Is Your Money Destroying Rainforests or Violating Rights?

Forests & Finance reveals the finance flowing into commodities driving deforestation and land degradation in Southeast Asia, Central and West Africa, and parts of Latin America

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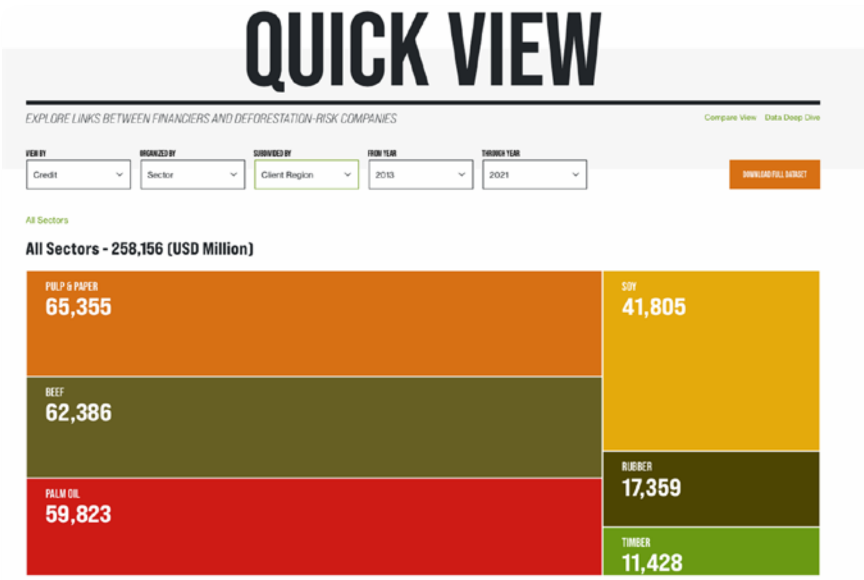
It features:

- a searchable database on financier-client deals from 2013 onwards
- scorecards on bank and investor policies as relevant to forest-sector environmental, social and governance (ESG) risks
- case studies on clients linked to deforestation and human rights abuses

Assessing Policies and Exposure

See how banks and investors measure up on environmental, social and governance (ESG) policies and their exposure to forest-risk sectors.



Materiality of ESG Risks in Tropical Forest-risk Commodity Sectors

Protecting the world's tropical forests is critical for achieving the Sustainable Development Goals and maintaining a habitable planet. But they are rapidly being destroyed. Tropical forests regulate global rainfall patterns; sequester and store carbon; enable over 1 billion people to meet their basic needs for food, water, shelter and medicines; and safeguard the majority of the Earth's remaining terrestrial biodiversity. Studies indicate that the fragmentation of forest ecosystems correlate with the emergence of new vector-borne and zoonotic diseases posing a significant biosecurity risk. Therefore, stopping deforestation could be crucial for preventing future pandemics.

However, tropical tree cover loss has nearly doubled over the past 10 years. In 2020 alone, 12.2 million hectares of tropical forests were lost. The primary cause is the clearance of land for agriculture, often done illegally. In Southeast Asia, palm oil, pulp and paper, and the expansion of industrial rubber and logging operations are the main drivers of deforestation and forest degradation. In Latin America, the expansion of pastures for beef production, the exploitation of timber, and the expansion of other commodities like soy and pulp and paper, are key drivers of deforestation and land degradation. In Central and West Africa, the exploitation of timber and the production of rubber are among the key sectors driving deforestation.

Deforestation and peatland degradation contribute most of the 23% of total human-caused GHG emissions attributed in the IPCC report to agriculture, forestry and other land uses, making it a major cause of climate change. However, protecting these critical carbon sinks has the potential to reduce GHG emissions by nearly a third, making it one of the most effective mitigation measures. The forest-risk sector is also associated with serious human rights violations as a result of land conflicts with Indigenous and local communities and exploitative labor practices, and has strong ties to corruption, tax evasion and organized crime. For example, the international policing body INTERPOL estimates that illegal timber alone generates up to USD 100 billion annually, laundered through the international financial system.

In addition to the devastating environmental and social harms caused, banks and institutional investors that finance forest-risk commodity companies are increasing their exposure to financial risk. (see below).

ESG ISSUES

ENVIRONMENTAL

- GHG emissions from forest and peat loss
- Biodiversity loss
- Land and ecosystem degradation
- Water, air, and soil disruption

SOCIAL

- Community conflict and violence
- Land rights violations
- Displacement
- Child labor, forced labor, and human trafficking
- Health hazards from haze and chemical exposure

GOVERNANCE

- Bribery
- Illegal activity
- Economic/financial crime: tax evasion, money laundering, transfer pricing

FINANCIALLY MATERIAL SUPPLY CHAIN RISKS

OPERATIONAL RISK

Loss of productivity, work stoppages, property damage, increased staff costs to deal with conflicts, etc.

