into financial sector reporting, accounting and decision-making by 2020.

***Montreal Carbon Pledge (2014):*** In 2015, only 7% of the world's largest asset owners were able to calculate their carbon footprint, according to a global ranking of pension and sovereign wealth funds[ix]. Signatory investors commit to measure and publicly disclose the carbon footprint of their investment portfolio on an annual basis. Currently, 120 investors with over $10 trillion in assets have signed.

2. **Responsible investment in deforestation-free sustainable and climate smart agricultural production and infrastructure.**

In many countries examples exist of Payment for Environmental Services entailing a large variety of payment schemes by governments, companies and farmers to preserve environmental services. These are not described here.

***Africa Agriculture and Trade Investment Fund (AATIF)*** – $152 million in 2017: Partnership fund between UNEP, ILO, Deutsch Bank, KfW and BMZ. KfW provides 'first-loss' capital as junior shares; Deutsche Bank and KfW invest in mezzanine shares; and private investors in senior shares. The Fund provides direct and indirect funding for SMEs in agriculture (production, processing, services and trade) in Africa.

***Althelia Climate Fund***: The Fund invests in projects that reduce deforestation, mitigate climate change, protect biodiversity and provide a fair and sustainable living to rural communities, whilst offering investors a fair return on capital. Current investments are in Brazil, Guatemala, Kenya, Peru, and Rwanda. Investors include EIB, FinnFund, Dutch FMO, AXA Investment Managers, Credit Suisse Group and the Church of Sweden. In 2014, USAID extended a US$133.8 million loan guarantee to the Althelia Climate Fund. The loan guarantee covers 50% of potential losses for Althelia's projects. The Fund generates revenues through the purchase and distribution of both environmental assets (including carbon and payment for ecosystem services) and environmentally-certified, sustainably-sourced commodities (e.g. beef, cocoa, coffee, timber).

***AndGreen Fund***[x]**:** The Fund aims to motivate the redirection of financial flows towards intensified land use, combining forest conservation (tropical forest and peatlands) with increased food production and economic growth, by investing in commercial agricultural projects. The Fund has currently $125 million in capital committed by Norway ($100m) and Unilever ($25m). The Fund will

provide subordinate credit under flexible terms. The aim is to grow to catalyse >$2 billion in investments, protect and restore 5 million ha of tropical forests and have 500,000 households benefiting from the Fund.

***Banking Environment Initiative (BEI):*** BEI comprises 11 banks[xi] with over $10 trillion of assets. The initiative works on global sustainable agriculture supply chains by innovation in banking products and services; developing industry-level standards; and engagement with policy and regulation.

***BEI and Consumer Goods Forum (CGF) 's Soft Commodities Compact (2015):*** The Compact intends to lead the banking industry in developing market norms that align bank practices with the CGF resolution on deforestation. The compact provides implementation guidance to banks and recommends key performance indicators for banks to consider. Progress is not monitored.

***Finance Alliance for Sustainable Trade (FAST)[xii]:*** FAST is part of the UN Sustainable Commodities Initiative and is an international, member-driven (150), non-profit association representing financial institutions (19), producers and others dedicated to bringing sustainably produced products to market. FAST prepares farmers using education and coaching tools, informs lenders with investment insights and analytics, and provides a platform to connect farmers and lenders.

**G20 Green Finance Study Group:** The Group aims to scale up green financing in support of a strong, sustainable and balanced growth. The G20 also has a Global Partnership on Financial Inclusion: This partnership focuses on smallholder inclusion into the agriculture financial system.

***Rabobank Kickstart Food Initiative***: A $1 billion Fund recently announced by Rabobank and UNEP. The fund aims to finance sustainable land use and help achieve the Paris Climate Agreement and Sustainable Development Goals. It will provide grants, de-risking instruments and credit to clients involved in sustainable agricultural production, processing or agricultural commodity trade who adhere to strict provisions for forest protection, restoration and the involvement of smallholders. The fund will start in Brazil and Indonesia.

**3. Direct part of the global capital market to restore degraded farmland to make commodity expansion on these areas commercially attractive.**

Globally more than 2 billion hectares of degraded and deforested land is available. These lands could either be restored to natural lands providing environmental services or used for agriculture: 1.5 billion ha would best be restored in mosaic pattern of forests, agroforestry, agriculture and settlements[xiii]. The FAO estimates $300 billion per year is needed to reach the SDG target of land degradation neutrality by 2030.[xiv] Following, some restoration efforts are presented. These are all public sector led initiatives. No specific financial sector led initiative could be found nor blended finance structures to direct commodity expansion to degraded lands. In general, corporate social responsibility by individual companies seems a driver to mobilise private funds for restoration[xv].

