DECEMBER 2020

CLIMATE TRANSITION RISK SURVEY

CAPITAL PROVIDERS FOR TROPICAL SOFT COMMODITIES

ORBITAS
Navigating climate transition risks

In Association with

pwc

FOREWORD

The financial sector is increasingly aware of climate risks. But how does that awareness translate into decision-making?

Equipping investors with the tools to manage, and eventually mitigate, their climate risk is critical for efficient allocation. In some sectors progress is already clear – stranded assets are an accepted risk category for energy sector investments, for example.

Orbitas was established to look at risks where a common understanding is still lacking. Producing tropical soft commodities contributes to climate change, from agriculture itself (fertilizer use, or enteric fermentation from cattle) to clearing forests to create new farmland.

The investment community should view climate transitions as a potential new risk category in the tropical soft commodity sector. A low-carbon transition could leave prevailing business models outdated. I'm assuming there is more than one business model in this space currently, but all of them are outdated when it comes to climate transitions. and failure to adapt could imperil investments. Orbitas is using cutting edge scenario analysis to demonstrate the materiality of these risks for financiers of tropical soft commodities.

Not all financial institutions think about these risks in the same way, however. It is therefore important to understand the prevailing approaches to managing climate transition risks across different firms.

Orbitas therefore worked with PwC to produce Orbitas' Climate Transition Risk Survey. Their interviews with a diverse collection of financial institutions provide both quantitative and qualitative insights into how investors think about climate transitions, and what they are doing to manage the associated risks and seize market opportunities. It is hugely encouraging that institutions see tropical soft commodity production as an overlooked sector deserving closer examination.

What PwC finds is a clear concern about climate risks, both from physical disruptions and looming transitions.

What is lacking, however, is a clear approach to integrating climate transition risk into financial decision making. Orbitas believes that tropical commodities have material risks that require a framework that quantifies exposure and examines options for reducing risks.

My hope is that in future surveys we will be able to see tangible progress in how financial institutions apply analytical frameworksto quantify, assess and reduce their risks.

Mark Kenber
Managing Director, Orbitas

INTRODUCTION

Survey Scope

This report presents the findings from interviews conducted with representatives from financial institutions between July and October 2020. Further details on the methodology for selecting financial institutions and the development of the interview questionnaire can be found on the following two pages. Responses given represent the views of individuals, and not necessarily the formal positions held by the financial institutions.

The report is divided into the following sections:

1. Investor exposure to tropical soft commodity production
2. Terms of financial instruments used to finance tropical soft commodity production
3. Levels of awareness of climate risk
4. Climate risk mitigation
5. Barriers and future needs
6. Key findings

PwC's Role

PwC engaged with financial institutions on behalf of Orbitas to understand the types of information - and the most useful format - that would enable capital providers to assess climate transition risks in the tropical soft commodity sector.

The insights from this engagement will build the foundation to enable Orbitas to best support capital providers' engagement with portfolio companies in this sector to reduce and/or eliminate these risks.

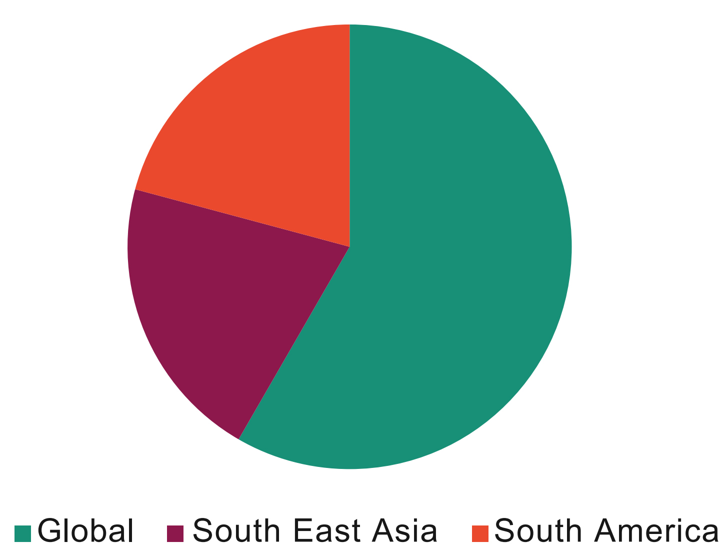
Methodology

To identify a long list of financial institutions to approach, PwC selected institutions included in relevant sources. These include Forest 500, the report "Money to Burn" and Forests and Finance. In addition, members of relevant groups were included, such as the PRI Investor Working Group on Sustainable Palm Oil and RSPO Financial Institutions Task Force.