REGULATORY RISK

Inability to adapt to changes in and/or breach of regulations related to GHG emissions, forests, peat, labor, land tenure and governance, etc.

REPUTATIONAL RISK

Damage to brand value and loss of social license to operate due to NGO campaigns or media exposés

LEGAL RISK

Litigation for failure to manage ESG risks, resulting in retraction of operating permits, fines, compensation costs, or confiscation of land, etc.

MARKET RISK

Cancelled contracts or decrease in consumer demand from failure to meet buyer standards, i.e. No Deforestation, No Peat, No Exploitation (NDPE) Policy

RISKS TO INVESTORS AND BANKS

FINANCIAL RISK

(INVESTORS)

- Loss of capital due to i.e. stranded assets.
- Negative return on investment (ROI)

(BANKS)

- Nonperforming loans / increased default risk
- Loss of revenue

REGULATORY RISK

- Inability to meet new requirements on the inclusion of ESG risk criteria in due diligence and risk weighting
- Failure to disclose ESG risks in portfolio

LEGAL RISK

- (INVESTORS) potential breach of fiduciary duty from failure to integrate ESG
- Accountability for ESG impacts under OECD Guidelines

REPUTATIONAL RISK

- Damage to brand value due to NGO campaigns or media exposés
- Breach of ESG commitments / policies (i.e. UN PRI, Equator Principles)
- Loss of credibility as a responsible investor/ bank

Key developments in Sustainable Finance Policy and Regulation

In **Indonesia**, the Financial Services Authority (OJK) published the second Sustainable Finance roadmap for 2021-2025. This includes a plan to publish new regulations that will require banks to integrate ESG risks into day-to-day lending decisions, as well as establish a national Green Taxonomy - a classification system of what is considered sustainable investment.

In **Malaysia**, the Joint Committee on Climate Change (JC3) published the Climate Change and Principle-based Taxonomy (CCPT) guidance in 2021 which complements the Value-Based Impact Assessment Framework (VBIAF) from 2019. The CCPT aims to standardize the classification and reporting of climate-related exposures and encourage financial flows towards supporting climate objectives. The Securities Commission also released a Sustainable and Responsible Investment (SRI) Roadmap for the Malaysian Capital Market in 2019, with the objective to position Malaysia as a regional SRI center.

In **Brazil**, the Central Bank proposed two new regulations for 2021 relating to forest-risk commodity finance. The first would establish an automatic alert in the banking system if a proposed transaction represents a certain type of social-environmental risk. The second proposes strengthening the rules on social, environmental and climate risk management.

In **Europe**, the EU commission published a taxonomy for activities that can be classified as sustainable, relating to climate change mitigation and adaptation. Though initially voluntary, financial institutions operating in the European Union will have to report on whether they apply the taxonomy in their finance. The European taxonomy is a first of its kind and is expected to be used as a model for taxonomies under development in other jurisdictions.

In **Japan**, the Financial Services Agency will urge banks to accelerate decarbonization by adding climate change measures to its bank guidance policy and requesting climate-related disclosure, while the **US** Securities and Exchange Commission is currently evaluating its disclosure rules with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change.

Methodology

This project assesses the financial services received by over 200 companies directly involved in the beef, soy, palm oil, pulp and paper, rubber and tropical timber ("forest-risk sector") supply chains, whose operations may impact natural tropical forests in Southeast Asia, parts of Latin America and Central and West Africa[1]. Financial Databases (Bloomberg, Refinitiv, TradeFinanceAnalytics, and IJGlobal), company reports and register filings, as well as media and analyst reports were used to identify corporate loans and underwriting facilities provided to the selected companies for the period 2013-2020 (April). Investments in bonds and shares of the selected companies were identified through Refinitiv, Thomson EMAXX and Bloomberg at the most recently available filing date in April 2021.

The policy assessment analyzed how the publicly available policies of around 50 of the largest banks and investors scored against 35 Environmental, Social and Governance (ESG) criteria, based on international agreements and conventions (mostly from bodies linked to the United Nations such as the ILO and UNEP) and best practices in the global business community and the financial sector with respect to forest-risk commodities. For each criteria a scoring table is set up whereby 10 points are granted if the financial institution commits unequivocally to the criteria and applies it to the company and its suppliers, and 8.5 points are granted if the financial institution commits only partially to the criteria, often because the criteria is not applied to the suppliers of the company. The scores for all 35 criteria are added up and then normalized to a scale from 0-10, for easy comparison.

