

China Certified !

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Presentation Outline

- Overview of HSBC's Forest Land and Forest Products Policy
- Challenges of implementing this in China
- Observations of the forestry sector in China
- Forest Financing structure

Overview of Forestry Policy

- First established May 2004, to be re-issued Q2 2008
- Sector scope
 - forestry & logging
 - primary and secondary timber processing such as sawmilling, manufacture of panel products and wooden furniture
 - timber trading (importers, exporters, agents & wholesalers)
 - pulp & paper manufacture
 - plantations (timber, oil palm, soy & rubber)

Overview of Forestry Policy (cont)

- FSC certification scheme is the HSBC benchmark though a number of others are equally recognised
- To be considered compliant, a customer's business must be 70% certified (by area or volume), with the remainder evidenced as legal
- Credible path – we support a step by step approach towards compliance, provided it is time-bound
- For non-compliant customers, who have made little or no tangible progress, an exit is encouraged

Client Compliance Matrix

Credit FIM, Guidance and Commercial Policy C4.3.3.3

HSBC Forest Land and Forest Products Sector Policy

CLIENT COMPLIANCE MATRIX

Date: _____

Client: _____

Business Type: _____

Office: _____



	Issue	4. Non-Compliant (Illegal)	3. Near-Compliant (Legal)	2. Compliant (Sustainable)	1. Leader
Commitment	a Environmental policy	No policy	Excludes illegal timber.	Excludes illegal timber & conserves biodiversity (including responsible land clearance).	Excludes illegal timber, conserves biodiversity & provides independent certification.
	b Social policy	No policy	Consults with & employs local communities, within local law.	Consults with & employs local communities, respecting customary use rights.	Engages with & provides benefits to local communities, respects customary use rights & provides independent certification.
	c Management accountability	No clear responsibilities	Staff member responsibility.	Senior manager responsibility	Clear board level responsibility
	d Stakeholder engagement	No engagement with external stakeholders.	Limited engagement with industry bodies such as trade associations.	Proactively engages with some stakeholders (including potential critics).	Proactively engages with industry bodies, NGOs & consultants (as appropriate).
	e Transparency	No disclosure.	Limited sharing of policies.	Public disclosure of policies.	Public disclosure of policies & performance.
	Assessment of Commitment				
Capacity	f Staff capability	Staff neither trained nor competent on sustainability.	Some staff trained & competent on sustainability.	Staff trained & competent on sustainability.	Staff are experts & provide external training & guidance on sustainability.
	g Funding capability	Doubts over the availability of funding for action plans & certification.	Funding will be made available for action plans & certification programme.	Funds are available for certification action plans.	Capability & budgets to fund full certification programme.
	h Environmental management systems	No documented systems in place or no apparent systems at all.	Systems in place, but documentation and reporting are limited.	Clear & documented systems, with reporting capabilities.	Sophisticated internal systems to ISO 14001 standard or equivalent.
		Assessment of Capacity			
Track Record	i ** Certification position **	No commitment or progress towards independent certification of legality or sustainability. Involved in illegal logging or Prohibited Business.	Progressing: Commitment to legal timber, plus tangible progress towards independent verification. Advanced: Timber is certified as legal, with progress towards sustainable timber, based on a credible action plan	A minimum of 70% of timber (by volume or hectares) is certified by an approved scheme as sustainable. The remainder can be proven to be legal, with a public policy to avoid illegal timber.	100% of timber is certified as sustainable by an approved scheme.
	j Recognition	Fines levied by regulatory bodies and/or valid adverse media & NGO comments	No public profile or historic (older than 1 year) criticism being handled proactively.	Recognition by media and/or NGOs, without awards or criticism.	Awards received for best practice in environmental and/or social management.
	k Support	No external support utilised.	Use of third party support (eg trade association).	Use of recognised consultants to achieve legality.	Member of Certification Support Programme with objective of sustainability.
		Assessment of Track Record			
Sustainability Risk Rating of client					

Notes

- a) This matrix is to be used to assess a client's compliance with the Forest Land & Forest Products Policy and to provide the Sustainability Risk Rating for the client.
- b) Logging companies will require reference to forest management certification and progress monitored by reference to area (eg hectares).
Primary processors such as sawmills, plywood mills and furniture manufacturers require reference to chain of custody certification and progress monitored by reference to volume (eg cubic meters).
- c) The client's Track Record on certification progress is the principal driver of the overall Sustainability Risk Rating, with Commitment and Capacity being good indicators of progress along the "credible path".
- d) Complete the grid by inserting an "X" in the relevant grey boxes, making allowances for the size of the client where appropriate (eg on engagement).
- e) Refer to the list of HSBC-Approved Certification Schemes in Appendix 3 for details of whether a scheme is approved and whether there are any gaps in a scheme which a client needs to resolve.
- f) Use the boxes over the page to provide details of a client's activities and, where appropriate, progress towards compliance with our Policy.