PwC engaged with 24 of these financial institutions between July and October 2020. The breakdown of financial institutions by country, region and type can be seen in the figures below. "Global" refers to institutions headquartered outside South East Asia and South America that have exposure to soft commodities in these regions. We focused on financial institutions with TSC exposure in Colombia, Indonesia and Peru, because these are Orbitas' priority countries in 2020.

It should be noted that PwC interviewed representatives from either an asset management entity or commercial banking entity of global financial institution groups. While policies, awareness and approaches related to this issue may be similar across different entities within a group, they may not be completely aligned and may vary across asset classes.

Figure 1 – Location of financial institution

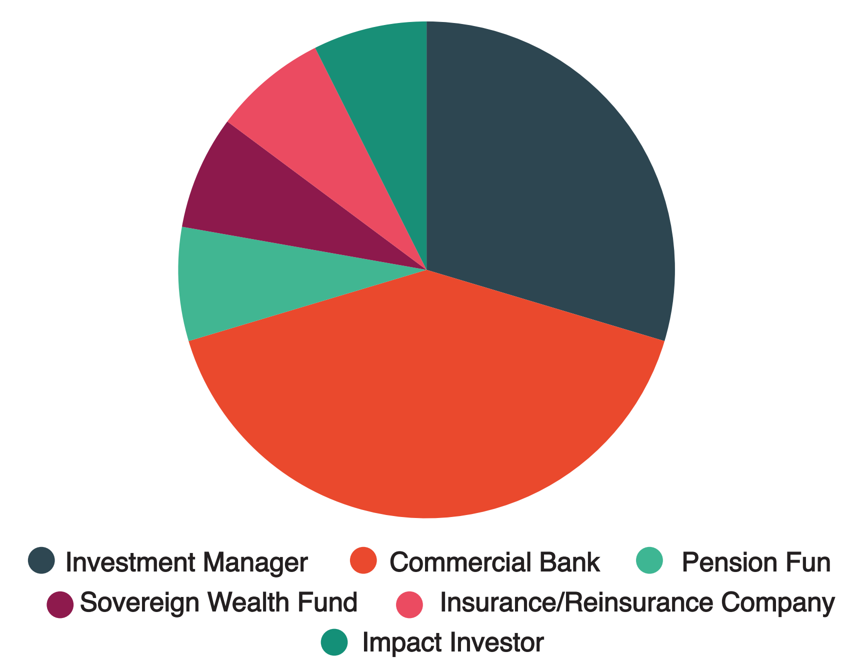


Questionnaire Construction

PwC asked interviewees five groups of questions:

1. About their level of financial exposure to tropical soft commodity production, by geography, sector, commodity and financial product type;
2. Whether they incorporated specific considerations when designing financial instruments for tropical commodities, especially around sustainability;
3. About their awareness of climate risk, including how both physical and transition risks are evaluated, monitored and managed;
4. Whether they are undertaking measures to mitigate climate risk, and challenges and barriers which they have found to implementing measures to mitigate climate risk; and,
5. About their appetite for more information related to management of climate risk when investing in tropical soft commodities, and the form which this information should take.

Figure 2 – Type of financial institution



Key Findings

Financial institutions are aware that investments in tropical soft commodities (TSCs) carry climate risks, but none currently use scenario analysis to quantify their risks from TSC production.

TSC climate risks are generally not integrated into financing. One-third of financial institutions don't assess climate transition risks at all. No institutions interviewed consider the climate risks (physical or transition) specific to tropical commodities when designing financial instruments used with TSC companies.

Institutions currently lack the data and tools to monitor these risks effectively: only five institutions are currently using tools to assess climate transition risks specific to TSCs. All institutions were eager to receive additional resources to support their assessment.

Opportunities for more sustainable financing exist. Four institutions are innovating with sustainability-linked loans for TSCs, while others use ESG scoring to differentiate companies. Scenario analysis would quantify risks for institutions developing these new financing products.

