FRANKLIN TEMPLETON

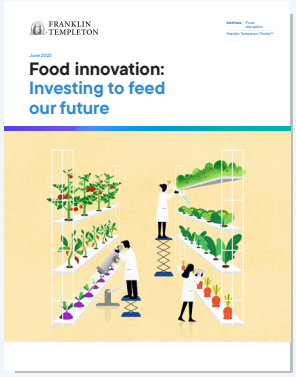
Institute | Food disruption

Franklin Templeton Thinks™

June 2022

Natural capital's key role in sustainable food systems

David Sheasby
Head of Stewardship and ESG
Martin Currie



The following is a chapter from the Franklin Templeton Institute piece, *Food innovation: Investing to feed our future*. As stewards of our clients' assets, we believe feeding a growing global population in the midst of climate change, geopolitical shocks, and uncertainty over the coming decades requires innovation in food and agricultural technologies; re-thinking old paradigms; and, investing in solutions that not only boost agriculture productivity and food's nutritional value but also reduce negative impacts on the planet—for which agriculture is a significant contributor—and improve the health of our global community. The investment needs are tremendous, which is where the deployment of new, smart capital can be so important. To read the full paper and explore views from across our specialist investment managers, please visit www.franklintempletonglobal.com/fooddisruption.

The food system as it currently stands is exposed to three significant gaps—the food gap, the land gap and the GHG mitigation gap. Addressing these gaps simultaneously is particularly challenging; see the Three gaps sidebar for more information. The financing of the food and agriculture industries and the role banks play will be key to building a more sustainable food system. The main barriers to success to date center on the lack of frameworks to effectively value natural capital[1] and the paucity of meaningful and consistent biodiversity metrics that are currently available to measure risk and monitor success.

However, we believe that the finance sector is waking up to this. We have seen that some of the leading banks are recognizing their impact in the way they are now approaching agricultural lending activities and the support and education that they provide alongside this. The development of reporting frameworks is the other key step—in particular the Principles of Responsible Banking (PRB) and the Task Force on Nature-related Financial Disclosure (TNFD). These frameworks will facilitate lenders and investors to make more informed assessments on the risks and opportunities associated with the food supply chain overall. Ultimately, we are encouraged by the progress we are seeing but recognize that there is a huge task ahead—if we are to build a more sustainable food system the financing of it needs to play a key role.

The role finance can play

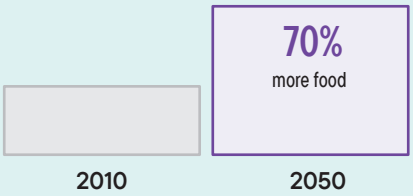
Recognizing the intertwined challenges of climate change and biodiversity loss and the food chain's key role in both,

Three gaps

With an eye on the future, three substantial "gaps" need to be addressed to create a sustainable food system to support the rising global population by 2050.[2]

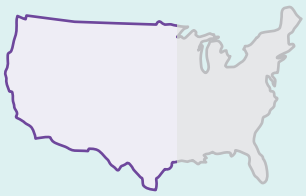
Food gap

Additional amount of food production necessary to meet likely demand in 2050.[3]



Land gap

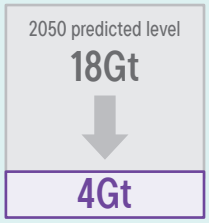
Global agricultural land area required in 2050 is estimated to need to expand by nearly 600 million hectares (almost 1.5 billion acres).



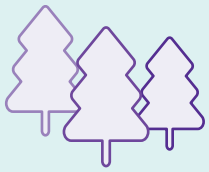
That's equal to roughly two-thirds the size of the United States[4]

GHG mitigation gap

Predicted level of annual GHG emissions from agriculture and land-use change in 2050 needs to drop to hold global warming below a 2°C above pre-industrial temperatures.



To hold global warming below 2°C increase...



...with aggressive reforestation to hold global warming below 1.5°C increase[5]

an important lever to help drive change is the consideration of natural capital and biodiversity, particularly in financing the agricultural sector. By applying a value to natural capital and the tangible benefits that this provides, capital flows can start to be redirected to more sustainable businesses alongside promoting best practices that are beginning to emerge.

The banking sector's key role

Banks provide a wide variety of finance to companies involved in agriculture—as seen in Exhibit 1—and food supply chains. These services include term loans, trade finance, revolving credit alongside project finance and more. It is therefore important to understand the different roles and approaches that are taken by the banking sector.

