4.2 Decoupling international finance from deforestation, and the need for regulation

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Introduction

Efforts to address deforestation and human rights issues in the production of forest-risk commodities such as palm oil, pulp and paper, rubber and timber have resulted in a surge of commitments from a range of supply chain actors. Scrutiny is now turning to the adequacy and implementation of those commitments. Less explored so far has been the impact of the financial sector in guiding the provision of financing to clients who operate in these sectors.

Like supply chain actors, banks and investors have the potential to exert influence over companies whose activities affect forests. Some financiers have adopted voluntary commitments to heightened due diligence on the financing of forest-risk sectors, and a handful have gone further and prohibit significant impacts on valuable forest ecosystems. Since the Paris Agreement on climate in 2015, a small number of financial institutions, like their corporate counterparts, have made zero deforestation commitments (GCP 2016). However, these voluntary commitments have not been sufficiently incorporated in policies to protect people and forests affected by the companies who work in forest-risk sectors. This is because such policies have been introduced largely in Europe and the USA and then only to varying degrees. Moreover, many financiers who have established voluntary safeguards appear to ignore them, routinely retaining clients in breach of their own standards.

FINANCIAL SECTOR REGULATIONS MUST DIRECT FINANCE AWAY FROM HARMFUL INVESTMENTS.

This article presents information about the financing provided to agricultural and forest-commodity companies in sectors where there are high risks of deforestation, human rights abuses and social conflicts. It explores how financial sector regulations in key jurisdictions could transform the allocation of capital away from harmful investments, such as those

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that facilitate deforestation and rights abuses. This could have the additional benefit of addressing a critical issue that hampers financial institution policy development in this area: competition to provide financial services to sought-after clients. Financial regulation creates a fair context for financiers, and forces companies to improve their practices.

Huge sums of money involved

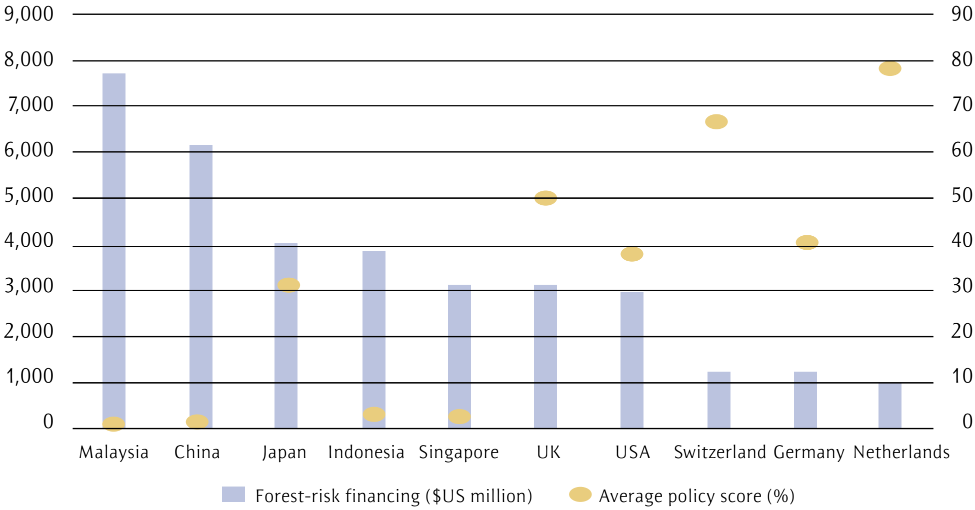
There are no detailed statistics at the global scale on the value of financing provided by banks and investors to companies at high risk of causing deforestation; neither banks nor investors nor their client companies are very transparent about this. However, the fragmented data that is available, mostly from annual reports and financial databases, suggests that the amounts are significant. Investigations by Profundo, Rainforest Action Network (RAN) and TuK Indonesia (see RAN 2016) found that 50 large agribusiness companies with forest-risk sector operations in Southeast Asia received at least US$ 38 billion in the form of corporate loans and underwriting of new share and bond issues between 2010 and 2015. The banks most involved include Malayan Banking, CIMB (Malaysia), DBS, OCBC (Singapore), Mizuho Financial, Sumitomo Mitsui Financial, Mitsubishi UFJ (Japan), HSBC, Standard Chartered (UK), JP Morgan (USA), China Development Bank, Bank Mandiri and Bank Negara Indonesia.

Gregory (2016), using different data from Profundo, also identified financial flows on a similarly vast scale through companies alleged of land grabbing, all of whom are active in sectors with high deforestation risks. Most of them had operations in Southeast Asia; 23 companies had received nearly US$ 50 billion in loans. Banks had helped them raise more than US$ 20 billion through underwriting new share and bond issuances over the period 2010–15, while banks and investors worldwide held more than US$ 50 billion in the bonds and shares of these companies. Asian banks and investors were the largest source of finance, but EU-based banks and investors were also significantly involved, led by HSBC (UK), BNP Paribas (France), Standard Chartered (UK), Rabobank (Netherlands) and *Crédit Agricole* (France). EU banks and investors accounted for nearly 40% of the loans to the companies surveyed. They had underwritten more than 25% of the money raised from new bond and share issues, although were relatively insignificant as shareholders.