Risk Exposure

Over half of the financial institutions PwC spoke with confirmed that they had exposure to Indonesian palm oil. Cattle and soy were the other major commodities which institutions were exposed to (Figure 3).

Within Orbitas' target countries (Colombia, Indonesia and Peru) Indonesian palm oil exposure far outweighed other options such as Peruvian palm oil and Colombian cattle. This is because of the relative size of Indonesia's palm oil industry, the world's largest, as opposed to Peru (16th largest). Outside of Orbitas' target countries, respondents identified their financial exposure to Brazilian TSCs (soy, beef, etc.).

Figure 3 – Number of financial institutions exposed to each commodity

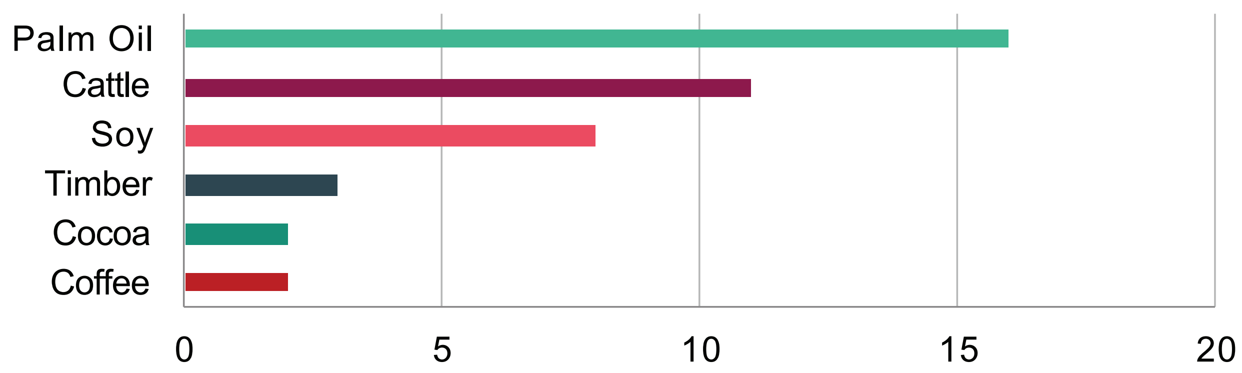
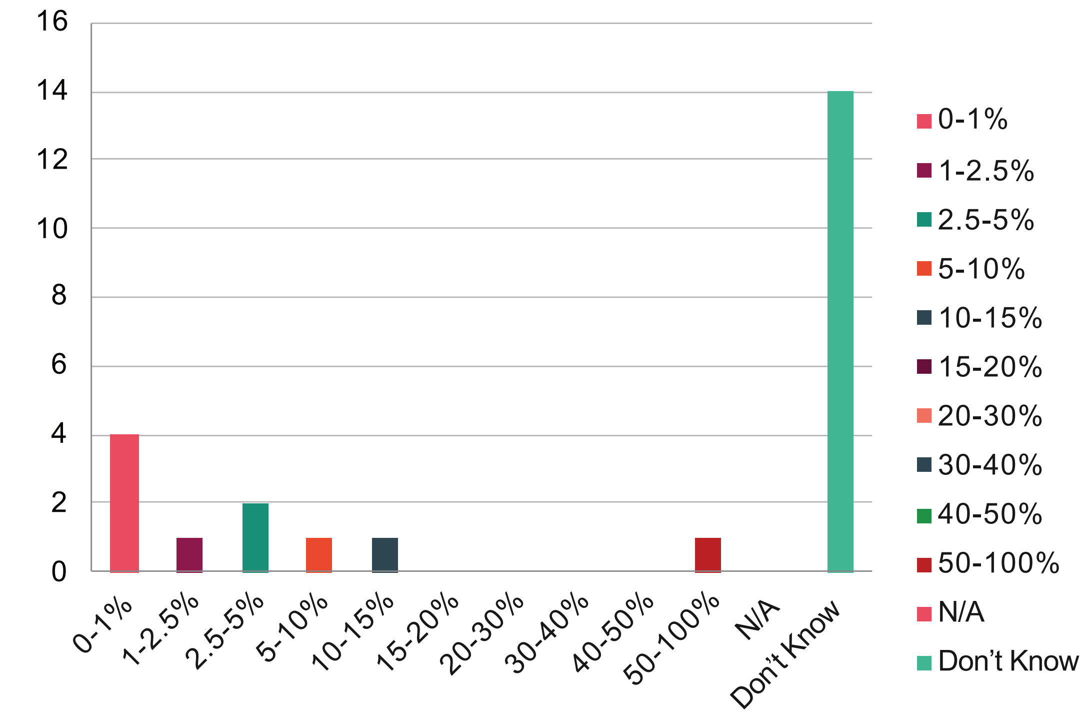