Domestic finance—here we are referring to national development banks and private banks—frequently provide finance in the form of low-cost loans. They can incentivize change by setting eligibility criteria that preclude, for example, the conversion of forest or ecosystems. These conditions can then be applied either retrospectively—looking at what food producers/landowners have done and removing eligibility where that is the case—or prospectively, whereby a penalty interest rate is applied where this activity takes place once the loan has been received.

International bodies, such as the World Bank, also play an important role and can use targets focused on agricultural productivity or protection of forests, or ideally in combination, to help support both goals.

Supply-chain financing can have a broader influence with buyers or financiers supporting "conversion-free" supply chains, whereby they choose to buy or finance only those agricultural commodities that are not linked to deforestation or to the conversion of other ecosystems.

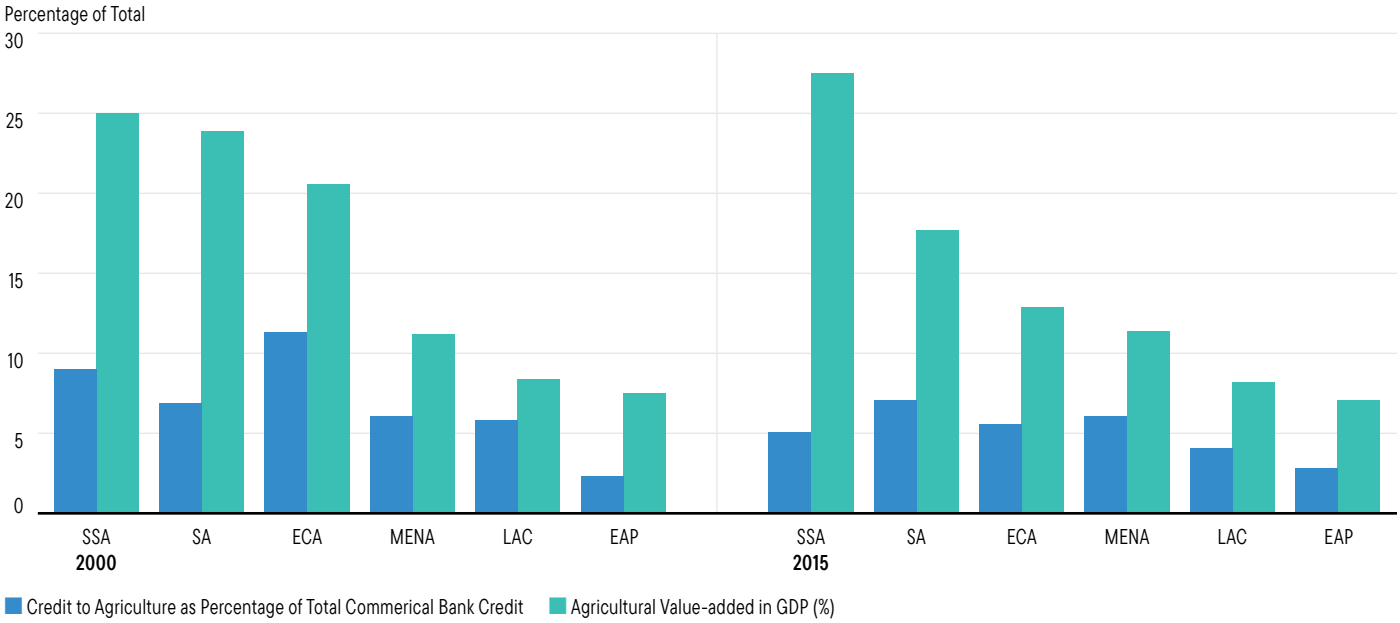
Soft commodities compact

The Soft Commodities Compact (SCC) is an example of how this might work. Set up in 2014, the SCC[6] was a joint sustainability initiative of the Consumer Goods Forum (CGF), an organization of chief executive officers from consumer goods manufacturers and retailers, and the Banking Environment Initiative (BEI), a group of sustainability focused global banks, and was signed by 12 major European and US banks. The goal of the SCC was for the banking industry to support clients to achieve net zero deforestation in their commodities supply chain by 2020. In particular, this initiative focused on the soft commodities—soy, palm oil, beef and timber-related products identified as the four key "forest-risk commodities." Under the SCC, the 12 signatory banks committed support to their clients in soft commodity supply chains to reduce deforestation through an approach largely focused on requiring clients to sign up to certification schemes.