Voluntary safeguards falling short

Only a limited number of banks and investors identified in the two studies have voluntary guidelines or policies that acknowledge environmental or social risks in operations in forest-risk sectors. The RAN/TuK/Profundo study (RAN 2016) assessed the safeguard policies of 28 commercial banks that provided most of the financing to forest-risk sectors in Southeast Asia in 2010–15. Evaluated against 15 criteria — incorporating environmental, social and governance risks and impacts typically associated with tropical forest sector operations — each bank received a score out of 30 (Figure 1). The findings show an overall lack of attention to the risks, especially environmental, posed by forest-risk sector clients. Banks with higher scores tended to be less significant financiers of forest-risk sector companies; those with lower policy scores were generally more important as financiers. There was little compliance with voluntary standards, even by banks with higher policy scores.

Figure 1. Forest-risk financing (US$ million) and average policy scores, 2010–15



Note: top 50 companies engaged in forest-risk sectors in Southeast Asia. Source: RAN 2016.

All 28 banks fell short on environmental standards, particularly regarding forests. Banks from China, Indonesia, Malaysia, Singapore and Japan did not have policies specific to forest-risk sectors. Of those from Europe and the USA that had forest sector policies, very few explicitly prohibited degradation or conversion of natural forests or operations in high conservation value or high carbon stock forests. Even Deutsche Bank and HSBC, which have made zero deforestation commitments, were found to have insufficient safeguards. In terms of social safeguards, very few banks required proof of free prior and informed consent, or a check of land tenure legality in operations and sourcing, which is a key issue in forest-risk sectors. Furthermore, many financial institutions, including those from Europe and the USA, do not require companies to have grievance mechanisms.

Asian banks, many of them located in tropical forest regions, had both the highest levels of forest-risk sector financing and the lowest scores on policy commitments and safeguards. European banks generally scored average to good in terms of policy adequacy, with a lower level of financing exposure (particularly the Netherlands and Switzerland), while USA and Japanese banks scored poor to average. Japanese banks in particular were found to have significant exposure to the forest-risk sector and no relevant publicly available forest-sector policies, with safeguards limited largely to project finance through the application of the Equator Principles. In theory, financial institutions with stricter policies should provide less financing to forest-risk sectors, because many companies do not meet their stated requirements. Conversely, financial institutions with no policies on environmental, social and governance risks and impacts, or only very weak policies, have a larger market to provide financing to. However, even where they exist, such policies clearly do not always translate into practice.

The three highest-scoring banks in terms of policy commitments and safeguards were ABN Amro (policy score: 24/30), Rabobank (23/30) and Credit Suisse (20/30). Even these banks have financed controversial clients in recent years, including some companies alleged to have carried practices such as converting high conservation value forests, peatlands and natural forests; illegal logging; operating on illegally awarded concessions, use of child labour; and abuse of workers' rights. Japanese banks Mizuho Financial (10/30), Sumitomo Mitsui Financial (10/30) and Mitsubishi UFJ (10/30) are implicated in financing companies reported to have been involved in ongoing land disputes, failing to respect customary land tenure and local and indigenous community rights to free prior and informed consent, and using fire to clear land. Of the USA banks in the study, Citigroup (18/30), JP Morgan (14/30) and Morgan Stanley (7/30) scored from poor to good, although they have all been involved in financing clients with poor environmental and social records. See RAN 2016 for more details and supporting evidence.

The case for regulation

As shown above, vast sums are invested in agriculture and forest-commodity operations that violate even the most basic environmental and social standards, with devastating impacts. Some signs of progress are apparent, including in-country reforms of forest governance and the adoption of international commitments regarding supply chains. However, better financial sector controls of the financing of forest-risk sectors would make a critical contribution to protecting the communities and habitats most affected by forest-risk sectors, and to meeting zero deforestation goals.

There is evidence that existing financial sector voluntary policies are not sufficient to restrict investment in harmful agricultural and forest sector activities, but several challenges are worth emphasizing. First, finance is internationally competitive, which results in a disincentive for banks and investors to adopt safeguard policies, and an incentive for those with policies in place to sideline them in favour of business decisions that increase profit margins. Second, many investors insist that it is better to make deals with clients with poor standards but at least some safeguards, rather than to turn these clients away, when they will simply seek finance from banks and investors with no policies at all. Third, social and environmental outcomes should not depend on the implementation of voluntary policies by financiers with a clear conflict of interest; the primary mandate of banks and investors is to secure investment deals.

