



Latin American Tropical Forest Investment Forum: Issues and
Opportunities for Investment in Natural Tropical Forests
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CHALLENGES FOR RESPONSIBLE INVESTMENT IN SUSTAINABLE TROPICAL TIMBER OPERATIONS

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Outline of the Presentation

1. **Chilling Effect in Financing Natural Tropical Forest Based Operations**
2. **Responses of the Financial Community**
3. **Market Requirements for Responsible Investment**
4. **Responses of Global Corporate Community**
5. **Implications for Tropical Timber**
6. **Opportunities and Ways Forward**





Attractiveness of Forestry Investments

- ◆ Possibility for high returns
- ◆ Appropriate return-risk combination
- ◆ Controllable risk
- ◆ Biological growth: non-depreciating asset, protection against inflation
- ◆ Long-term yields for institutional investors
- ◆ Diversification of portfolio

However,

- **Forest investments are mostly made in non-tropical countries**
- **In the tropics they go to plantations**
- **The above advantages are not always found in NTF**



Barriers to NTF Investments

- ◆ Inadequate investment climate: non-enabling conditions and high transaction costs
 - ◆ High country risk
 - ◆ Corruption
 - ◆ Unfair competition from illegal operators dampen prices
 - ◆ Specific reputational risk
 - ◆ Property rights and forest tenure
 - ◆ Tax barriers
 - ◆ Limited liquidity, difficult exit
 - ◆ Limited management expertise among financing institutions
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- ➔ **Only part of the barriers are sector specific**
 - ➔ **Country risk is often a sign of sector problems**
 - ➔ **Responsible investors shy away from the sector**





Socially Responsible Investment

- ◆ USD 2.16 trillion in professionally managed socially responsible portfolios in the USA
 - ◆ European flows also very large
 - ◆ Net inflows are positive; return targets similar to other investments
 - ◆ Mechanism: screening out companies not meeting good governance, environmental and social standards
 - ◆ Limited experience in sustainable forestry operations but the financial track record is poor (Canby & Raditz 2005)
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- **Potential major source for SFM investment in NTFs**
 - **Social responsibility is being mainstreamed gradually**



Caveats and Gaps in NTF Investments

- ◆ Small-medium sized forest enterprises (SMFE) (e.g Guyana case)
- ◆ Environmental services (carbon emerging)
- ◆ Sources of funding (mostly domestic, little from capital markets, SRI funding only niches)
- ◆ Governance of family-owned enterprises; internal rules
- ◆ Plantations as major policy goal (subsidies undermining timber value from NTF)
- ◆ Market recognition of responsible operations mostly in niches

- ➔ **Lack of transparency contributes to suspicion and conflicts**
- ➔ **Social responsibility is not recognized or rewarded**



Private Investment in Forest-based Operations

- ◆ WB earlier estimate for the 1990s USD 10-12 bill.

- ◆ Current level (tropics and countries in transition) USD 15-20 bill.
 - plantations USD 2 bill.
 - processing and logistics USD 13-18 bill.
 - SFM of natural tropical forest ?

- ➔ **Private investment flows are about 10 times more than Official Development Assistance**





“Chilling Effect” in International Financing of Natural Tropical Forests

◆ World Bank:

- The 1992 Forest Policy: ban any investment in utilization of NTF
- The 2002 Forest Policy and Strategy: possible if projects meet the Bank’s specific requirements
- Impact: capacity building investments in PNG, Cambodia and DRC, community forestry in Mexico and Laos, etc.

◆ IFC:

- Portfolio mainly consists of pulp and paper operations and wood-based panel projects with less investment in resource creation and sawmilling
- Plantation-based operations have been expanding
- **The “Chilling Effect” continues in practice in the Bank Group and influences other international financing institutions’ operations**



NGO Critique on NTF Projects

- Unclear if **outright opposition** against any NTF-based operation
- Main **specific concerns** of NTF projects
 - take-over of indigenous peoples' lands
 - displacement of peasant farmers
 - favoring capital intensive choice of technology in using land
 - political marginalization of smallholders in land-use planning
 - lack of adequate participation
 - inadequate impact assessment
- ➔ **Value issues: whose forests, for whom, and how to get rid of poverty**