Forestry Policy – other features

- Sustainability also includes social issues
- Prohibitions – High Conservation Value Forest, Primary Moist Tropical Forest, Critical Natural Habitats, Endangered Species
- HSBC recognises some schemes in terms of legality, others for both sustainability and legality

Forestry Policy – other features

- Preferred certification support providers are Rainforest Alliance, ERM, Global Forest & Trade Network, ProForest, SGS, TFT, URS
- Applicability
 - all customer groups, not just Project Finance
 - materiality and common sense must be applied
- Commitment, Capacity and Track Record

Practical Application of the Forestry Policy in China

- Some of these concepts are still quite new to China, given HSBC's standards are global, and our Chinese customers generally focus on provincial standards
- Chicken and egg problem – certification is desirable but costs money that could be deployed into a growing business
- Customers must meet provincial standards as a starting point, then a gap analysis is performed to determine the credible path

Practical Applications in China (cont)

- HSBC encourages national certification schemes to develop – we watch the situation in China with interest
- Training a relatively inexperienced workforce on these issues is a challenge
- Our network in China is still relatively small (17 branches), therefore coverage of customers in remote areas is difficult
- “My other banks aren’t asking these questions”

Observations of forestry in China

- The government is supporting the introduction of large, high-tech pulp and paper mills, replacing smaller, less efficient mills
- While the majority of imports are from well-managed forests and plantations, about 32% are from E. Russia and Indonesia, where forest governance capacity is low
- Risk of including illegal wood in final product is therefore high
- The greatest environmental challenge for China's fibre consumption is to ensure that its pulp imports from "high risk" countries is legal and sustainable

Observations of forestry in China (cont)

- China is importing huge volumes of old magazines, newspapers, catalogues from the West because it is cheaper/quicker than growing trees locally and pulping them
- This is also positive for the environment – use of recycled paper products is very common in the West

Forest Trends' Constructive Recommendations

- Systems should be established that track wood all along the supply chain
 - all imported pulp should be certified as to sustainability of supply
 - all pulpwood imported should be certified that it was harvested from sustainably managed forests
- Chinese government assistance is required to actively promote certification, log-tracking, supply chain approaches

A black and white photograph of a forest scene. In the foreground, there are several tree trunks and a dense thicket of branches and leaves. A red rectangular box is overlaid on the left side of the image, containing white text. The text reads "Innovative Finance for Sustainable Forest Management".

**Innovative Finance for
Sustainable Forest
Management**

Financing Forests: Current Trends

Commercial operators in natural forestry face significant risks, typically

-Political risk

-Insecure property rights

-Property loss

-Income loss

-Operational risk

-Reputation

-Investment liquidity

The key to unlocking long term capital lies in the cost effective management and mitigation of these risks

- International capital flows into natural forests are currently limited
 - There is a strong correlation between poor access to capital and high deforestation rates. The high returns required by investors encourage unsustainable forestry practices, which focus on the value of the timber rather than the wider ecosystem.
- Most international investors see natural forestry as an equity play
 - Limited timber extraction at sustainable levels requires large-scale operations. Many investors looking for higher short term returns will not practice sustainable forest management. Most debt finance is short term working capital or 1-3 year term loans.
- The use of securitisation would allow forest operators to borrow against future income.
 - This would incentivise operators to protect the long term value of their forest assets.
 - Financing structures could include funding costs of certification, harvesting and processing equipment and technical assistance. It could also include cashflows from emerging ecosystems markets such as carbon, watershed protection and biodiversity offsets, adding further incentives to protect forest assets.
- Feasibility is dependent on risk mitigation and credit enhancement
 - This could be achieved through country selection, asset diversification and third party credit enhancement. Economic/political stability and effective forest governance are key to country selection. The ability to secure political risk cover, long term offtake contracts and insurance will reduce risks and provide credit enhancement.

