BRAZIL’S FOREST CODE

Implications for financial institutions
Comments and queries

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About SCRIPT

SCRIPT (Soft Commodity Risk Platform, available at www.scriptfinance) is a new freely-available system to help financial institutions understand and mitigate the deforestation risks associated with financing companies in soft commodity supply chains. The platform provides unrivalled tools and guidance for financial institutions to establish a robust sustainable financing policy and screen their portfolios to determine the companies and issue areas that pose the greatest risk to their institution.

About Global Canopy

Global Canopy is an innovative environmental organisation that targets the market forces destroying tropical forests. Since 2001, we have been testing new approaches to tackling deforestation, and guiding companies, investors and governments worldwide to think differently about our planet’s forests.

Funding

This work is part of a collaboration among the Gordon and Betty Moore Foundation and other partners designed to eliminate the loss and degradation of tropical and subtropical forest ecosystems that results from the production of globally traded agricultural commodities by ensuring that key commodities (beef and soy) are sourced only from deforestation-free areas. For more information see www.moore.org.
Key Takeaways

• Brazil’s Forest Code (Law 12.651 – 2012) establishes a regulatory framework for land use and environmental conservation on rural properties, with the purpose of protecting native vegetation.

• Financial institutions operating in Brazil can no longer provide rural credit to landowners that are non-compliant with the Forest Code requirement of registering their property in the Rural Environmental Registry (CAR).

• By introducing a legal framework for protecting native vegetation and a tool to monitor compliance, the Forest Code, and associated CAR, increases business risks for companies responsible for illegal clearance and for the downstream buyers who purchase their commodities.

• While financial institutions without headquarters or physical operations in Brazil are not directly regulated by the Forest Code, they are exposed to potential financial downsides as the related business risks may reduce the profitability of companies in their portfolios.

• In order to mitigate these risks all financial institutions, and not just those operating in Brazil, should require proof that the production and procurement of commodities is in compliance with the Forest Code before financing companies in these supply chains.

• To mitigate all business risks associated with illegal and unsustainable commodity production, financial institutions should push for best practice, going beyond legal compliance towards zero conversion of native vegetation.
What is the Forest Code?

The Brazilian Forest Code was established to regulate land use and conservation of native vegetation on private properties. The law was revised in 2012 and introduced a stronger focus on monitoring and enforcing compliance. All rural landholders in Brazil are now obliged to register their properties in the Rural Environmental Registry (CAR). The CAR is a public registry with data on rural properties and their compliance with the environmental requirements of the Forest Code.

The Forest Code establishes two main types of land under environmental protection: Permanent Protection Areas (PPA) and Legal Reserves (LR). PPAs provide absolute protection of environmentally significant areas, such as riparian zones of rivers and hilltops. Legal Reserves are the areas in which rural landowners are required to set aside a proportion of their land that must maintain native vegetation. This is either through conservation or sustainable activities, and applies even if their property does not contain PPAs. The proportion that must be set aside varies according to property size and location. Within the Amazon as much as 80% of a property must be set aside, whereas it is 35% in the parts of the Cerrado which fall within the legal definition of Amazonia, and 20% in the rest of rural Brazil.¹

Implications of the Forest Code for the finance sector

Banks operating in Brazil² are legally required under the Central Bank’s Resolution BC 4.327/2014 to check that companies and landowners are registered in CAR before providing financing, and must not finance landowners who are not. Furthermore, they cannot finance operations on properties that have been embargoed by the Brazilian Institute for the Environment and Renewable Natural Resources (IBAMA).

Financial institutions based outside of Brazil — with no branches or physical operations in Brazil — are not legally required to conduct checks on whether a company is compliant with the Forest Code. The resolution also only applies to loans and therefore financial institutions investing in companies are not required to conduct these checks, regardless of where they operate. Figure 1 shows the loans which the Central Bank’s resolution applies to, and those not directly covered by the resolution but which may still be connected to landowners and companies operating illegally.

²Banks operating in Brazil are those that are either Headquartered or have a presence, such as a branch, in the country. These are licensed to operate in Brazil by the Central Bank and therefore must comply with the Central Bank’s resolutions.
The unsustainable production of commodities creates a number of risks for producers in Brazil, as well as buyers internationally. These risks are heightened by the Forest Code as it draws additional attention and enforcement to companies associated with environmental impacts.

As illustrated in Figure 2, the operational risks, fines, reduced access to markets, and loss of access to rural credit lines by banks operating in Brazil, are all possible impacts of non-compliance on a landowner. Downstream companies risk disruption in commodity supply and the reputational risk of being...
Market risk

Increased downstream awareness of the impacts and risks associated with unsustainable commodity production can lead to restricted access to certain markets. Given that the Forest Code makes some clearance of native vegetation illegal, greater checks are more likely to be made by purchasing countries to make sure that the products entering their markets are legally produced. For example, FLEGT regulation in the EU and the Lacey act in the United States were implemented to stop illegally produced timber from entering their markets. If successfully implemented, such regulations can restrict access to key markets of consumption unless companies have proof that products stem from legal operations.