Figure 4 – Proportion of financial institution portfolios exposed to TSCs



Over half of financial institutions PwC surveyed were not aware of the nature or degree of their exposure to tropical soft commodities.

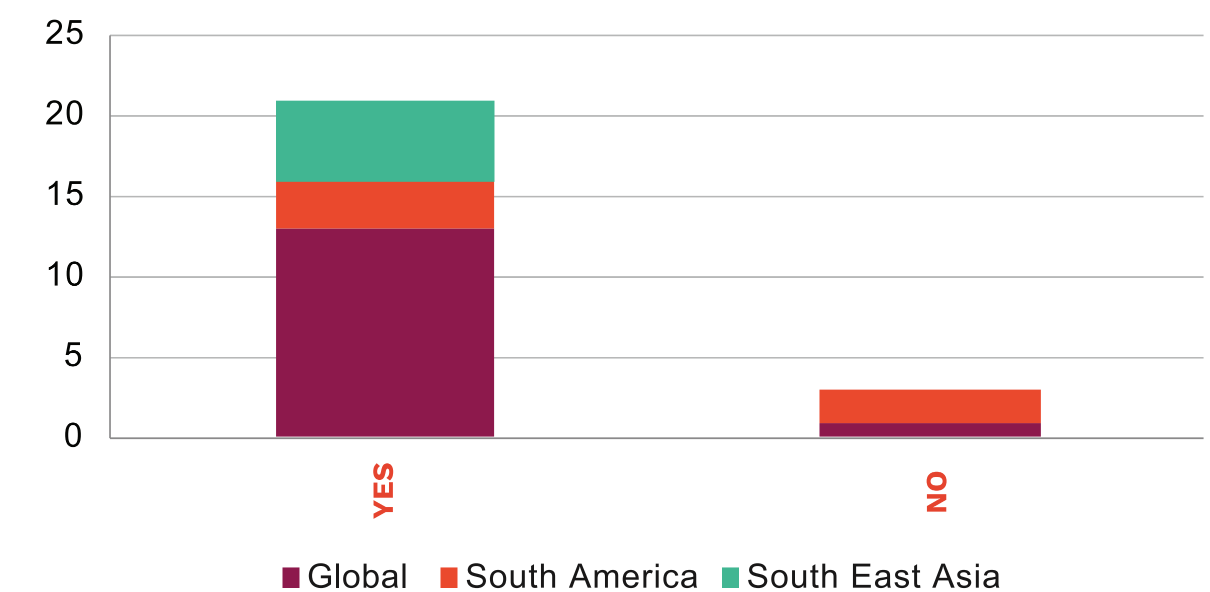
Only 42% of financial institutions PwC interviewed were able to estimate the percentage of their overall portfolio which is exposed to tropical soft commodity production (Figure 4).

Awareness

Over 95% of the institutions interviewed consider climate risk at senior level. For investment managers and sovereign wealth funds, responsibility typically lies with an Investment Stewardship team. Commercial banks and (re)insurance companies typically give responsibility to the Chief Risk Officer or their ESG team.

Only four institutions do not consider climate risk under their broader risk management (see Figure 5). Two of those institutions are based in South America, where management is in the early phases of integrating these risks.