CIFOR Critique of Pulp Project Financing

- **wood cost 35-80%** of the total manufacturing costs
- pulp mills are highly **capital intensive** and therefore their financial feasibility is highly sensitive to utilization ratio
- in plantation -based projects competing projects make create **unexpected impacts**
 - wood market price driven up due to excessive demand
 - interactions between sawlog and pulpwood prices
 - pulpwood demand could encourage
 - illegal harvesting
 - unplanned land conversion

Source: CIFOR 2006

→ **Inadequate due diligence related to raw material availability**





The Other Side of the Chilling Effect: Insufficient Demand for NTF Financing

- ◆ Few reputable project sponsors
 - ◆ Lack of technically and financially sound projects
 - ◆ Lack of enabling environment (corruption, unfair competition from illegal timber, over-regulation, high transaction costs, etc.)
 - ◆ Significant reputational risks
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- **Chicken and egg -syndrome**
 - **Management knowledge and perception on NTF investments**
 - **Project complexity and high transaction costs**



Restructuring Overcapacity

- ◆ Overcapacity should be re-dimensioned to reduce incentive for illegal logging but politically difficult
- ◆ Machine stock is mostly obsolete but cannot be renovated due low cash-flow and shortage of funding
- ◆ Sawmilling moves along the frontier but relocation of existing plants lags behind encouraging
- ◆ Wood cost represent a high share of the total
- ◆ Cross-border impacts can be significant

- ➔ **Restructuring is blocked, illegal logging difficult to control**
- ➔ **Regulatory restructuring would be at high social and political cost, and would impact wood price**
- ➔ **(At least) new investments need adequate regulation based on information on the resource potential**





Responses of Financing Institutions



Role of the International and Regional Development Banks and their Private Sector Arms

- ◆ Create enabling conditions for private investment in SFM and SFM-based processing
- ◆ Capacity building and technical assistance
- ◆ Comfort factor for investors against policy risk
- ◆ Provision of equity and loan financing
- ◆ Leverage effect from other sources (4-5 times)
- ◆ Investment guarantees (MIGA)
- ◆ Advisory service
- ◆ Developing and testing innovations



Equator Principles Financial Institutions

- ◆ **EPFI Principles** ensure that the projects (more than USD 50 million) financed are developed in a socially responsible manner and reflect sound environmental management practices

- ◆ **Objectives:**
 - (i) borrowers' engagement with locally affected communities
 - (ii) serve as a common baseline and framework for members' internal social and environmental policies, procedures and standards

- ◆ **No loan financing** to borrower unable to comply with the respective social and environmental policies and procedures that implement the Equator Principles.



EPFI Principles

1. Review and Categorisation
2. Social and environmental Assessment
3. Applicable Social and Environmental Standards (IFC)
4. Action Plan and Management System
5. Consultation and Disclosure
6. Grievance Mechanism
7. Independent Review
8. Covenants
9. EPFI Reporting

www.equator-principles.com



IFC Performance Standards

- ◆ PS 1: Social and Environmental Assessment and Management Systems
- ◆ PS2: Labor and Working Conditions
- ◆ PS3: Pollution Prevention and Abatement
- ◆ PS4: Community Health, Safety and Security
- ◆ PS5: Land Acquisition and Involuntary Resettlement
- ◆ PS6: Biodiversity Conservation and Sustainable Natural Resource Management
 - **Protection and Conservation of Biodiversity (natural, modified and critical habitat, protected areas, invasive alien species)**
 - **Management and Use of Renewable Natural Resources (natural and plantation forests)**
- ◆ PS7: Indigenous Peoples
- ◆ PS8: Cultural Heritage



IFC Requirements for Forest Projects

- ◆ In natural forests: not to cause any conversion or degradation of **critical habitat**.
- ◆ Where feasible, to locate plantation projects on **unforested land or land already converted** (excluding land that is converted in anticipation of the project).
- ◆ Ensure that all natural forests and plantations over which they have management control are **independently certified** as meeting performance standards compatible with **internationally accepted principles and criteria** for sustainable forest management.
- ◆ Where a pre-assessment determines that the operation does not yet meet the requirements of such an independent forest certification system, the client will develop and adhere to a **time-bound, phased action plan** for achieving such certification.



