ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

FOOD VALUE CHAIN WORKSHOP

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NOTES FROM THE FOOD VALUE CHAIN WORKSHOP

The PRI's [ESG in credit risk and ratings initiative] is, for the first time, bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from the food value chain workshop and adds to the series [Bringing credit analysts and issuers together]. The series features the voices of traders, producers, manufacturers, retailers, as well as credit analysts from both investment institutions and credit rating agencies (CRAs). This was the eighth of a workshop series that began at the end of 2019.[1]

The food value chain workshop, held on 24 March 2021, attracted over 60 participants, including representatives from 11 companies (see Figure 1 below), as well as 22 credit analysts from 20 organisations and five representatives from three CRAs (see Appendix 1 for a full list of participating organisations). The discussion was under the Chatham House Rule. It was structured around guidelines that were circulated to participants prior to the event, alongside a draft deforestation policy created by Global Canopy (see Appendix 2).

Figure 1: Participating companies

Sub-sector	Companies
Producers	Expocaccer, Minerva Foods, Sime Darby Plantations
Traders	ADM, Bunge, Cargill, Viterra
Manufacturers	BRF, Sigma
Retailers	Auchan, ICA

This workshop tackled the topic of deforestation as it relates to soft commodities (palm oil, soy, cattle products, and timber products) and the food value chain – a relatively new issue for fixed income investors. We used deforestation as an example of a range of issues that will come to the fore when considering how ESG factors can affect credit risk in across the food value chain.

[1] This workshop series follows an initial string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.

Over the last decade, financial institutions and governments have taken on ambitious commitments to address deforestation in supply chains and financing. Yet deforestation is getting worse, with tropical primary forest loss increasing by 44%[2] since the signing of the landmark New York Declaration on Forests in 2014. The Forest 500 assessment finds that 43% of the 500 companies and financial institutions in forest-risk supply chains do not have a commitment on deforestation.

Market expectations of ESG disclosures vary widely, and different stakeholders approach sustainability topics from different perspectives. There is little consensus about what type of ESG information companies should provide, or even which ESG factors are relevant to credit scores. The workshop highlighted interests that are common to all parties:

- align expectations around sustainability considerations;
- understand which ESG factors are financially material;
- streamline the disclosure process;
- ensure that ESG questionnaires are relevant; and
- reduce the number of questionnaires required of borrowers.

This workshop used a mock investor deforestation policy to understand ESG policy standards and how they can be met and evidenced. The Global Canopy developed the policy, which follows the Accountability Framework guidelines. Our intention was to provoke discussions between corporates across the supply chain with fixed income investors and credit rating agencies. As credit analysts and companies' Treasury representatives typically do not discuss this topic, this was an opportunity to share how they would approach the problem; explore if there is alignment between how credit analysts and companies map risks; discuss metrics; understand the challenges of implementing deforestation policies; and consider what kinds of engagement would be productive in raising the issue of deforestation in the food supply chain.

Several observations in this workshop echoed themes highlighted in previous workshops covering different sectors. In the remainder of this report, we focus on the priorities that each of our groups highlighted as being crucial to making progress on deforestation in the food value chain.

1. TRANSLATING DEFORESTATION TO MATERIAL CREDIT RISK

Trying to assess how deforestation might impact companies' ability to service their debt is difficult because companies have only begun to view it as a material business consideration. Furthermore, deforestation is generally perceived by both companies and

[2] See Global Canopy (2021) Time for change: delivering deforestation-free supply chains.

credit analysts as a long-term risk. When selecting appropriate metrics, the key is understanding which of the available ones are both important from an ESG perspective and credit-relevant.

Action on deforestation is being slowed by a disconnect between the incorporation of ESG-related risks any related costs or benefits. For example, the costs of proving sustainable approaches to soft commodities (e.g. through certification, or other forms of reporting) are not yet linked to the cost of funding (either through a higher premium penalising bad practices or, conversely, a lower cost of finance to reward good practices). Some producers pointed out that they are not being sufficiently compensated for the carbon they are sequestering in land they are protecting.

Additionally, investors and credit analysts are looking for companies to make the best use of their assets – this creates a structural demand for efficiency of land use that can be at odds with carbon storage efforts. Until deforestation translates to a material risk with financial and balance sheet implications, progress in systematically considering it as a risk will be slow. Credit analysts also voiced concerns around how change in default risk from non-compliance with deforestation mitigation objectives could be quantified.

EMERGING SOLUTIONS

Both credit analysts and companies were unsure as to the pricing of deforestation risk, so further work remains to outline the materiality of deforestation and how it would impact borrowers' cost of funding.

2. THE CHALLENGES OF MULTIPLE ESG FRAMEWORKS

Companies that must respond to challenges across the entire ESG spectrum face inconsistencies in the source and nature of questions posed, particularly with respect to climate change and other established issues. In addition, the lack of issue prioritisation by investors can contribute to difficulties in managing competing asks to companies.