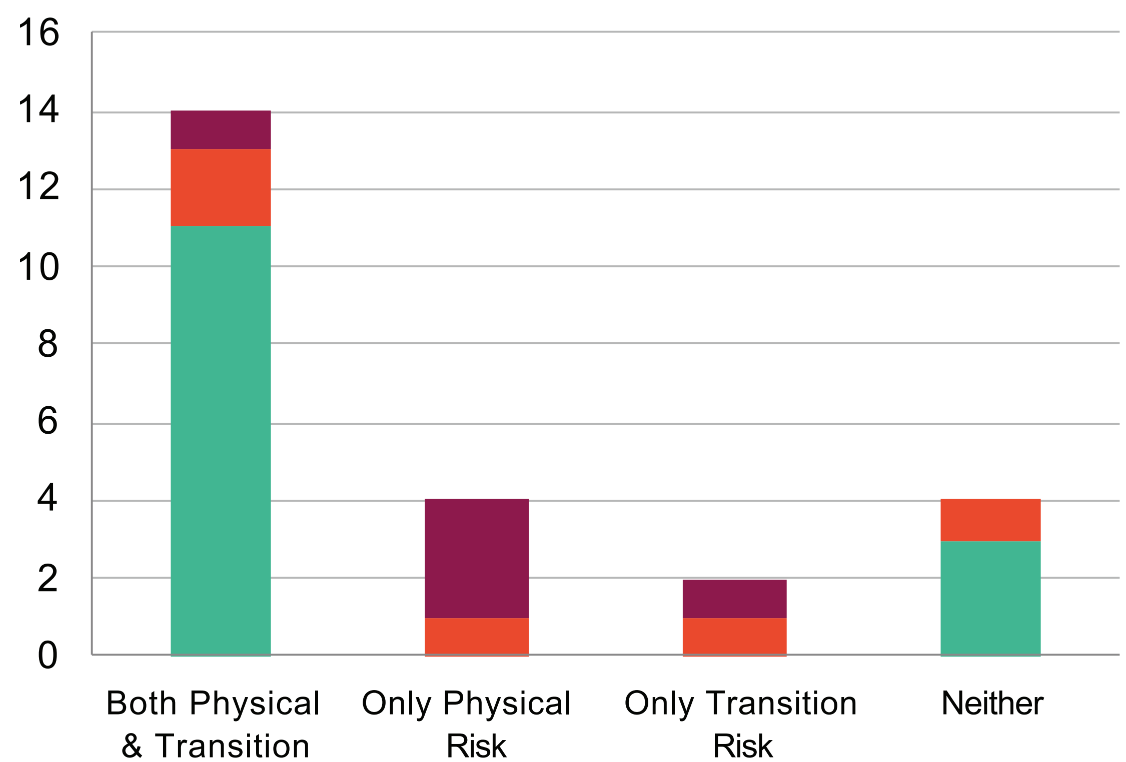
Figure 5 – Is climate risk integrated into broader risk management?



Awareness (cont.)

However, 33% of institutions surveyed do not currently consider climate transition risks. Generally, institutions with longer investment horizons such as sovereign wealth funds and pension funds are most concerned with transition risks (Figure 6).