Commercial Lending to Agriculture

Exhibit 1: Agricultural Credit and Agricultural GDP Share by Region, 2000 vs. 2015

As of 2019



Source: Data from World Bank (2019). Note: Sample size 127. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and Caribbean, MENA = Middle East and North Africa, SA = South Asia, SSA = Africa south of the Sahara.

> **“Reliable and robust biodiversity data, which is critical to enabling target setting, are not readily available in a format that can either be easily understood by banks or that can be readily fed into the decision-making process. As such, there is a real need for more streamlined biodiversity-related KPIs. Encouragingly, we are seeing extensive effort put into building potential frameworks.”**

So what was the outcome of this initiative? BankTrack published a report looking at what progress was made and the extent to which the goals of this initiative were met.[7] While there was clear progress in most cases, the report found that none of the banks succeeded in ensuring all their clients were certified by 2020. Cambridge Institute for Sustainability Leadership (CISL) has published a follow up report,[8] which makes some recommendations based on the lessons from the SCC, the most important of which we believe are: ensuring that there is collaboration between global and local banks; aligning standards for measurement; and setting specific, short milestones and key performance indicators (KPIs) in order to achieve the ultimate goals.

Addressing gaps

Reliable and robust biodiversity data, which is critical to enabling target setting, are not readily available in a format that can either be easily understood by banks or that can be readily fed into the decision-making process. As such, there is a real need for more streamlined biodiversity-related KPIs. Encouragingly, we are seeing extensive effort put into building potential frameworks.

A key one for us is the PRB, which has recently issued guidance on biodiversity target-setting for banks.[9] The PRB recognizes that, to date, the financial sector has failed to channel significant capital into biodiversity, whether it be conservation, restoration or sustainable use. This suggests, to some extent, there is a lack of understanding of biodiversity and its importance among banking professionals. The aim of the PRB framework is to address this gap by establishing KPIs and targets that are understandable, relatively easy to measure, report and verify alongside robust guidance for lenders. These are key elements to support capital flows, and the framework looks to address some of these shortcomings. Structured in the right way, these can also have a direct impact on the profit or loss for the client and the bank issuing the product and potentially drive improvements in practices, in our view.

Under the PRB framework, signatory banks commit to taking three key steps enabling them to reduce their impact on biodiversity:

1. Analyze their current impact on the environment, society and their economies. This may include identification of their impacts and dependence on biodiversity, where this is relevant to their portfolios.
2. Based on this analysis, set targets in their areas of most significant impact (and dependencies), such as biodiversity, which should include clear implementation plans.
3. Publicly report on progress (based on measurement of the targets), including biodiversity where this is identified as an area of significant impact.

The framework that the PRB is establishing aims to ready the banking sector for developing science-based targets—requiring them to be achievable, verifiable and supported by a clear rationale. The framework sets expectations around the lending due diligence process, the need for exclusions—not financing activities with high negative impact—and setting out clear policies and targets (for example, zero deforestation). The report also cites examples of strong practices across some of the global banks—notably ING, Rabobank, Credit Suisse and Mitsubishi UFJ Financial Group.

The other framework that we are focusing on is the TNFD. This is a market-led global initiative that aims to support financial institutions and companies in assessing nature-related risks and opportunities. Its stated goal is to *“support a shift away from nature-negative impacts and toward nature-positive global financial flows, by providing a framework for organizations to report and act on nature-related risks, including impacts and dependencies.”*

The TNFD will play a key role in providing a reporting framework that will allow for consistent and comparable reporting. The reporting framework will be designed to complement the Task Force on Climate-Related Financial Disclosure’s (TCFD) framework and is expected to be launched in 2023.

Banks leading the way

Our own analysis has also identified interesting examples of the work banks are doing in driving more sustainable agricultural practices in economies dominated by agriculture.[10] In the emerging market space, India is a prime example. Agriculture is huge industry in India, and HDFC Bank is the country's largest private sector bank.[11] For agriculture-related loans, which potentially present higher credit risks due to exposure to climate change impacts, the bank supports food producers by connecting them to government initiatives and expert advice on weather, soil health and cropping patterns. The bank has also specifically outlined a goal to "provide access to capital for environmentally sustainable projects that contribute to climate change mitigation." The group has a specific Social and Environmental Management System (SEMS) framework, which assesses various parameters, including negative environmental impact when deciding whether to lend to a business. These include pollution, waste management and climate change, alongside the ecological impact.

