

# **Finance response to market demands in the forest sector**

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## **Management of Responsible Finance**

Ladies and Gentlemen,

In this morning's session, we heard the various government responses to the policy framework that governs forest management and forest products trade. In this plenary, we have here the business responses to the changing policy and market conditions. I will now speak about an equally important stakeholder in this process – that of institutional financial investors and the role of finance in shaping the forest businesses.

My presentation will address three fundamental questions:

- What is at stake about the forest sector that is relevant to bankers?
- Why have financial investors taken proactive steps to address social and environment concerns in their lending in forest sectors? And
- How are financial institutions responding to the financial needs in this sector in a responsible manner?

### **What is at stake?**

Despite its value to humanity, over 50 percent of the world's original forest cover has disappeared and forests continue to be lost at a rate of 9-16 million ha/year. At the same time, the quality of much of the remaining forest is declining rapidly. Without significant changes in policy and practice, the process of forest conversion and degradation will continue at this alarming rate and pose a major threat particularly to High Conservation Value Forests. This has serious socio-economic consequences for the lives of forest dependant peoples, and threatens numerous animal and plant species. Forest loss not only causes job losses and reduced GDP, it disrupts water balances, causes soil degradation, and impacts at a global scale, through climate change, loss of potential wood and non timber forest products. The global trade in forest products has an estimated annual value to the scale of 270 billion US.

By financing projects such as pulp and paper mills, palm oil plantations and forest timber extraction, financial institutions can have a significant impact on forest conversion, degradation and destruction. In recognition of such risks, and society's increasing social and environmental expectations of the financial sector, leading players have started to screen potential projects according to environmental and social criteria. By doing so, the financial sector is beginning to contribute towards sustainable business models by promoting environmental stewardship and socially responsible development.

NGOs have also increased the pressure on financial institutions to play a more positive role in advancing environmental and social accountability, and in January 2003 a coalition of NGOs launched the "Collective Declaration on Financial Institutions and Sustainability". The Declaration calls for commitment to six key principles: sustainability, 'do no harm', responsibility, accountability, transparency and sustainable markets, and governance.

### **In RESPONSE**

In response, the Equator Principles, collaboration between commercial banks and the International Finance Corporation of the World Bank Group, was launched in June 2003. Initial EP signatories included: Citigroup, Barclays, Credit Suisse, HSBC and Standard Chartered amongst others. The Equator Principles is one of the first industry-wide attempts to encourage environmentally and socially responsible lending.

The principles require the banks to adhere to the IFC's guidelines and policies for sustainable development, which include safeguards on issues ranging from environmental impact assessment, natural habitats, involuntary resettlement, indigenous peoples and child labour. In 2002, the 10 original signatory institutions alone underwrote some \$14.5 billion in project loans (equal to about 30% of world syndication) and therefore have the potential to make a significant contribution to improved environmental stewardship and socially responsible development.

While NGOs welcome the efforts of these leading banks, they continue to press Equator Principle signatories on several issues including: using a precautionary approach rather than one based on mitigation; disclosure of their environmental management systems i.e., explaining how they implement and monitor the principles; and the lack of accountability mechanisms.

The increasing NGO pressure on international financial institutions to implement investment safeguards is beginning to show some tangible results, especially when it is combined with a strong business case for comprehensive environmental and social due diligence procedures. Banks that are spending more and more of their energy, time, and assets in managing both financial and reputational risks are missing opportunities.