Scores were assigned separately for each forest-risk commodity in which the bank or investor is involved in through its financings and/or investments. Each bank or investor therefore received up to six scores for the different commodities (beef, palm oil, pulp and paper, rubber, soy and timber), plus an overall score. This overall score is calculated by using the financing and investment data in the Forests & Finance database (covering the period January 2016 - June 2020). Based on the total financing and investments found for a particular financial institution, the percentages going to each commodity are calculated. These percentages are combined with the policy scores for each commodity, to calculate the overall score for the financial institution.

1 For the detailed methodology and full list of countries in each forest-risk region see www.forestsandfinance.com/methodology

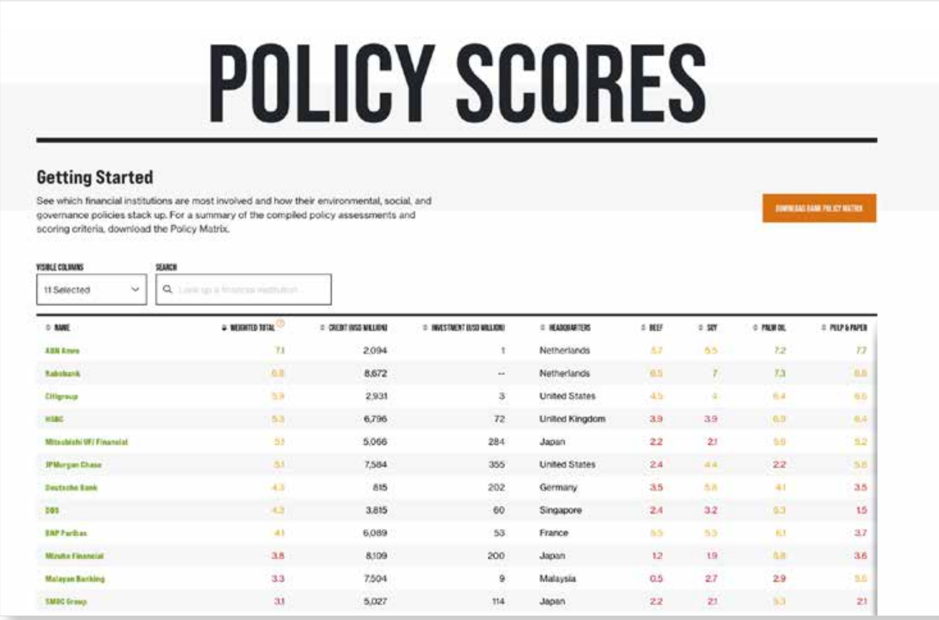
POLICY ASSESSMENT

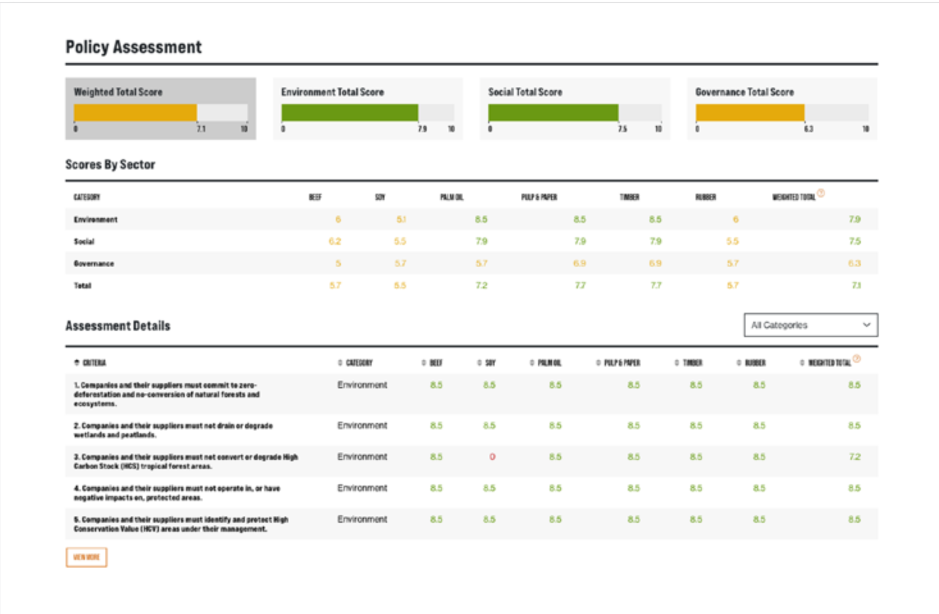
Policy profiles by financial institution

The assessment found that the average policy score for the 50 most significant financial institutions financing tropical forest-risk sectors globally was just 2.3 out of 10. Collectively, these institutions accounted for USD 128 billion in credit and underwriting from 2016-2020, and a further USD 28 billion in share and bond holdings as of April 2021. This indicates that the majority of forest-risk financing is not subject to even basic desk-based social and environmental checks, much less actual verification of client standards. Therefore, financial institutions are generally unable to identify, assess or manage ESG risks in their portfolios.