Another Indian bank, ICICI Bank, takes a very proactive approach. Rather than excluding firms with poor practices, it has a specific group that seeks to find and lend to projects promoting biodiversity or environmental sustainability. It has also intervened with many rural agricultural businesses and farmers to provide education to help transform their crop rotation, paddy cultivation, pest control and food security. The group has also recently started to use satellite technology to assess the creditworthiness and risks associated with agricultural lending, with the intention of expanding this capability rapidly in the near future.[12] While these are small steps, we believe they can start to have a real impact once at scale.

Of the banks in developing economies, we view some of the best practices are from National Australia Bank (NAB). Agriculture is an important sector for the Australian economy, and NAB was a founding signatory to the PRB. Additionally, NAB is the only Australian bank to sign up to the Natural Capital Declaration (NCD)—a global statement recognizing the potential risks and opportunities that natural capital poses to the finance sector. NAB has clearly identified finance as a potential driver for more sustainable agricultural practices.

The bank has set out a Natural Value strategy, which leverages its understanding of the linkages and dependencies of natural capital upon customers, operations and supply chains. A crucial element of this is the work it is doing on valuation, with a focus on the connections between strong management of natural capital, financial risk and business resilience—essentially trying to put a "dollar value" on investments in natural capital. NAB has worked with valuation experts to explore the links and dependencies between the good management of natural capital assets, financial performance and business resilience. Initially, this approach has been focused upon agribusiness customers; however, it plans to extend this across the entire business. By integrating this understanding into products and services, NAB can reward clients that demonstrate they are working to lower their impact and risk across issues such as soil health, water scarcity, energy cost, runoff and waste.

The aim here is to encourage sustainable agricultural practices by enabling landholders who manage their assets sustainably to access more competitively priced debt, obtain premium prices for their land and enhance the value of their produce. Such products include discounted loans for energy efficient and renewable energy assets, like water-efficient irrigators and fuel-efficient agricultural equipment, and green bonds to assist investors in prioritizing investments that finance climate change solutions.

Conclusion

Finance, particularly the banking sector, has a key role to play in managing and mitigating the impact of the food supply chain on biodiversity and climate change. Banks that are leading this process will both seize the potential opportunity as well as effectively manage the potential risks associated with the sector. Frameworks such as TCFD, which is focused on climate, and the emerging TNFD, focused on natural capital, will increase transparency of both practices and impact and consequently increase investor scrutiny on the sector. The PRB guidance on biodiversity target-setting also provides a strong starting point for how banks can approach this.

At Martin Currie, we have been working to create a framework to help identify those companies with the highest potential exposure to biodiversity risk, focusing in particular on those exposed to the food supply chain. This framework and the learnings that we have taken from the emerging disclosure standards and the engagement that we have already had with the banks involved in these sectors will help us identify those companies that really are prepared for this important and emerging issue.

Notes

Endnotes

1. Natural capital is the world's stocks of natural assets, including geology, soil, air, water and all living things.
2. Note: The three gaps were originally identified by the World Resource Institute (WRI) in 2018. Key statistics have been updated from other sources to reflect current estimates.
3. Source: FAO. 2009. *High Level Expert Forum—How to Feed the World in 2050*. Rome: FAO.
4. Source: WRI. 2019. *Creating a Sustainable Food Future*. Washington DC: WRI.
5. Source: Crippa, M., Solazzo, E., Guizzardi, D. et al. 2021. Food systems are responsible for a third of global anthropogenic GHG emissions. *Nat Food 2*, 198–209
6. Source: University of Cambridge Institute for Sustainability Leadership. 2014. *Implementation of the 'Soft Commodities' Compact*. Cambridge: University of Cambridge Institute for Sustainability Leadership.
7. Source: BankTrack. 2020. *Soft Commitments. Hard Lessons: an analysis of the Soft Commodities Compact*. Nijmegen: BankTrack.
8. Source: University of Cambridge Institute for Sustainability Leadership (CISL). 2020. *Banking Beyond Deforestation*. Cambridge: University of Cambridge Institute for Sustainability Leadership.
9. Source: United Nations Environment Programme Finance Initiative (UNFP FI) and World Conservation Monitoring Centre (UNEP-WCMC). 2021. *Biodiversity Target-setting, Principles for Responsible Banking*, Geneva: UNFP.
10. Any companies and/or case studies referenced herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton. The information provided is not a recommendation or individual investment advice for any particular security, strategy, or investment product and is not an indication of the trading intent of any Franklin Templeton managed portfolio.
11. Source: HDFC Bank, *Sustainability Report*, 2019–2020.
12. Source: ICICI Bank, E*nvironment, Social and Governance (ESG) Report*, 2020–2021.

FRANKLIN TEMPLETON