Echoing previous workshop discussions, participants delved into the importance of data. Comparability and compliance are both important factors when selecting data to assess ESG risks; the lack of disclosure requirements makes these assessments more challenging. On the topic of disclosure, discussion centred around certification and the need for a standardised approach to be agreed between credit analysts and companies to support the prioritisation of action and the quality of disclosure.

Global Canopy's mock deforestation policy would be improved by the inclusion of specific deforestation indicators, how these would impact on materiality, and how they would align with other indicators with which companies and investors must comply. The Accountability Framework Initiative was raised as a potential way to manage and streamline indicators and provide consistency that would benefit both sides.

“If we can use external frameworks like the Accountability Framework Initiative to provide consistent indicators so we are not fielding 50 different surveys from financial institutions – which causes us to focus on responding rather than driving the work forward – that would be ideal.” — Corporate borrower

EMERGING SOLUTIONS

Companies suggested that investors could aid progress by agreeing a common set of KPIs for companies on deforestation that are integrated with other investor ESG asks/priorities. This would be particularly relevant for new debt issuance.

3. FAIRNESS FOR SMALL AND MEDIUM ENTERPRISES

As already noted, responding to multiple ESG asks from investors can be complex and burdensome. This is particularly so for small and medium companies and could lead to consolidation, crowding out smaller firms.

Traders in particular showed concern for farmers and cooperatives, highlighting the need to provide financing and incentives to help farmers abide by deforestation policies. The more ambitious investors were viewed as key to developing trustworthy relationships with, and incentives for, farmers.

Concerns were raised that some certification processes focus on documentation rather than understanding what it is companies do. Participants expressed support for ensuring that the outcome of compliance efforts is a change in practice rather than meeting a superficial standard.

“There will not be a solution without involving the farmers.” — Corporate borrower

EMERGING SOLUTIONS

The impact of traceability and other asks on small and medium companies should be considered; companies working hard to implement deforestation policies should also benefit from incentives, for example reduced costs of capital).

Collaborative engagement by investors with smaller companies would be welcomed, particularly if the expertise and knowledge of companies is leveraged to create a meaningful dialogue.

4. VISIBILITY AND ACCOUNTABILITY ACROSS THE VALUE CHAIN

In Brazil, deforestation is tracked using the Instituto Brasileiro do Meio Ambiente y Recursos Naturais Renováveis (IBAMA) report, which lists compliant and non-compliant suppliers. It is updated every 15 days to show blacklisted direct suppliers, but this information on its own is not sufficient for investors and credit rating agencies as it does not cover the whole supply chain.

Traceability is particularly difficult for indirect suppliers. Retailers do not have full control of the large supply chains they depend on, which exposes them to industry-specific risks (such as a lack of oversight on their suppliers' impact on biodiversity). It is also very complex for analysts to be precise and quantify these risks. Companies noted that indirect suppliers necessitate a sector-wide approach which should include government agencies.

Other challenges related to traceability and accountability include mapping large geographical areas, understanding laws and regulations in different countries, and comprehending the numerous approaches to rankings and ratings from ESG information providers. Participants recognised a need to pinpoint what is materially important and pertinent for each country and stage of the supply chain. Credit analysts face tensions between national laws and international standards, and must also balance environmental and socio-economic considerations.

> "The issue of traceability is becoming critical, as the reputational damage can be significant especially for large companies." — CRA

EMERGING SOLUTIONS

Some participants saw technological innovations as the means to enhance supply chain visibility and traceability and to support data disclosure and accountability.

Credit analysts said having a dedicated company contact responsible for fielding all related questions would be helpful; at the same time, companies thought that aligning with the Accountability Framework Initiative would provide consistent guidance across the supply chain.

5. ENGAGEMENT

For fixed-income investors, ongoing engagement is a challenge, with most contacts taking place at the time of new issuance. Companies said that they would welcome investors starting a dialogue on deforestation, if they put the time and effort into respectful collaborative engagement. Participants expressed hope that companies and investors can together move beyond data disclosure to collaborate on finding solutions.

There was pushback from some companies on the idea of annual policy updates, stating that these would not be feasible, given timelines needed to review, agree and approve these documents. There were concerns that annual reviews would not enable teams to have appropriate bandwidth to drive progress, as opposed to simply reporting data. Instead, an annual review of action plans was suggested to incorporate progress, learning and latest thinking. Others thought that reporting publicly and annually, although additional to existing reporting requirements, would be necessary to make progress on deforestation.

Investors need to understand why companies are not meeting their targets – ascertaining whether it is because they don't want to or because they are trying but finding it difficult. This is crucial to identifying the appropriate engagement strategy – particularly in the cases of smaller companies that may need further investor support to make progress.