While the Equator Principles begin to address the broader 'Corporate Social Responsibility' (CSR) agenda, WWF has been working with these institutions to develop investment policies that address sector specific investments that impact the forest industry. The WWF Guidelines for Investment in Operations that impact forest published in 2003 was intended to provide guidance for the forest policy of financial institutions starting with development banks and later with a diverse group of commercial banks, investment banks and others. We helped shaped their internal banking policies on how to manage their responsibilities in safeguarding the environmental and social qualities of forests impacting projects. We worked with these institutions in the area of capacity building and training for their frontline managers to screen investments based on the social and environment principles. Some conditions in the policies include:

- commitment to identify and protect high conservation value forests in areas managed by the company
- a call on companies to eradicate corruption, illegal practices and abandon unsustainable logging practices and adopt guaranteed and controlled sustainable forestry management and wood sourcing
- a respect and guarantee of the rights and livelihoods of people living in and around the forest
- stop the conversion of natural forests with high conservation values into timber, or pulp plantations, pastures and croplands
- to have in place or a clear indication of moving towards Credible certification and chain of custody.

## **How are financial institutions responding to the financial needs in this sector?**

Five years on, today, we wanted to know if the application of environment, social and governance screening criteria were delivering significant improvements in forest management or simply driving non-compliant forest sector clients towards alternative sources of finance.

To track the change and transformation, WWF commissioned a study this year to survey over 40 financial institutions ranging from private equity, local and international banks, development banks, trade finance and microfinance institutions to understand the different approaches to finance the forest business and the effective implementation of the sustainability policies within each institution. We wanted to better understand the type of projects that financial investors considered as being most attractive, their preferred mechanisms for providing financing, potential areas of engagement and action to catalyse responsible forest finance.

I like to highlight some of the findings in the study:

Multinational operators have access to a diverse range of financing mechanisms. Large operators have the internal resources needed to develop and run the complex management reporting systems needed to authenticate and support sustainability claims. In addition multinationals are important sources of demand for those local SME that can meet their operational standards.

By contrast the challenges faced by the majority of tropical forestry SME in raising money are well documented; difficulties in funding working capital and expansion requirements, the high cost of implementing certification standards to name a few. Where it is available local capital is generally expensive and difficult to secure, particularly for longer term projects.

Our survey also suggests a slightly different picture – several banks interviewed highlighted the lack of good quality business proposals and the risk nature of the forest sector as a key obstacle to their greater involvement. In most cases the cost of applying and maintaining environment, social and governance screening is disproportionate to the income that forestry sector businesses generate for these institutions. Unless more cost effective ways of delivering responsible forest finance can be found, the case for these institutions remaining engaged is more likely to be based on corporate responsibility than commercial logic.

Our findings also reinforce the importance of matching specific forest sector business proposals with the most appropriate financial mechanism and institution for their circumstance. This applies to traditional forms of finance (equity and debt) as it does to more innovative approach.

I like to take the remaining time to address the issue of financial risk – this is by far the most critical consideration of any investor/banker in their decision to inject capital into a forest company or any business for that matter.

### **Financing Risk**

The diverse nature of the international financial community reflects the fundamental trade off between risk and return. At the one hand of the spectrum sits risk adverse institutions such as banks that accept lower returns for taking lower risk whilst on the other sits opportunistic investors such as private equity and hedge funds that strive to maximize their returns by taking higher risk. Financial institutions therefore assess opportunities in the tropical forestry sector

based on where they themselves sit within the risk spectrum. For this reason, the same aspect of a tropical forest sector opportunity can be weighted completely differently by different institutions. Matching the right project with the right financial institutions is the essence of successful funding.

Risk considerations tend to fall into 3 sectors:

Country Risk, Sector Risk and Project Risk

### Country Risk

It is useful to first reflect on the economic background against which tropical forestry businesses operate: -

- Tropical economies – frontier markets especially are quintessentially high risk investment environments; They attract opportunistic investors more easily than risk adverse institutions
- Global consumption is driving demand for cheap agricultural land
- Tropical economies are the fastest growing market for tropical timber products
- There is significant demand for tropical timber products both in internal markets (eg. Brazil and Southeast Asia) and between tropical countries – (eg. Mexico is the primary market for tropical timber products from Peru)
- China is the dominant export market for tropical timber products

Equity investors play a dominant role in financing tropical forestry businesses, particularly in plantation management where delayed income makes it difficult to convince commercial lenders that debt will be serviced in a timely manner throughout a term. Development and multilateral finance institutions are the leading lenders to the sector, and also play a catalytic role in enabling private lending and trade finance through various forms of credit enhancement. By transaction volume: timber processing and in particular the pulp and paper sector is the most significant recipient of these funds.