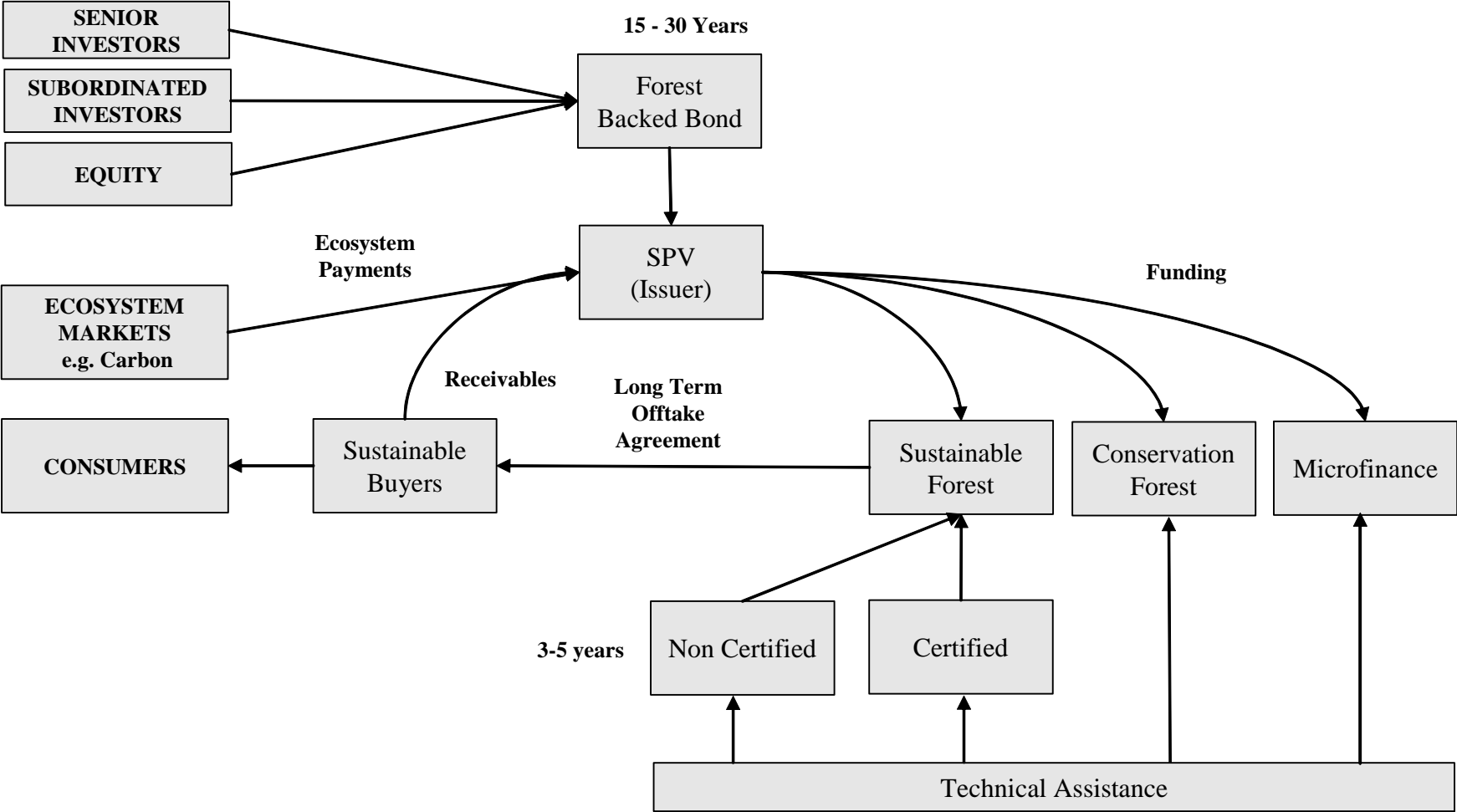
Forest Backed Bond: Key Features

Forest-backed bonds combine conventional securitisation techniques and emerging eco-systems markets. Applied to forestry, they aim to provide access to longer term finance, one of the missing elements of Sustainable Forest Management (SFM).

The issuance of forest-backed bonds will create a long term capital pool accessible to SFM operators and investors. This will enable the creation of long term asset value rather than short term yield.

- Any financing structure would need both credit enhancement and risk mitigation
 - Private sector investors will require a third party to take first loss (equity) risks in any long term structure. There will also be certain other risks that they will not bear, such as some political risks, insecure property rights, property/income loss and operational risks.
 - If these risks can be covered by first loss/equity investors and/or third party insurance, senior investors will be more prepared to extend the tenor of the bond (15-30 years or more) and accept lower (debt type) returns.
 - Government/multilateral aid could be diverted to fund the equity tranche; this would act as a **catalyst** for other development banks and institutional investors (insurance companies, pension funds) to provide senior/subordinated debt and **leverage** government/multilateral funds.
 - Government/multilateral involvement could be by way of funded first loss/equity or guarantees or both.
 - The availability of insurance for medium-sized forestry operators increases the potential to include them in the portfolio.
- Capital markets are unlikely to deliver the tenor required at an affordable price without credit enhancement and risk mitigation
 - Long term investors are looking for assets that match the tenor of their liabilities, often 30-50 years.
 - We believe there will be demand for long term forest backed bonds, provided there is some form of credit enhancement (first loss/equity tranche, credit insurance) and certain risks (political, operational, property rights) are mitigated.

Forest Backed Bond: Conceptual Structure



Forest Backed Bond: Benefits

- The scoping study has outlined the potential and both public and private sector players are now involved
- There is potential for significant demand from private investors for forestry investment vehicles but public sector support is required to catalyse it.
- This could facilitate other countries to provide funding, adding to the multinational dimension of this structure
- This initiative could assist the development of ecosystems markets such as carbon, watershed protection and biodiversity offsets, increasing the value of the world's forests.
- It could also support pro-poor funding, either with a direct microfinance tranche or guarantees to support local bank funding for forest dependent people.

A black and white photograph of a forest. In the center, a person is climbing a tree trunk using a ladder. The forest floor is covered with dry branches and leaves. The background shows more trees and foliage.

Innovative Finance for Sustainable Forest Management