Only 9 financial institutions achieved a score above 50%, with Dutch bank ABN Amro scoring highest at 7.1 out of 10. It was followed by 7 US and European institutions scoring between 5 and 6.8, and the Japanese bank MUFG.

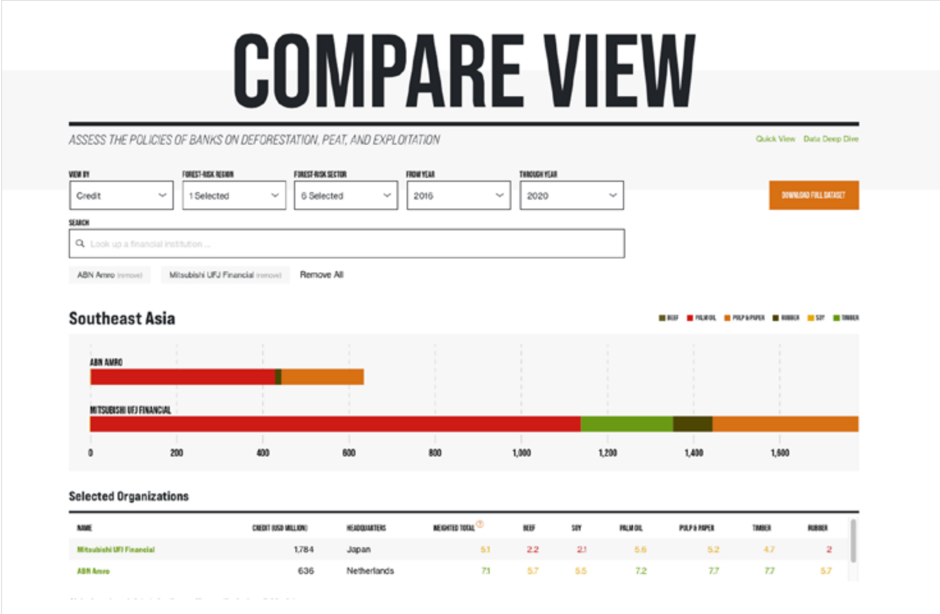
There were 28 banks and investors that scored below the average score of 2.4 with 17% of all those assessed scoring under 1. The largest investor, Permodalan Nasional Berhad scored 0 across every sector which means that USD 5.7 billion in investments in 2021 to the forest-risk sectors was not covered by policies to identify and address ESG risks. Banco do Brasil, the largest creditor overall, scored just 2.2.





Policy Profiles by sector

The policy assessments include a breakdown per forest-risk sector. Overall, the financial institutions assessed scored highest for their policies for the palm oil and timber sector, 2.7 and 2.5 respectively. While the lowest scoring sector was beef with 1.7.



Recommendations

- Robust ESG standards and due diligence processes by banks and investors are needed to turn the tide on the devastating social and environmental impacts endemic to the forest-risk commodity sectors. Financial institutions need to move faster, in larger numbers, across more regions, and adopt uniformly higher ESG standards than has occurred to date. Financial sector regulation has a critical role to play in accelerating and shaping this agenda, in order to ensure the economy serves public policy objectives.

Financial sector regulators in all major financial centres should:

- Develop stronger financial sector regulatory oversight and compliance mechanisms in support of environmental and social public policy objectives;
- Require financial institutions to adopt and disclose robust ESG safeguard policies, enhanced due diligence procedures, and impacts of their financing, with detailed guidance for specific sectors with high ESG risks, such as the forest-risk sector;
- Strengthen requirements on financial institutions to proactively identify and notify regulators of any financial transactions suspected of being associated with forest-risk sector corruption;
- Implement a credible and transparent monitoring and investigation mechanism on ESG compliance issues for complaints against financial institutions;
- Require financial institutions to report annually against the Global Reporting Initiative (GRI) G4 Financial Services Sector Disclosure Framework and Task Force on Climate-related Financial Disclosures, inclusive of land use emissions resulting from financing;
- Introduce penalties and fines for financial institutions and their board members for non-compliance with the above regulations and requirements.

