HSBC Global Research

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Paradise Lost?

Investing in natural capital and biodiversity

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ESG

- "Resilience" is the word of the hour in light of the pandemic – for businesses, economies and our natural ecosystems
- Our very existence relies upon stemming biodiversity loss now; investors and policymakers are increasingly alive to this fact
- We highlight three ways investors are affected

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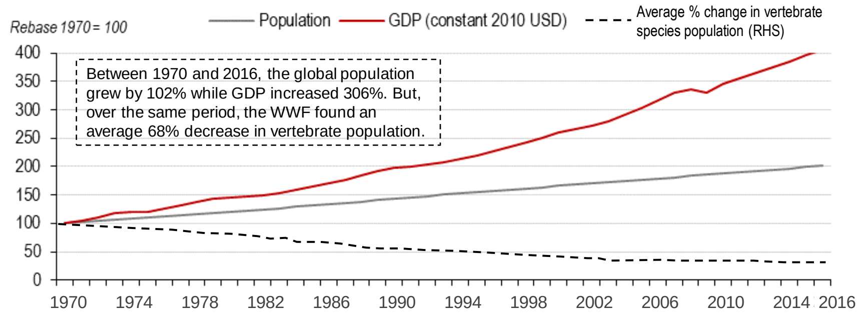
Biodiversity loss presents a "systemic risk" for the global economy, according to a UN report. The COVID-19 pandemic continues to throw into question much of what we do, how we operate as one humankind, and our relationship with the earth's natural capital. Thus, the topic of "future resilience" is high on agendas. The report estimates a USD4.1trn financing gap in nature which must be closed by 2050 if we are to meet critical climate and biodiversity targets. We sense renewed ambition from investors and policymakers to address ecosystem degradation, and expect to see further developments at the UN Biodiversity Conference in China in October this year.

A crisis awaits: Despite posing significant threats to society, economies and business, biodiversity loss has garnered less attention from investors and policymakers than other sustainability issues such as climate change. A recent report finds humans – making up just 0.01% of all living creatures, have caused the loss of 83% of known wild animals, and 50% of plants (Economist Intelligence Unit). Three quarters of land and two thirds of oceans have been "severely altered" by human actions, putting close to a million species at risk. We rely on biodiversity for our very survival; for food, raw materials, weather regulation and medicine – half of all modern drugs are developed from natural products. And, continued rates of ecosystem decline could cost USD9.87trn over 2011-2050 (WWF).

Changing tides: It is hard to quantify the biodiversity crisis given its heterogeneity, and as a result, it is *very* hard to solve. But motivation is clear; investor engagement programmes such as Nature Action 100 have been proposed, and biodiversity frameworks and methodologies are rising in popularity. And, from Kenya to the Philippines, China and the UK – biodiversity related policies and pledges are weaving their way into national strategies. We believe all of these factors will be pivotal if we are to close the significant biodiversity financing gap. We explore three courses of action for investors.

Chart 1: Financial and human capital coming at a cost to natural capital



Source: World Bank, Living Planet Index, WWF

This is an abridged version of a report by the same title published on 01-Jun-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Investing in biodiversity

Biodiversity loss is widely accepted as a significant threat to our existence, but the inability to easily measure and value biodiversity means it has been relatively under considered by investors, policymakers and society, in our view. Valuing biodiversity is challenging when we are yet to fully know all of the species on this planet, and when the value we hold in a specific species (both alone and as part of the broader ecosystem) is almost completely unquantifiable. The rate of ecosystem decline is hard to track, and ensuing risks are typically slow-onset rather than event risk.

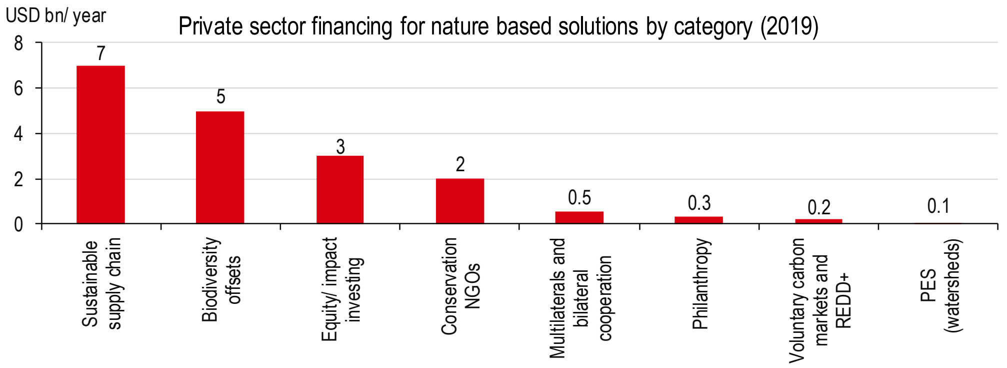
> **The health of ecosystems on which we and all other species depends is deteriorating more rapidly than ever. We are eroding the very foundations of our economies, livelihoods, food security, health and quality of life worldwide**
>
> **Sir Robert Watson, Chair of the IPBES**

Biodiversity financing gap

And so, whilst this area does still remain at a nascent stage, we believe that the market and governments alike are demonstrating a marked enthusiasm for biodiversity considerations. There is room for this market to grow dramatically, too. According to a recent UN report "State of Finance for Nature", the world needs to close a USD4.1trn financing gap in nature by 2050. Current investments are estimated to be close to USD133bn – only about 0.1% of global GDP. The vast majority of funding currently is public.

A number of existing private sector finance instruments for promoting biodiversity conservation include: debt-for-nature swaps; tourism revenues; biodiversity offsets and direct voluntary payment for ecosystem services. However, these are typically not scalable or within the mandates of mainstream investment funds – it is these large pools of capital which need to integrate biodiversity risks into their methodologies, stewardship and asset selection strategies, if the financial services sector is to play a material role in addressing the crisis. Chart 2 demonstrates the most popular channels for private sector financing. Sustainable supply chains are by far the most popular, and a consideration that we touch on in this report.

Chart 2: Supply chains most common private sector consideration for biodiversity



Source: United Nations "State of Finance for Nature", HSBC

We set out three key areas where we believe investors will focus their efforts on preventing biodiversity loss in the near term:

1. Responsible investment: engagement, voting and disclosures
2. Improved methodology and data collection (and potentially increased use of mean species abundance metrics)
3. Asset allocation that incorporates broader environmental considerations into investment frameworks (including pollution, ocean and land degradation, and supply chain considerations). Chart 2 demonstrates how supply chain considerations were some of the most common private sector financing solutions in 2019.

Methodologies and data lag behind

We believe most progress will come from investors around asset allocation and responsible investment processes, whilst data and measurement lag behind due to the complexities associated with quantifying biodiversity, its value, and its rate of loss.

Concluding thoughts

The unfortunate fact is that as the global population increases, our demands for food and energy will increase, placing ongoing and unprecedented strain on our natural capital. Avoiding this will require fundamental changes across technology, economies and society. Until then, as the world continues to warm, climate change will further alter the biosphere and its ecosystems. As investors and policymakers become increasingly alive to these risks, we believe that investors should be prepared for government policy change, increased pressure to engage with corporations, efforts to standardise and measure biodiversity related risks, and heightened awareness of supply chain “hotspots”, where deforestation and threatened species may be more common.

This is an abridged version of a report by the same title published on 01-Jun-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

The full note contains sections on how investors can integrate responsible investment into their investment strategy, how biodiversity related risks will increasingly become prominent in ESG integration related decisions, and how, ultimately, an evolving government policy is key to move biodiversity to the fore of investment and corporate decisions

Disclosure appendix

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