IFC Requirements for Forest Certification

- ◆ independent,
- ◆ cost-effective,
- ◆ based on objective and measurable performance standards
- ◆ developed through consultation with relevant stakeholders, such as local people and communities, indigenous peoples, civil society organizations representing consumer, producer, and conservation interests
- ◆ fair, transparent, independent decision-making procedures that avoid conflicts of interest

→ **The World Bank and IFC requirements are equivalent**



WB/WWF Forest Certification Assessment Guide

- ◆ For use by WB/WWF and **others** to establish acceptability of standards and systems
 - ◆ To assist countries in developing their systems
 - ◆ Relies on ISO/ISEAL frameworks and mechanisms
 - ◆ Structure: criterion → background rationale → requirements → guidance → scope
 - ◆ Analytical tool for (a) identifying strengths and weaknesses, and (b) decision making on technical assistance and investment projects
- **Utilization: (1) assessment of international systems → (2) assessment of national systems**



Implications of EPFI Principles/FCAG

- ◆ About 45 major commercial banks signed, more flowing in (4 BRA)
 - ◆ Only project financing but may expand beyond
 - ◆ Under consideration to reduce the project size to USD 10 million
 - ◆ Disclosure requirements higher than regular
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- ➔ **Not presently relevant for most tropical timber industry projects, but the requirements are likely to be mainstreamed in the future.**
 - ➔ **Application in practice will require compromises, need for minimum requirements; no room for Corrective Action Plans**
 - ➔ **EPFI Principles can be helpful for companies for risk mitigation but business tends to go first (ex. US Ex-Im Bank financing of APP in spite of policy not clearing forests)**
 - ➔ **Acceptability of certification schemes remains to be established for World Bank Group financing**



Are Safeguard Tools Adequate?

- WB Inspection Panel: requests and reports on NTF projects point weaknesses:
 - inadequate consultation
 - project management and supervision
- **WB/IFC Safeguards can be considered mostly adequate but their application can be improved**
- **Perception: safeguards are risk mitigation tools, not barriers**
- **Impossible to foresee all problem situations (Uruguay pulp mill case)**



Market Requirements for Responsible Investment



Market Drivers for Responsible Investment

- ◆ **Private** procurement policies since early 1990s
 - Private policies since 1990s (pioneers, WWF Buyers' Groups, GFTN, others)
 - Marketing advantage (FSC certification)
 - companies subject to activist NGO attacks (DIY chains)
- ◆ **Public** procurement since 2000
 - NGO and media pressure
 - Activist campaigns in some countries (particularly UK)
 - Local government policies to ban, limit tropical timber use since the 1990s
 - Morally not acceptable to use illegal timber in public projects (construction projects)



Overview - Countries with PPPs

National policies

1. Pioneers or otherwise advanced
 - ◆ DEN, NET, UK
2. Recent policies
 - ◆ BEL, FRA, JAP, NZL
3. Upcoming, under preparation
 - ◆ GER, SPA, BRA, MEX, etc.
4. “On the margin” (eco-labelling, GPPs)
 - ◆ CAN, SWE, etc.

Sub-national policies

- ◆ Local governments in several countries



PPP Objectives

- ◆ **Immediate:** Response to civil society criticism and activist campaigns: morally unacceptable to use illegal timber in public projects
- ◆ **Broad goals:** Promote SFM, good forest governance (and sustainable consumption)
- ◆ **Specific objectives:**
 - ◆ Ensure legal origin and legal compliance in the origin of products
 - ◆ Establish and promote market preference to sustainably produced timber



Requirements for Forest Standards: Legality

		DK	NL	UK	EU-FLEGT Briefing note 09
Legal harvest rights		✓	✓	✓	✓
Compliance with national and local laws on:	Forest management	✓	✓	✓	✓
	Environment	✓	✓	✓	✓
	Labour, Tenure rights etc.	✓	✓	✓	✓
Payment of all relevant royalties and taxes		✓	✓	✓	✓
Compliance with CITES		✓	✓	✓	





Requirements for Forest Standards: Sustainability

	DK	NL	UK
1. Legal, policy and institutional framework	✓	✓	✓
2. Extent of forest resources (conversion)	✓	✓	(✓)
3. Forest health and vitality	✓	✓	✓
4. Production functions of forest resources	✓	✓	✓
5. Protection functions of forest resources	✓	✓	✓
6. Biological diversity	✓	✓	✓
7. Socio-economic functions	✓	✓	Under review