> "For the companies that are failing to meet their targets, but are trying to, engagement continues. For the ones that are not making efforts, you always have the choice to divest." — Investor

Outstanding questions on engagement include:

- How can sustainability be better incorporated into bond updates?
- How can accountability be spread across all levels of organisations?
- How can investors have more meaningful conversations with retailers?
- How can fixed-income investors most productively engage with borrowers at the time of new debt issuance?
- How can companies disclose their deforestation "footprint" to better understand their risk exposure and help investors to prioritise engagement?

EMERGING SOLUTIONS

Stakeholder management is time consuming, but participants highlighted effective approaches:

1. Investors giving a clear order of priorities
2. Clear incentives for those priorities
3. Improved standardisation of disclosure

APPENDIX 1

Figure 2: Other participating organisations

Investment institutions	
Allianz Global Investors	Federated Hermes
APG Asset Management	Janus Henderson
AXA	Jupiter Asset Management
BlueBay Asset Management	Legal & General Investment Management America
BMO Global Asset Management	Ninety One
BNP Paribas Asset Management	NN Investment Partners
Christian Brothers Investment Services	Payden & Rygel
Church of England (The Church Commissioners)	PIMCO
Church of Sweden	Saturna Capital
DDJ Capital Management	Schroders
CRAs	
DBRS Morningstar	Qivalio
Moody's Investors Service	
Others	
Centre for Climate Finance and Investment, Imperial College Business School	World Business Council for Sustainable Development
FAIRR	World Economic Forum

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APPENDIX 2

DEFORESTATION POLICY – GLOBAL CANOPY

MARCH 2021

"This draft deforestation policy was an initial iteration of what a good deforestation policy might look like for asset managers. This first draft of the policy built off the assessment methodology of the Forest 500 which has assessed the strength of financial institution deforestation policies since 2014. It was designed to provide an opportunity for the participants at the PRI workshop to feedback on and input into the policy based on their experiences and perspectives - including how the policy could be clarified and strengthened further. Future iterations of this policy will build upon this initial draft and the feedback provided in the workshop to create useful and comprehensive guidance on strong deforestation policies for asset managers." – Global Canopy

KEY ASKS FOR A FIXED INCOME DEFORESTATION POLICY

Sourcing and procurement practices

- Require companies to: set a commitment and plan to become compliant within a set time frame or already be compliant with the fixed income policy in advance of receiving financial products or services.
- Require companies to: have and implement a public commitment to ensure that the forest-risk commodity they produce, process, or procure have not contributed to deforestation or the conversion of natural ecosystems.
- Companies must apply their commitment to all their relevant operations (namely all operations, subsidiaries, sourcing regions and direct and indirect suppliers).
- Require companies to: ensure the protection of other landscapes including globally important ecosystems (including UNESCO, RAMSAR wetlands, and IUCN sites 1-5), explicitly including High Carbon Stock (HCS) and High Conservation Value (HCV) forests, within their commodity production or sourcing.
- Require companies to: conduct assessments to check that their own operations and their supply chains are operating in compliance with all relevant national and international laws and regulations.

Social considerations

- Require companies to have taken steps to address these risks in their operations/supply chains, including making and implementing commitments to: labour rights.
- Require companies to have taken steps to address these risks in their operations/supply chains, including making and implementing commitments to: gender rights.
- Require companies to have taken steps to address these risks in their operations/supply chains, including making and implementing commitments to: smallholder inclusion.

- Require companies to have taken steps to address these risks in their operations/supply chains, including making and implementing commitments to: Free and Prior Informed Consent (FPIC).
- Require companies to have taken steps to address these risks in their operations/supply chains, including making and implementing commitments to: grievance mechanism.

Scope

- Apply to all of the financial institution's branches and operations, services, products, deals and companies (including all segments of the supply chain).
- A strong deforestation policy outlines the requirements for companies/clients in financial portfolios, which operate in the supply chains of all forest risk commodities, or at least the four commodities with the highest forest-risk – palm oil, soy, cattle products, and timber products.

Implementation

- Be made publicly available.
- Deforestation policies should be reviewed and updated at least annually.
- Require all companies in a financial portfolio to disclose any and all subsidiaries which operate in soft-commodity supply chains, publicly or privately.
- Financial institutions should annually review all relevant companies for compliance with the deforestation policy.
- If a company is found to be non-compliant with the deforestation policy: financial institutions should engage with them on the issue work with the company to bring them into compliance within a specific time-frame, of no more than three years.
- If after repeated engagement, the company continues to operate in contradiction to this deforestation policy and does not show evidence of progress, financial institutions should divest from the company as a last resort.

Reporting

- Financial institutions should report publicly and annually against their deforestation policies and for all the commodities covered by this policy.
- Reporting should clearly include:
  - how many companies have been monitored annually;
  - the number or proportion of companies in the portfolio who are compliant with the policy;
  - how many companies have been engaged in the past year;
  - including those that are working towards compliance through time-bound plans.