Figure 6 – Climate Risk Considerations by Risk Category



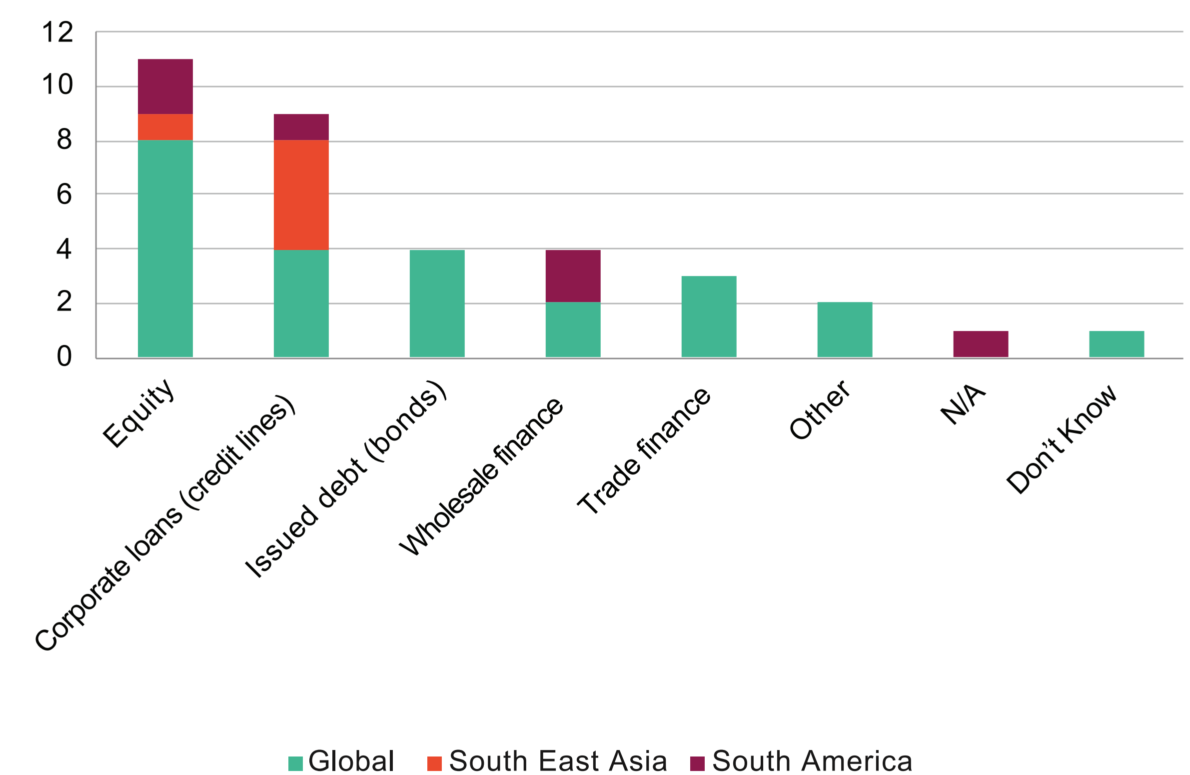
Critically, none of the institutions interviewed consider the climate risks (physical or transition) associated with tropical commodities. Some consider other environmental risks, such as deforestation or impact on high conservation value areas.

Financial Instruments

Equity was the most common financial instrument used to finance TSC companies among our interviewees, closely followed by corporate loans (Figure 7). Other instruments applied include issuing debt, wholesale finance or trade finance.

South East Asian institutions finance palm oil production primarily through corporate loans, while the exposure of South American institutions to tropical soft commodity production is spread between equity, wholesale finance and corporate loans.

Figure 7 – Financial Instrument Use by Respondent Region



Financial Instruments (cont.)

Financial instruments specifically designed for tropical soft commodities were uncommon. Of the financial institutions we interviewed, relatively few cited specific considerations for designing financial instruments for tropical commodities.

This may be partly because a large portion of the financial institutions we engaged with had only indirect exposure to tropical soft commodities. This question was also not applicable to most of the investment managers interviewed by PwC given the types of asset classes they invest in.

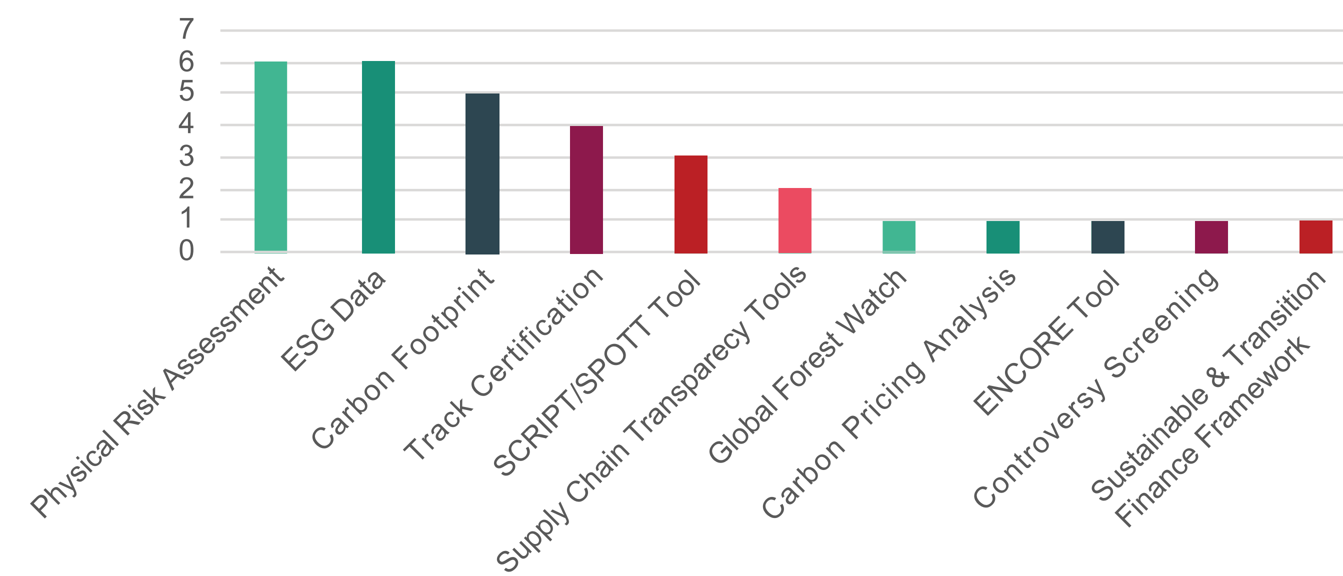
However, sustainability-linked loans for tropical soft commodities are nascent but growing in South East Asia. Two global commercial banks and two regional banks PwC spoke with are providing sustainability linked-loans to companies in the palm oil sector.