Instruments to Demonstrate Legality and Sustainability

- Certificate of chain of custody (legal origin)
- Certificate of SFM (existing certification schemes)
- Independent attestation of verification of legality (private auditors)
 - Certification relies on absence of evidence on on-compliances, not fully fledged verification of legality
 - Scope of verification
- Alternative documentation (still largely open)



Criteria for Assessment of Certification Schemes

Key requirements		DK	NL	UK
Certification	Consistency with ISO guidelines 62, 65, 66 or equivalent	✓	NEN EN ISO 14001	✓
	Consultation with stakeholders	✓	✓	✓
	Information from certification reports publicly available	✓	✓	✓
Accreditation	Consistency with ISO 17011 or equivalent	✓	NEN-EN-ISO 45012	✓
Chain of Custody	Performed by accredited body or auditor complying with ISO 65 or equivalent	✓	NEN-EN-ISO 45012	✓
	Threshold for verified legal	100%	100%	100%
	Threshold to be verified sustainable	100% (under review)	70%	70%
	Recycled material controlled origin	Unclear	✓	✓
Labelling	Clear credible and non misleading rules	✓	✓	✓



Status of Acceptability of Certification Systems

Country	FSC	PEFC	SFI	CSA	ATFS	MITCC	LEI	Other
Belgium	X	X	X	X				
Denmark ^h	X					X ^b	X ^c	Swan and EU Flower Eco-label ^{d)}
Germany	X	X	X ^g	X ^g	X ^g			Other Schemes, comparable to FSC & PEFC
Japan	X	X	X	X		X	X	SGEC
New Zealand	X	X	X	X	X	X		Eco-timber
Sweden ^g	X	X	X	X		X		Equivalent system
UK	X ^e	X ^e	X ^e	X	X	X ^f		



Alternative Documentation

- Certificate of verification schemes (DEN)
- Export permits, certificates of origin, other declarations from the authorities and from suppliers and sub-suppliers (DEN)
- Concession agreement, forest management plan, etc. (DEN, FRA)
- A documented eco-management system (DEN)
- Specification of principles and criteria, standards and guidelines, monitoring system (DEN)
- Documentation under bilateral agreement between the EU and the supplying country (DEN)
- Producer statement ensuring legality and sustainability which has been controlled by a independent party (FRA) or self declaration (JAP)
- Attestation of the commitment to a code of conduct (FRA, JAP)

→ Independent verification is likely to be a common requirement.