***AFR100***: A country-led effort to bring 100 million hectares of land in Africa into restoration by 2030. The imitative was launched formally at COP21 UNFCCC in 2015 and will support the Bonn Challenge.

***African Resilient Landscapes Initiative:*** A NEPAD-initiative to promote forest and landscape restoration, conservation, climate smart agriculture and rangeland management. The World Bank and WRI support the mobilisation of financial and technical resources.

***Bonn Challenge:*** A global commitment to restore 150 million hectares of the world's deforested and degraded land by 2020 and 350 million by 2030. The initiative will use the forest landscape

restoration approach. Several producer countries have committed to restore areas including: Argentina (1 million ha), Brazil (12m), Colombia (1m), Côte d'Ivoire (5m) and Ghana (2m).

***CGIAR Restoring Degraded Landscapes***. Programme led by CIAT to support governments and people to restore degraded landscapes.

***Collaborative Partnership on Forests (CPF):*** An informal, voluntary arrangement among 14 international organisations and secretariats with substantial programmes on forests. Increasing Finance for Sustainable Forest Management is one of the initiatives.

***Global Partnership on Forest Landscape Restoration:*** This network initiative includes various governments and organisations to implement the Bonn Challenge. It does not include financial sector partners.

***IADB Risk Mitigation for Land Restoration***: Co-financed by GEF ($15m) and the Inter-American Development Bank ($120m), the initiative deploys innovative risk mitigation instruments to support public and private sector investments to restore degraded lands. Public funds are are used for subordinated loans and to provide guarantees.

***World Resources Institute' Atlas of Forest Landscape Restoration Opportunities:*** An interactive map showing the opportunities of mosaic restoration or full restoration.
See: http://www.wri.org/applications/maps/flr-atlas/#

Another example of how to direct agriculture investments is Brazil's Agro-ecological zoning:

***Box 1: Brazil Agro-ecological zoning: combining spatial planning and conditional credit***

Brazil has an Agro-ecological Zoning law on sugar cane (200)9 and palm oil (2010). The agricultural research institute EMBRAPA assessed regions' suitability including environmental, economic and social aspects for sugarcane production. Guidelines for the mapping and zoning included:

- Exclusion of areas with native vegetation (national parks, indigenous areas and other protected areas. Prohibition of deforestation);
- Exclusion of the Amazon and Pantanal biomes and the Upper Paraguay River basin;
- Identification of areas with agricultural potential without need of full irrigation;
- Identification of areas with slopes below 12% (for mechanised harvesting);
- Respect for food security (under guidance of the Ministry of Agriculture).
- Prioritisation of degraded areas or pasture.

The rules do not apply for plantations already in operation or those that already had an environmental license for expansion. The zoning identified more than enough land for sugarcane expansion while excluding 92.5% of the national territory. The law also includes additional incentives:

(a) Rules and guidelines for the concession of public and private credits to the sector (mostly provided by the Brazilian development bank BNDES), i.e. the farm has to be compatible with the zoning;
(b) If evidence of illegal activity is found the government reserves the right to refuse the granting or renewal of permits to local processing facilities (sugarcane has to be processed within a few hours so cannot be transported far).

The Program for the Sustainable Production of Palm Oil[xvi] prohibits deforestation for palm oil but allows farmers to plant on low-productivity deforested land., includes conditional credit and technical assistance.

## Investment challenges sustainable agriculture

Following is a list – in random order - of investments challenges mentioned in literature:

- *Disclosure*: Lack of transparent data and figures from individual banks and investors, or the sector as a whole, on investment in agriculture and sustainable agriculture. Annual reports of banks and their investments funds are often quite generic and lack detail.
- A *performance framework* to measure progress (effectiveness, efficiency, resilience) focusing on three key dimensions: architecture, markets, and flows & stocks;
- Sustainable finance requires a *strong commitment* from owners and managers to make sustainability considerations a primary component of business strategy, not a niche area associated with other initiatives that -while also important, such as corporate social responsibility and environmental risk management - are not at the core of most FIs' business strategies.
- The *capacity of financial sector stakeholders* is limited (technical expertise and experience) and there is an information asymmetry between investors and recipients. A lack of understanding of a clear business case can further compound capacity issues.
- *Public support*: Governments' responses include efforts to create an enabling environment for a sustainable finance system and direct financing (e.g. risk sharing mechanisms).
- *Land as an asset:* Unclear land rights – often in developing countries - make it impossible to invest because of due diligence (existing land conflicts) and unclear investment contracts.
- *Expected revenue:* Conditions for a minimum revenue percentage on an investment, which might be difficult to attain or proof for commodity investments in certain regions.
- *Risk perception*: Investors perceive the risks as too high. Banks and institutional investors are often not allowed to invest due to a low credit rating (rating issued by S&P, Moody's or Finch for investment decisions). Many developing countries have a low credit rating.
- *Bankable projects*: Lack of a pipeline of 'bankable' projects of sufficient quality and size, and a lack of development finance for such projects.
- *Integrating environmental issues*: Difficulties in internalizing environmental externalities.
- *Management fees* of commercial parties to manage complicated blended financial structures may exceed actual investments and the high fees may be unacceptable to government who provide (ODA-)grants.
- *Public risk finance*: Lack of public finance for 'first loss' in blended finance structures.

In addition, major banks committed to deforestation-free and sustainable commodity production, which are active in the above initiatives, are mainly Western. The Forests & Finance initiative identified that the banks investing in South-Asian operations mainly come from Asian countries.

## Starter questions for the discussion

1. What could be the role of policy and public financing in creating or enhancing enabling conditions for private/commercial financing to become "greener"?
2. What could the earlier mentioned international initiatives do to support local banks in changing their policies and practices to more sustainable investments?
3. What type of activity (global, promoted by AD group and others) is recommended to upscale the impact of already ongoing individual and collective initiatives on green financing for agricultural commodities?

# Annex: some financial terminology

***Blended finance:*** Public development finance and philanthropic funds are used in in a multi-layered financial structure to mobilize private capital flows. Structure: (1) Donor funding (grant or loan) is used to cover the first-loss risks (junior shares); (2) Mezzanine shares are often held by international or development finance institutions; and (3) Private investors hold the senior shares.

***Bond:*** A transfer of money from the public/market to a company that issues a bond. The issuer owes the bondholder a debt and is obliged to pay interest (the coupon) or repay the principal at a later date.

***Concessional funding***: Also called 'soft loans or grants'. Development finance institutions and non-government finance organisations issue concessional loans. They provide debt financing on terms that are 'concessional' as on or more of the following conditions may apply:

- Longer maturities (up to 10 years)
- Longer grace periods (up to 3 years)
- Lower collateral requirements
- Subordinate debt or other forms of quasi-equity finance
- Complementary technical assistance grant

***Credit or loan:*** Transfers for which repayment is required or the ability to obtain goods, money, or services in return for a promise to pay at some later date. This is the regular activity of a commercial bank.

***Credit Risk Sharing (CRS)***: Credit risk is the risk of a loan not being fully repaid. The credit risk can be shared through a bilateral contract between the bank and an investor. The bank agrees to pay a coupon in return for the investor covering losses in the risk-sharing portfolio, up to a maximum amount equal to the amount invested. The loans in the risk-sharing portfolio are not transferred but remain on the balance sheet of the bank and continue to be serviced by that bank. The CRS transactions typically cover the first 5% to 10% of the losses of a well-diversified portfolio of loans, often called 'credit protection'.

***Equity*** (also called stocks or shares): The value of shares issued by a company, or the value of the assets and the value of the liabilities of something owned by a company.

***Grace period:*** Interval to first repayment of capital.

***Grant***: an amount of money given normally by governments to a non-commercial entity for a special purpose. Grants to not have to be repaid. They are mentioned here because more and more government funding and commercial funding are blended whereby government grants are often used to cover the 'first loss' part of a fund.

***Green or Forests Bonds*** allow banks, companies, governmental organisations, etc. to borrow money from investors in order to finance or re-finance 'green' projects, assets or business activities. The green bond market is expanding rapidly but still accounts for less than 1% of total bonds outstanding worldwide.[xvii] Also Forest Bonds can be sold whereby the buyer is paid back in cash or carbon credits at a fixed price.

***Maturity***: The date at which the final repayment of a loan is due; by extension, a measure of the scheduled life of the loan.

***Mezzanine financing***: A hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the borrower in the case of default.

***Seniority (senior and junior)***: Senior debt (or preferred stock), frequently issued in the form of 'senior notes /senior loans' is debt (or stock) that takes priority over other unsecured or otherwise more 'junior / subordinated' debt (or stock). If a company liquidates its assets, debt has also higher priority than (is senior to) equity.

# References


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