



DEFORESTATION AND CONVERSION

AN INTRODUCTORY GUIDE FOR CENTRAL BANKERS,
FINANCIAL REGULATORS AND SUPERVISORS

EXECUTIVE SUMMARY

Climate change and nature loss represent threats to the macroeconomy and the financial system. In addressing these threats, especially as they relate to long-term financial and price stability, central banks and financial regulators and supervisors (CBFS) have an important role to play.

CBFS have begun to take action on climate but are mostly neglecting the threats that broader environmental issues – including deforestation and the conversion of non-forest ecosystems – pose to financial system stability.

This report, part of a series of guidance for CBFS from WWF's Greening Financial Regulation Initiative, makes the case for action by CBFS on deforestation and conversion, and directs them towards tools that can help them take that action.

In its first section, the report sets out the importance of forests and other threatened terrestrial ecosystems to life on Earth in general, and humanity in particular. It also sets out the direct and indirect economic drivers

of deforestation, including agricultural expansion, the role of finance in enabling that expansion, and how those drivers are transmitted along supply chains and through trade.

Efforts are underway to address these drivers, through international agreements, corporate deforestation commitments, and by environmental corporate disclosure frameworks. However, notwithstanding these efforts, few commitments have been met, disclosures tend to be voluntary, and there is little consensus on metrics.

The second section then presents reasons why CBFS need to play their role in addressing the crisis in deforestation and conversion. These are that:

DEFORESTATION AND CONVERSION RISK FINANCIAL AND SYSTEM STABILITY

Through the provision of capital, the financial system supports activities that directly drive deforestation and conversion, such as agriculture and mining, as well as sectors with an indirect impact on deforestation. Meanwhile, the financial system is highly dependent, through its lending and investments, on the ecosystem services provided by forests and non-forest natural ecosystems.

The physical and transition risks involved have the potential to pose systemic threats. By working to mitigate these adverse environmental impacts, CBFS will mitigate future financial risks linked to climate change and nature loss.

CENTRAL BANKS ARE INDIRECTLY CONTRIBUTING TO DEFORESTATION AND CONVERSION THROUGH THEIR MONETARY POLICY PORTFOLIOS

Deforestation and conversion can be embedded in central banks' collateral baskets and asset purchase portfolios. Holding as collateral securities issued by companies

that drive deforestation and conversion means that CBFS are contributing to the associated impacts and risks.

The report includes a case study looking at the exposure of the European Central Bank's collateral basket to deforestation and conversion risk-commodities, and the measures it could take to reduce these exposures.

The third section describes the actions taken by some CBFS and financial institutions:

SOME CENTRAL BANKS AND FINANCIAL REGULATORS ARE ALREADY TAKING ACTION

A handful of central banks – including Bank Negara Malaysia, De Nederlandsche Bank and the Monetary Authority of Singapore – are beginning to take action on deforestation. Banco Central do Brasil has played a crucial role in encouraging sustainable practices within the Brazilian financial sector, including through measures that link the availability of credit to agricultural enterprises to their adherence to environmental regulations around deforestation.



Forest fire and deforestation to clear land for planting soybeans. Amazon Rainforest, Vilhena. © Andre Dib / WWF-Brazil

ACTION TAKEN BY FINANCIAL INSTITUTIONS IS INCIPIENT AND REGULATORY SUPPORT IS REQUIRED

Similarly, some financial institutions are beginning to take action, but these efforts are generally nascent and inadequate. This raises the potential for cascading and compounding nature- and climate-related risks.

On the positive side, extensive, detailed guidance is available to support financial institutions in identifying, assessing and eliminating deforestation and conversion risks from their portfolios. There is much that CBFS can do to help the financial institutions that they oversee begin to address these risks.

The report describes 15 tools used by financial institutions to eliminate deforestation and conversion from their lending and investment portfolios. These tools can also be used by central banks to eliminate deforestation and conversion risks from their monetary policy portfolios. The report also considers metrics that CBFS can adopt or develop on deforestation and conversion that they can apply to financial system supervision as well as to their monetary policies.

RECOMMENDATIONS FOR CBFS

Finally, the report offers a number of recommendations for CBFS to address deforestation and conversion of non-forest ecosystems. In the short-term, they need to:

- Undertake research to understand and manage the risks associated with deforestation and conversion, including systemic risks.

- Issue clear supervisory expectations for financial institutions to integrate deforestation- and conversion-related risks in risk management processes, including in their strategies and risk appetite.
- Establish expectations that financial institutions estimate the environmental materiality of deforestation and conversion risks within their portfolios, and manage them accordingly.
- Issue supervisory expectations that disclosure requirements and due diligence include deforestation-related risks.
- Apply strict regulations and penalties for financial institutions that underestimate and insufficiently manage deforestation- and conversion-related risks.
- Assess the contribution of their own portfolios to deforestation and conversion and the associated financial risks.

Over the medium term, CBFS should:

- Establish expectations for financial institutions to develop deforestation- and conversion-free policies, with clear objectives and time-bound targets, covering all their financial activities and all deforestation-risk commodities.
- Account for deforestation- and conversion-associated risks within tools used by CBFS, such as their refinancing operations and reserves tiering.
- Account for deforestation and conversion within tools such as capital requirements and credit guidance, and within their monetary policy portfolios.



Our Mission

Together, we protect the environment and create a future worth living for generations to come.

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