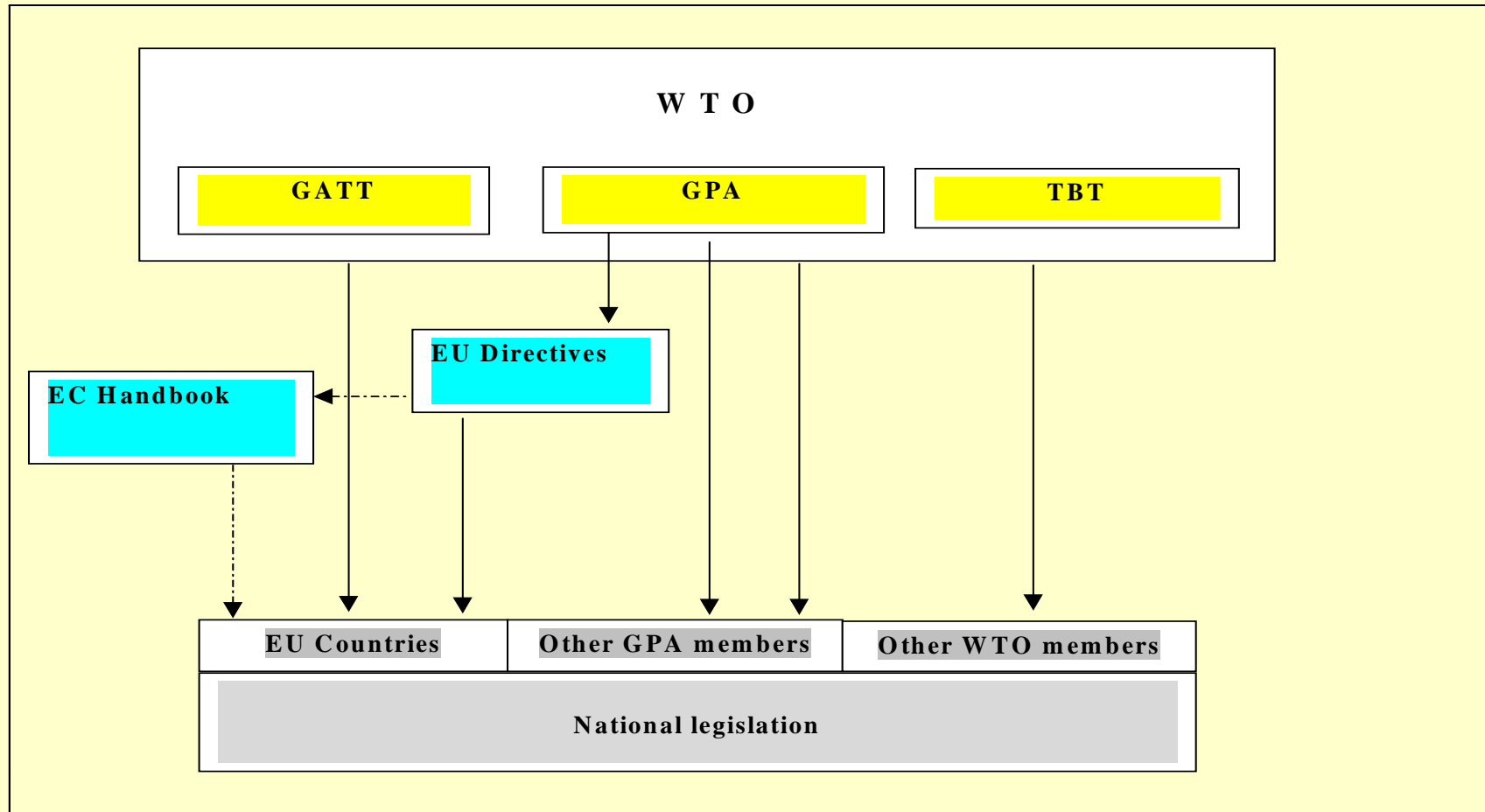
PPPs: Commonalities and Differences

- ◆ Objectives (usually related to promotion of SFM and legal compliance)
- ◆ Targets and implementation strategy (often through a phased approach)
- ◆ Level of obligation (often voluntary but sometimes mandatory)
- ◆ Actors concerned (typically central government purchasing agents)
- ◆ Product scope (sometimes excluding pulp and paper)
- ◆ Definitions for sustainability and legality
- ◆ Criteria applied in the procurement process
- ◆ Use of certification schemes as a reference
- ◆ Documentary evidence required
- ◆ Implementation and institutional aspects

→ **FAO Policy Forum (October 2006) called for harmonization**



Legal Framework





Legal Issues

- ◆ How to ensure non-discrimination
 - ◆ Can social criteria be included
 - ◆ How to use eco-labeling (certification) schemes as a reference
 - ◆ How the PPP criteria could be applied in awarding contracts
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- ➔ **Case law will be needed for clarifying these issues**
 - ➔ **Alternative for certificate needs to be offered**
 - ➔ **PPP cannot refer to a single certification system only**



Implementation - Lessons Learnt

- PPPs are market catalysts; impact depends on how other actors take up similar policies, public-private cooperation is helpful
- Supporting measures are needed: guidelines, communication, technical advice, training, awareness raising,
- Supply availability needs to be clarified (market analysis)
- Greatest impact with a **focus** on largest market segments (building construction sector)
- Transaction costs and knowledge of procurement officers (lack of information), possible source of substitution
- Level of obligation: middle ground (obligation to establish agency-wise GPPs)
- Outsourcing of training and technical advisory service (UK experience)