Climate Risk Management

The majority (63%) of financial institutions PwC interviewed are using tools to assess and manage risks associated with TSC exposure, **but only one considers TSCs in its climate risk policy.**

At many institutions climate risk assessment of TSCs is not embedded in policy or procedures but occurs on an ad-hoc basis. **In addition, only a minority of institutions assess transition risks specifically.**

Figure 8 – Financial Instrument Use by Risk Category



Climate Risk Management (cont.)

The most common tools relied upon by financial institutions are physical risk assessments and ESG data (Figure 8, previous page). For example, one respondent scores companies A-F based on their ESG performance. “E” rated companies can only comprise up to 15% of a portfolio, and ”F” rated companies are excluded altogether. However, more specific assessments of transition risks are not present **– none of the institutions interviewed use scenario analysis specific to TSC production.**

Five institutions use data on the carbon footprints of companies to evaluate their carbon risk exposure. This data was either sourced from ESG providers (e.g. Trucost) or was taken from company disclosures. Investors have used this information practically – one respondent quantified carbon footprints for dairy producers to evaluate potential carbon tax liabilities.

Finally, three financial institutions PwC surveyed have taken an active decision to divest from specific tropical soft commodities, citing sustainability concerns.

> “We have sold out of many listed palm oil companies due to concerns about the sustainability of their business models, including the environmental impacts associated with producing these commodities”
>
> *European Financial Institution*

Barriers and Challenges

Lack of Understanding
A key challenge reported by interviewees across the range of institutions we interviewed was a lack of understanding of climate risk methodologies for tropical soft commodities, and a lack of agricultural climate risk scenarios.

The lack of climate risk scenarios for agriculture is an impediment to conducting more mature portfolio-wide climate risk assessments. Interviewees mentioned that scenarios aligned with Science-Based Target Initiative (SBTi) or the Transition Pathway Initiative would help them improve their assessments.

Lack of data
Only one financial institution felt it had sufficient data to fully understand and assess risks associated with their TSC financing. Commercial banks are particularly interested in gaining access to more location-specific data on risk exposure while investment managers are more interested in data on the exposure of portfolio companies.

> "Big banks are progressing in the right direction regarding climate risk, we do not feel like we are missing out on financing opportunities but rather capitalizing on new opportunities."
>
> *South American Financial Institution*

Barriers and Challenges (cont.)

Inability to Trace Soft Commodity Supply Chains
Several institutions identified the lack of upstream traceability as a barrier. Multiple financial institutions expressed concerns about the dominance of smallholders' TSC production, and that many fast-moving consumer goods (FMCG) companies have not disclosed their downstream suppliers.

Institutions emphasized that this was more of an issue with certain commodities and geographies, such as soy in South America, where the vast number of smallholder producers makes traceability cumbersome.

Managing risks for Passive Funds
Investment managers and pension funds seem to have unique concerns, including potential conflicts between ESG criteria and fiduciary duty, ability to influence fund managers on sustainability-related risks and how the current migration of capital from actively to passively managed funds can result in potential limitations to manage commodity-specific climate risks.