Banks and investors should:

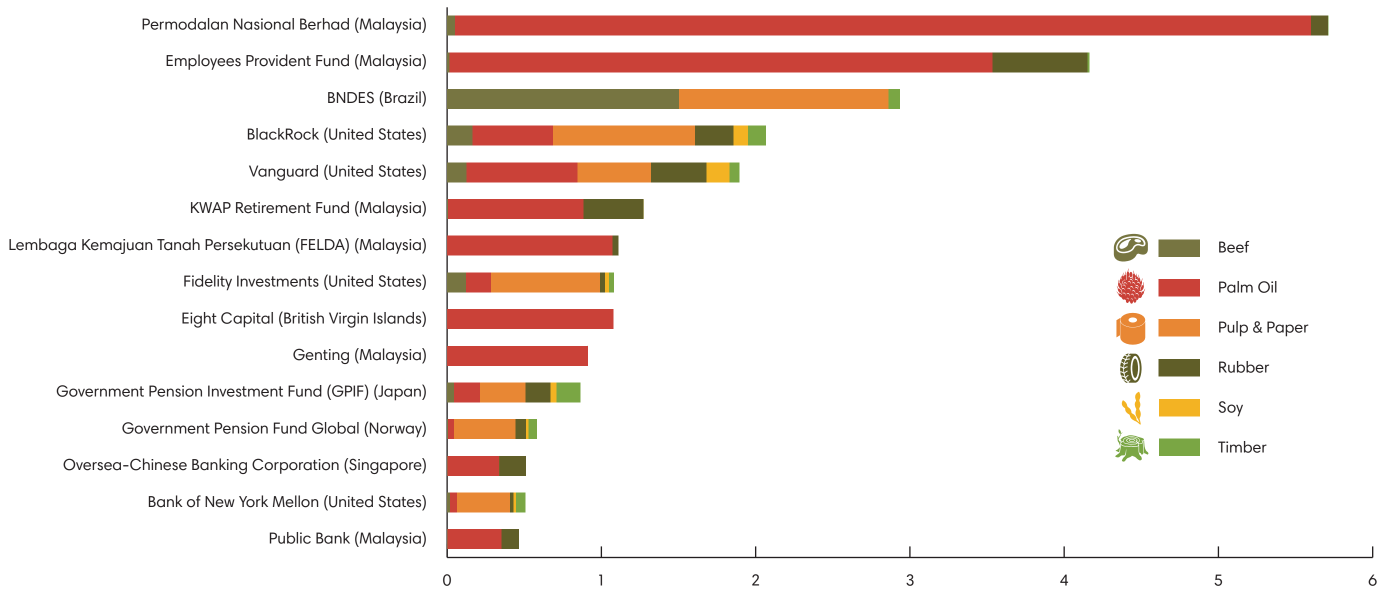
- Adopt, disclose, and implement ESG policies and standards for all financial services provided to producers and associated supply chain actors in forest-risk commodity sectors, and require client compliance at a corporate group level. Policies should include: No Deforestation, No Peatland and No Exploitation (NDPE) criteria, prohibitions on use of fire for land clearing, legality in operations and sourcing, Free Prior and Informed Consent (FPIC) procedures for activities impacting Indigenous and customary land rights of local communities, conformance with international ILO and Human Rights conventions and norms, anti-bribery and anti-tax evasion, and monitoring, verification and dispute resolution mechanisms;
- Enact zero tolerance procedures within financing portfolios to prevent violence, criminalization, intimidation, and killing of human rights, land, and environmental defenders;
- Ensure environmental and social impact due diligence procedures and requirements are integrated across all business lines, competently staffed and supported, and implementation incentivized;
- Include environmental and social safeguard requirements as covenants in financing agreements;
- Engage with companies across forest-risk commodity value chains to support improved transparency, independent monitoring, supply chain traceability, adoption of sustainable production practices, and remedy for social and environmental harms arising from their activities;
- Know and publicly disclose the footprint of financial services impacting forests, peatlands and the rights of Indigenous Peoples and communities affected by logging and the expansion of industrial agriculture. Report annually against the GRI G4 Financial Services Sector Disclosure Framework and the Task Force on Climate-related Financial Disclosures, inclusive of land use emissions resulting from financing;
- Support the establishment of harmonised financial sector regulations that seek to address forest-risk sector financing harms, as described above.

Investor update: Bondholding & shareholding at April 2021

Compared to 2020, the total value of investments in forest-risk commodity companies has increased from USD 37.2 billion in 2020 (April), to USD 45.3 billion in 2021 (April).

The 15 investors with the largest exposure accounted for 56% of all investment with USD 25 billion. Overall, the palm oil sector attracted USD 22.5 billion, 50% of all investment and an increase of USD 2.5 billion from a year ago. The pulp & paper sector received 20% of all investment with USD 9.7 billion. The investors most exposed include several public funds, with Malaysia's institutional investors in the lead, largely invested in the palm oil sector in Southeast Asia.

FIGURE 1. Top 15 Global Investors by Sector 2021 (April) (USD billion)



Largest recipient of investment: palm oil

Geography overview

The top 15 investors provided USD 25 billion to forest-risk sector companies in the three largest tropical forest basins. Southeast Asia attracted 66% of all investment with USD 30 billion while Latin America accounted for 33% and West and Central Africa just 1%.