Operational risk

If a producer is non-compliant with the Forest Code requirements of legal reserves (LR) or permanent preservation areas (PPA) they face several operational risks. If properties have been clearing natural vegetation illegally after 2008 all agriculture and forestry activities must be suspended immediately and the landholders face the costs of restoring linked to illegal operations. In turn, these impacts may lead to lower production, higher costs, and reduced growth perspective, which will impact company profits and cash flow and therefore present risks to the financial institutions that finance them.

Monitoring systems and the implementation of the Forest Code

Due to more developed monitoring mechanisms, illegality from Forest Code non-compliance is more likely to be detected than unsustainable but legal practices. For example, in 2016 Brazilian Institute for the Environment and Renewable Natural Resources (IBAMA) and the Federal Public Prosecution Service (MPF) cross-checked information using maps of embargoed areas, satellite imagery, and Rural Producer Certificates to identify non-compliant properties. From this monitoring, Santander was fined for financing cultivation of soy and corn in an area which had already been embargoed by IBAMA for non-compliance with the Forest Code. IBAMA embargoes are issued to individual properties and the lists of embargoed properties are made public. Owners are not permitted to grow anything else on these areas and nor should agriculture in these areas be financed.

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the areas. Illegal clearing prior to 2008 means landowners have to either restore their lands or pay to offset their deficit. If landholders do not comply with this they will risk fines and may have areas embargoed⁴. Embargos affect the whole supply chain, for instance in 2017 JBS, one of the largest meat processing companies in the world, was sanctioned for sourcing beef from cattle ranchers embargoed by IBAMA⁵. The ranchers in question had deforested illegally.

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**Figure 2: How the Forest Code presents risks to financial institutions, through risks to the businesses they finance.**

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**Reputational Risk**

Reputational and brand damage from being linked to unsustainable clearance of native vegetation can affect business profitability, which has impacts throughout the supply chain, and for the institutions that lend to or invest in these companies. The Forest Code presents increased reputational risk because it adds illegality to the sustainability conversation. Where misalignment or ambiguity may exist in what constitutes sustainable practice,
legal compliance is much clearer. In turn, this makes it easier to hold companies and financial institutions to account against legality issues rather than sustainability issues.

**Physical risk**

The set-aside of protected areas is to protect the natural ecosystems that underpin many natural processes in Brazil and the world. This includes processes that agriculture depends on, such as the water cycle and pollination. Clearing areas that were designated to be protected could reduce the productivity and yields of the property and affect the profits of the business.

The Forest Code maintains these ecosystems and the services they provide and therefore compliance with the code reduces the physical risks landowners face from clearance. This in turn mitigates financial risk to the landowners, buyers and financial institutions.

**Expectations and recommendations for international financial institutions**

As a minimum financial institutions who finance landowners and producing companies in Brazil directly should require clients to provide proof that they are compliant with the Forest Code. Financial institutions providing capital to downstream companies should require their portfolio companies to only source from companies compliant with the Forest Code, and ask for verification of this.

Financial institutions should engage with companies that do not meet this requirement to ensure that they understand how the Forest Code impacts their and/or their suppliers’ business, and put in place a time-bound plan to meet these targets, thereby improving their clients’ productivity and the financial institution’s own returns.

Financial institutions should ultimately push for best practice in mitigating the risks outlined in this brief and for conservation of the important ecosystems that the Forest Code aims to protect. Under the Forest Code, 92 million hectares of native vegetation can be legally cleared\(^6\). But legal clearance of that land also exposes supply chains and financial institutions to similar reputational, operational and physical risks as illegal clearance\(^7\). Unsustainable clearance exposes companies to the same

\(^6\) [http://journals.plos.org/plosone/article?id=10.1371/journal.pone.0152311](http://journals.plos.org/plosone/article?id=10.1371/journal.pone.0152311)

physical and reputational risks and can reduce access to markets as consumer demand for more sustainable products increases.

Beyond compliance with the Forest Code, financial institutions should push for companies to protect all forest habitats and native vegetation. The demand for agricultural commodities until 2040 can be met without any further deforestation\(^8\). Financial institutions should expect and ask companies to put in place zero deforestation or conversion commitments and time-bound plans to implement these.

Financial institutions can push for best practice through engagement, setting deadlines for companies to meet sustainability targets or by offering more favourable credit to companies who can prove that their production and procurement is sustainable. Guidance on developing policies and engaging with companies is available online at script.finance.

\(^8\) https://www.sciencedirect.com/science/article/pii/S0959378014001046