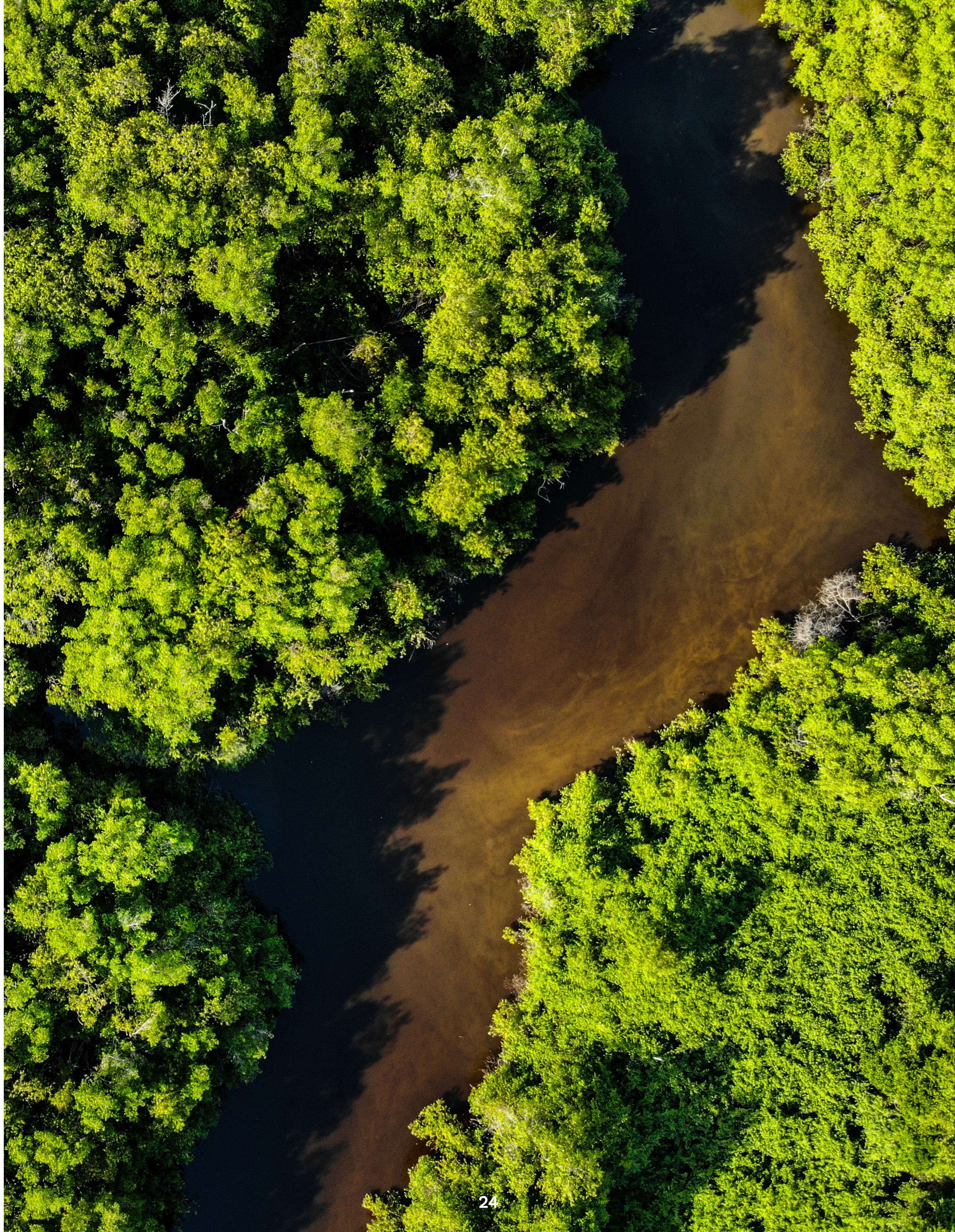
Next Steps

Climate change will bring a broader range of financial and operational risks into play. The focus should move beyond reputational risks associated with financing TSCs.

Initiatives such as TCFD have been effective at raising general awareness of climate risk amongst financial institutions – but more sector-specific approaches are needed.

Institutions need to deploy approaches to understand the transition risks specific to TSCs. Only one institution interviewed had a TSC-specific climate risk policy, and none use scenario analysis to quantify these climate risks.

All institutions interviewed showed strong interest in approaches to quantify climate transition risks from TSCs, including the scenario analysis Orbitas has developed.

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