FIGURE 2. Top 15 Global Investors by region 2021 (April) (USD billion)

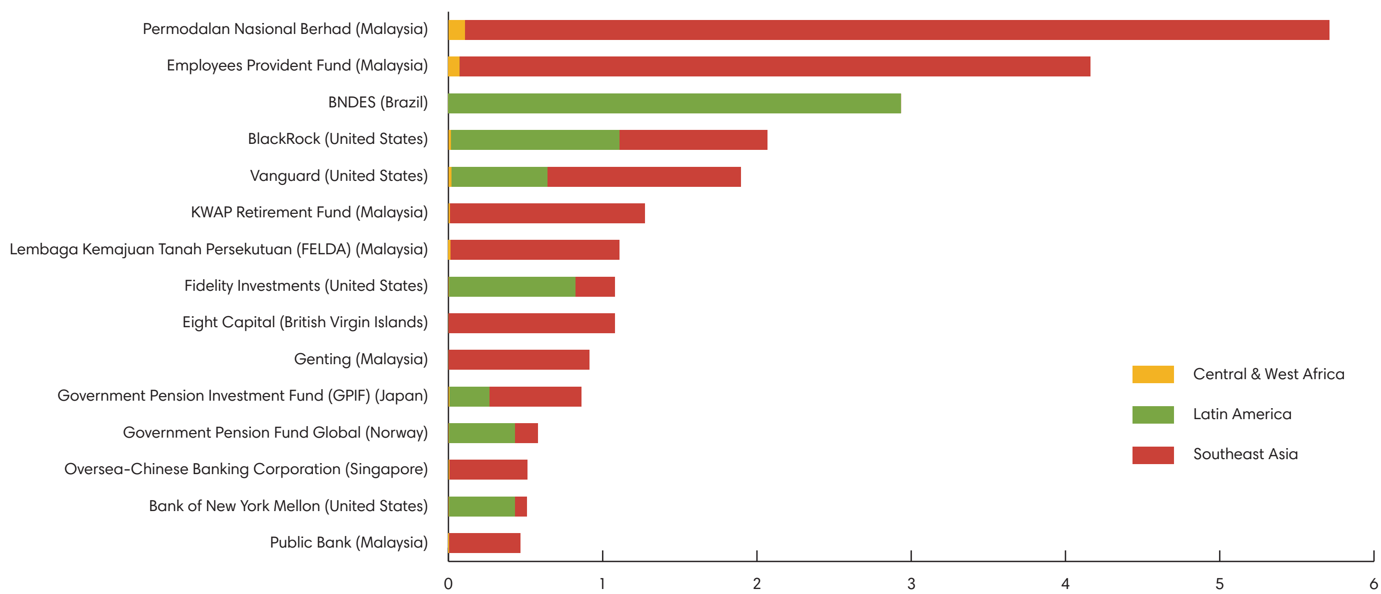
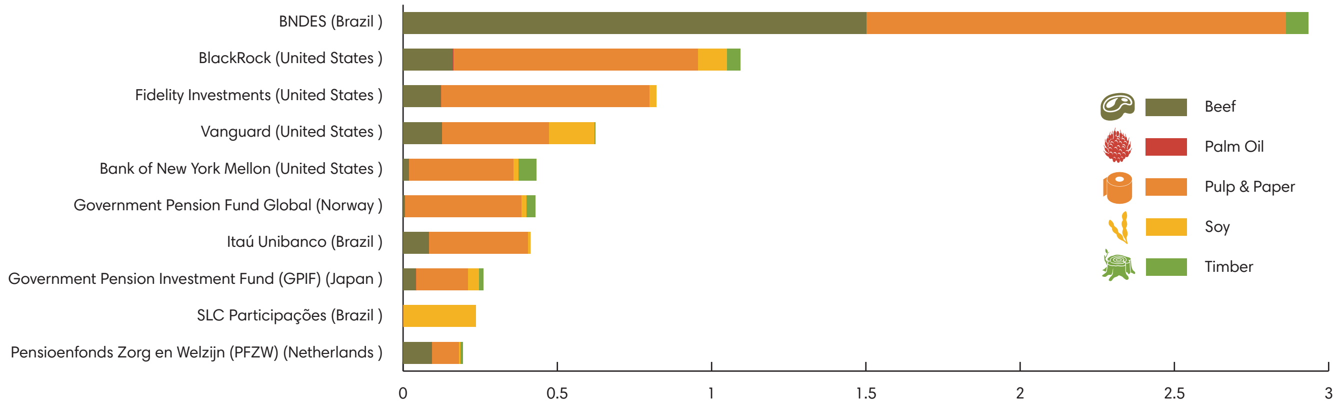
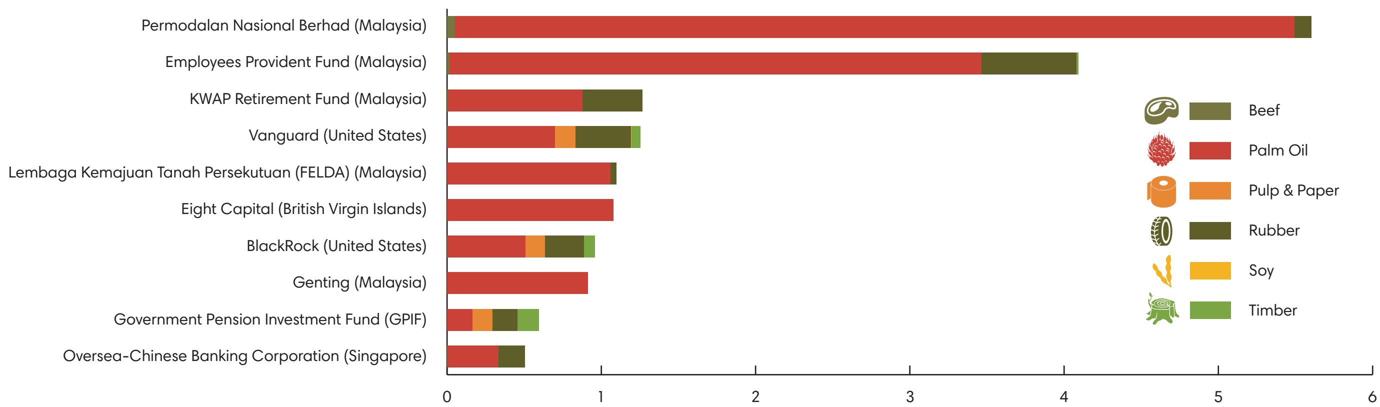