### Sector Risk

This is the next level of risk analysis carried out by financial institutions relating to the forest sector within country. These risks include: -

- Reputational risk: accountability by civil society. by financing controversial projects, banks are attractive targets for NGO campaigns,
- Compliance risk – regulatory regime relating to concession rights, ownership structures, taxes
- Operational risk that includes climatic vulnerability caused by poor environment planning resulting in losses due to floods, fires, disease
- Infrastructure – access to markets, supply of power, access and proximity to water sources
- Market risk – demand for sustainable forest products, presence of competition

Forestry operations are typically located in relatively remote regions, and as such, there is a high correlation between the location of forestry projects and the presence or predominance of indigenous communities in the same regions. This often leads to a complex operating environment in terms of the relationships that forestry companies must negotiate, in order to obtain and retain the goodwill and informed consent of the local population where extractive activities are concerned. The social license to operate required for successful operations is not something that can be taken for granted and can easily be compromised.

### Project Risk

This is the final level of risk analysis taken out on the business itself. The forest sector value chain presents a number of different business models each with their own risk profile from plantation

(reforestation), concession management, primary processing (sawmilling), secondary processing (furniture production) and distribution.

One of the clearest signals to emerge in our study was the relatively low number of banks willing to consider lending for forestry management, in comparison to those that would look at processing. Forest management is deemed higher risk, and few institutions are willing to accept standing timber as collateral. Project risks associated with forest management cited include unclear ownership structure, lack of progress on certification, credit risk, over-reliance on unproven revenue models (such as carbon or eco-system services) and unrealistic or unsubstantiated assumption about growth and yield/inventory levels of commercial timber species.

While international commercial banks are playing an increasingly important role in tropical economies, their overall exposure to the forestry sector has decreased.

That said, the emergence of forest funds have strong in house capacity for identifying and evaluating tropical forestry management project risk, and are generally structured to mitigate these risks internally eg. by investing in a portfolio of forests of different ages and in different locations.

Honorable guest, I thank you for the opportunity to present these findings to you. WWF continues to engagement the finance community to establish responsible lending criteria, strengthen their internal capacity in the application of the policies in their investment decisions....all this in the hope that we can influence companies towards better and sustainable forest management and in the hope that investments, when done in a right way will safeguard the rich and diverse assets that is found in the remaining forest, stop rapid conversion of high conservation value forest, control the rate of deforestation and degradation.

Please do not hesitate to speak with me after the session if you like to know more about WWF's engagement with financial institutions.

Questions that Rico will ask

**1. Looking at some of the international banking standards such as the Equator Bank Principles and the United National Principles on Responsible Investments, how has these standards influence banks in the way to do business and make investments in the forestry sector?**

### **Sustainability Trend**

A trend emerging is not so much to the design and introduction of investment guidelines and tools as to their application. Sustainability department originally emerged as specialist functions within risk management, resulting in centralised strategy planning and decision making. Several banks appear to be exploring ways to streamline this process. The “new owners” of sustainability are likely to be front line staff sitting in a very different environment to their predecessors.

We also anticipate significant future demand for services that support the application of existing investment guidelines and tools within commercial banks. If recent trends continue we believe that competition from international banks will increase interest in sustainability amongst local banks.

**2. How have some of the banks operating in Asia responded to the evolving policy and market demands in the forest sectors - Are there differences between the responses of international vs domestic banks?**

In theory, local banks are in a better position to lend to local forestry businesses – local knowledge, networks. One finding of the research conducted was the local banks may have little or no engagement at all with the forestry sector or that they are not open to their exposure in the sector.

**3. How has the interface between WWF and some of the financial institutions that you work with help to improve company operations and eventually change the way businesses operate and become more sustainable.**

GFTN's step wise approach