Banks and investors alone cannot stop the financing of environmental destruction. The financial sector is increasingly globalized. Although local issues should still be regulated locally, global issues such as money laundering and financing of terrorism, as well as climate change and environmental destruction, should be regulated and mitigated globally. Companies with the poorest human rights and environmental records must be prevented from shopping around for financiers with the lowest standards.

Currently, many governments and financial regulators believe their responsibility is limited to maintaining the stability of the financial system. To halt deforestation and prevent human rights abuses financial regulators must enact and enforce regulations that require financial institutions to adopt and disclose robust safeguard policies and due diligence procedures, with detailed guidance for specific sectors with high risks, such as forests.

Small steps in the right direction

In Brazil, sustainable banking regulation began in 2008 with Resolution 3545. This made the granting of loans to agricultural activities in the Amazon conditional on compliance with legal and environmental requirements. It was estimated that the deforestation rate was almost halved the following year as a direct result of this initiative, and that 2,783 km^2 of Amazon forest was saved from deforestation between 2009 and 2011 (Assunção et al. 2013), though this latter achievement cannot be credited solely to Resolution 3545. The resolution was followed by Resolution 3876, which prohibits lending to entities or individuals associated with poor worker rights, and in 2014 by Resolution 4327, which requires financial institutions to have a Social and Environmental Responsibility Policy and provides implementation guidelines. To support change, Brazilian Central Bank Circular 3547 provided banks with guidance on implementing the Internal Capital Adequacy Assessment Process in Pillar 2 of Basel III, an international process of bank reform.

The Bangladesh Central Bank has developed three policies: a "green" banking/finance framework; a monetary policy facility for cheaper loan refinancing; and a "green" lending target (IISD, Bangladesh Bank and UNEP, 2015). A dedicated Sustainable Finance Department monitors progress and publishes quarterly reports.

In China, the China Banking Regulatory Commission (CBRC) issued the Green Credit Policy in 2007. It was replaced in 2012 by the Green Credit Guidelines, which stipulate that banks must create environmental and social risk management systems, and which monitors and promotes borrowers' compliance with rules and their environmental and social performance (Bai, Faure and Liu 2014). Granting loans can be made conditional on such compliance, and banks may even use punitive measures against noncompliant borrowers.

Indonesia issued a Roadmap to Sustainable Finance in 2014, including a detailed work plan for a sustainable finance programme for the banking, capital market and non-bank financial service industry sectors. The programme falls under the authority of the country's financial services regulator, the OJK. This is part of a multi-year plan with the goal of achieving sustainable finance by 2024, and although progress has so far been limited, the OJK has shown openness to discussing the roadmap with civil society.

EU, G20 and OECD countries are also taking some steps toward considering sustainability in the financial sector, including the EU Non-financial Reporting Directive, the G20 Green Finance initiative, the Financial Stability Board Task Force on Climate-related Financial Disclosures, and the OECD initiative to promote responsible business conduct in the financial sector. At the national level, the recently adopted Dutch banking Sector Agreement on international responsible business conduct regarding human rights is an excellent example of a multi-stakeholder policy developed by banks, government, trade unions and civil society. The ministers who signed the covenant want to support similar agreements at EU and OECD level.

There is a clear need to further explore the introduction and scaling up of domestic and international standards that address the financial sector's role in facilitating deforestation and associated human rights abuses. Besides the efforts in developed economies discussed above, a group of developing countries (loosely organized by the World Bank's International Finance Corporation in the Sustainable Banking Network) have also taken some interesting and innovative regulatory steps. It is important to highlight that developing countries are making specific regulations, while developed countries are only encouraging the scaling up of some best practices. Developed countries are not asking for the incorporation of environmental, social and governance criteria into due diligence procedures, whereas China and Brazil, for example, have made the consideration of such risk criteria in lending a necessary requirement. It is too early to say how well these regulatory initiatives will rein in the financing of unsustainable activities in the long term, but their impacts should be assessed in detail to help develop scalable best practices into the future.

Conclusion

Vast sums of investment flow into agriculture and forest commodity operations in violation of even basic environmental and social standards, with devastating effects on people and forests. There are efforts to develop voluntary safeguard policies to prevent such impacts, but this approach appears insufficient, as even financiers with established policies routinely retain clients in breach of their own standards. Several developing countries have taken steps to regulate the sector, and although it is too early to draw conclusions as to their effectiveness, they do show some progress in tackling deforestation.

Realizing commitments to reducing deforestation and preventing human rights abuses in the forest sector requires a coherent economic and political effort across all levels of society and within all sectors of the economy, and a decisive shift in financial flows away from socially and environmentally destructive economic activities. Binding regulation at the national and international level will be required to direct finance away from harmful investments, and will be most effective when accompanied by detailed implementation guidance and standardized disclosure and due diligence frameworks.

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