FIGURE 3. Top 10 Investors by Sector in Latin America 2021 (April) (USD billion)



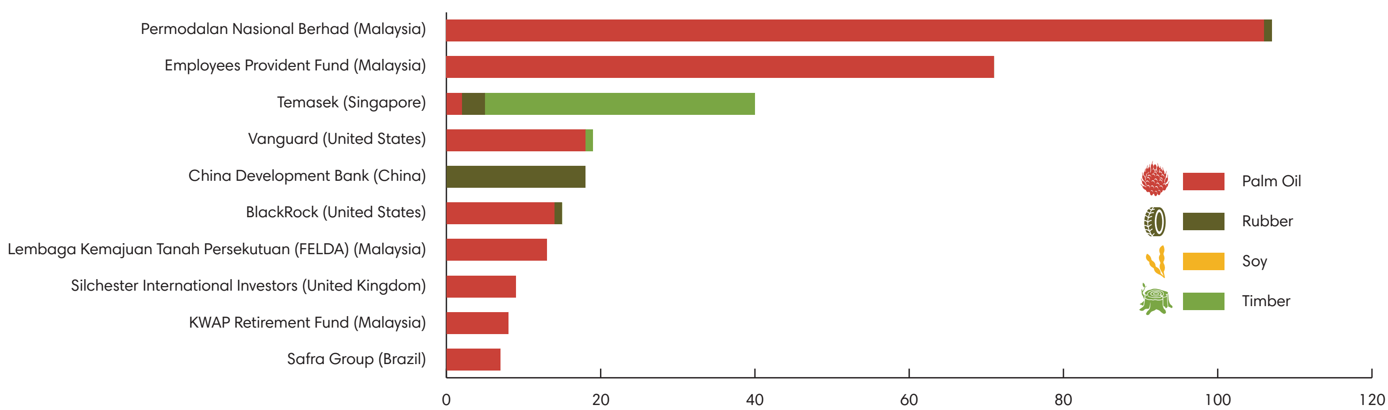
Of the USD 14.8 billion investment in the forest-risk sectors in Latin America in 2021 (April), 50% was in the pulp & paper sector while 31% was in the beef sector. The top 10 investors include major US financial institutions responsible for 20% of total investment in the region. BNDES was the largest investor by far, providing USD 2.9 billion to forest-risk companies with over half of its investment in the beef sector.

FIGURE 4. Top 10 Investors by Sector in Southeast Asia 2021 (April) (USD billion)



Of the USD 30 billion investment in the forest-risk sectors in Southeast Asia in 2021 (April), 74% was in palm oil. The top 10 investors include 5 Malaysian financial institutions with Permodalan Nasional Berhad providing USD 5.6 billion, 19% of all investment in the region.

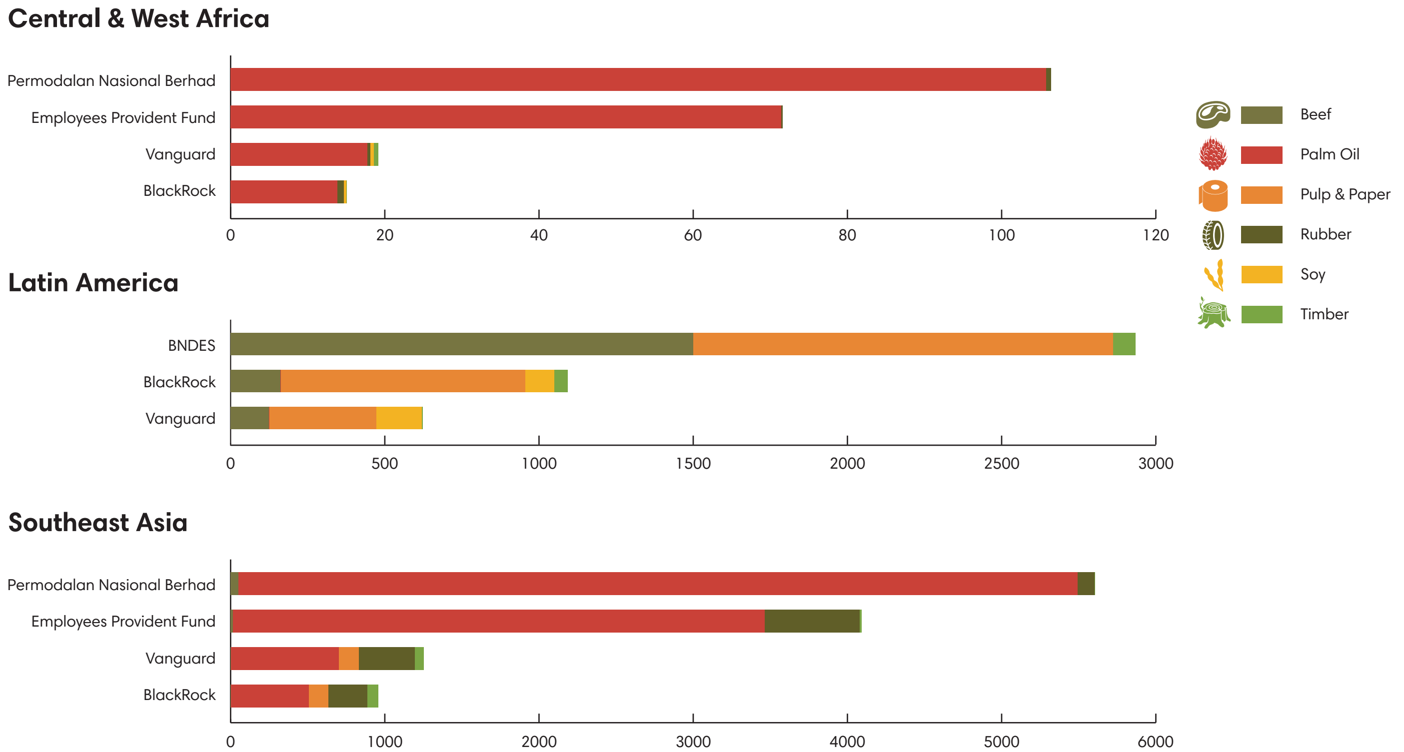
FIGURE 5. Top 10 Investors by Sector in Central and West Africa 2021 (April) (USD million)



Of the USD 0.3 billion investment in the forest-risk sectors in Central & West Africa in 2021 (April), 77% was in palm oil. Permodalan Nasional Berhad is also the largest investor in this region providing USD 106 million, 21% of all investment.

The 5 largest investors in forest-risk commodity companies are: Permodalan Nasional Berhad (Malaysia); Employees Provident Fund (Malaysia); BNDES (Brazil); BlackRock (United States); and Vanguard (United States). Of these 5, Permodalan Nasional Berhad and Employees Provident Fund are the largest investors in the palm oil sector with 98% of their financing in Southeast Asia, while BNDES is the largest investor in the beef and pulp & paper sectors with 100% of its financing in Latin America. Blackrock and Vanguard are most exposed to the pulp & paper sector in Latin America and the palm oil sector in Southeast Asia. The policy comparison shows that none of these investors has a strong policy in any category with BNDES scoring the highest overall with 2.9.

Investments of top 5 largest investors in the three tropical regions 2021 (April) (USD million)



About Us

Forests & Finance is an initiative by a coalition of campaign and research organizations including Rainforest Action Network, TuK Indonesia, Profundo, Amazon Watch, Repórter Brasil, BankTrack, Sahabat Alam Malaysia and Friends of the Earth US. Collectively we seek to prevent financial institutions from facilitating environmental and social abuses common in forest risk commodities. We seek to achieve this through improved financial sector transparency, policies, systems and regulations.

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