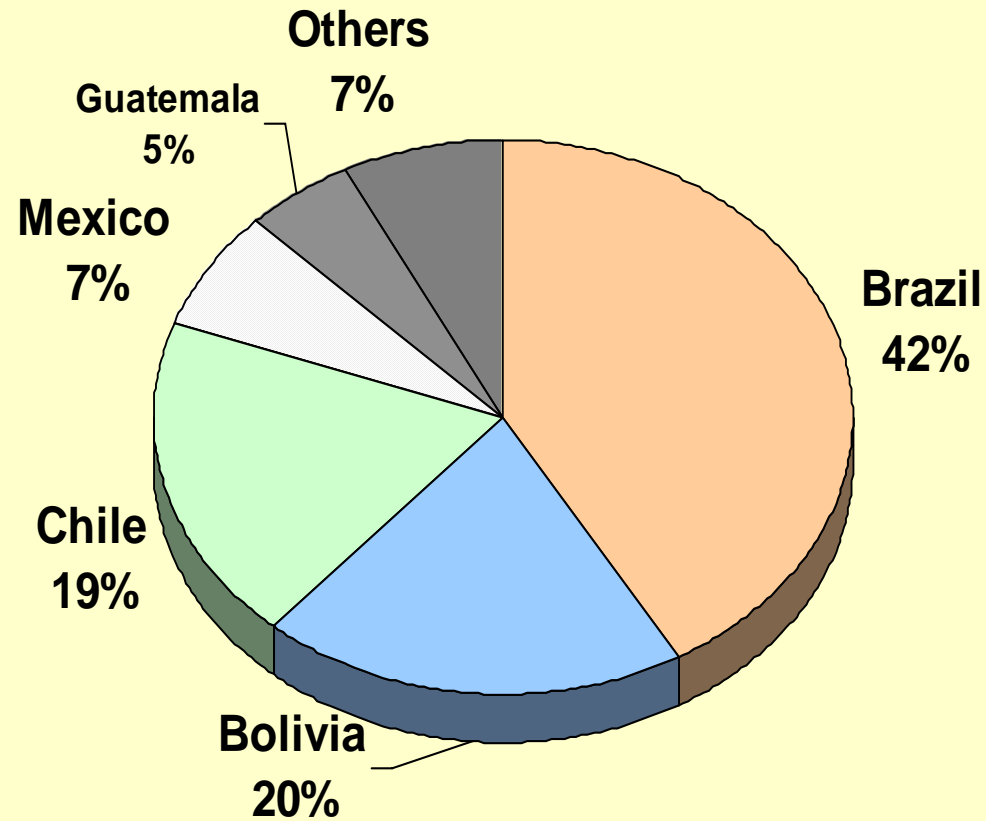
Market Impacts of PPPs

- ◆ Demand: leverage impact of 10-25% is significant; boost for certification as few clear other options
- ◆ PPPs are likely to spread to more countries
- ◆ Segments impacted most:
 - » building construction
 - » furniture and fittings
 - » park, garden and municipal infrastructure
 - » civil works
- ◆ Theoretical potential supply vs. actual availability (legal and sustainable) → price increase
- ◆ Cost impacts: supply chain, transaction costs of procurement
- ◆ Trade diversion (Asia)
- ➔ **Tropical sawn hardwood and plywood will be most affected**
- ➔ **Substitution: buying wood more complex than other materials**





Certified Forest Area in Latin America by Country



TOTAL = 10.3 million ha

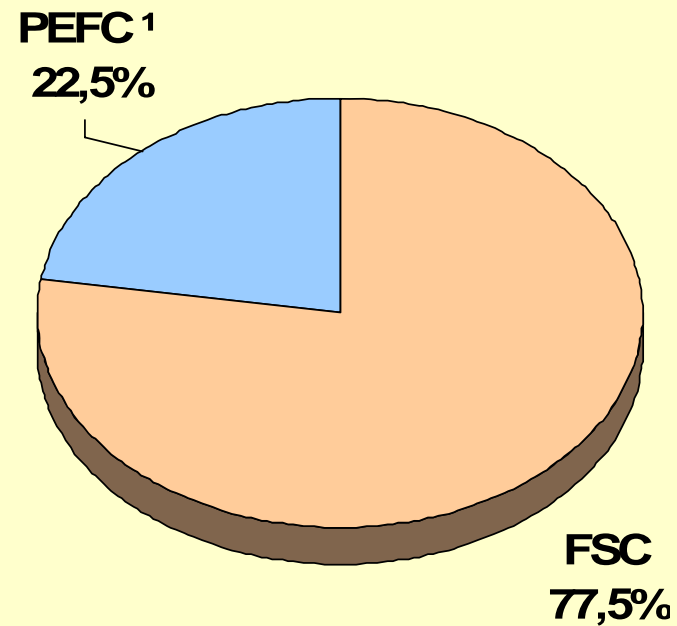
Includes CERFLOR (Brazil – 762,700 ha) and CERTFOR (Chile – 1.56 million ha) schemes.

Sources: FSC, PEFC, others; adapted by STCP.

1.2% of total forest area is certified



Certified Forest Area in Latin America by System



TOTAL = 10.3 million ha

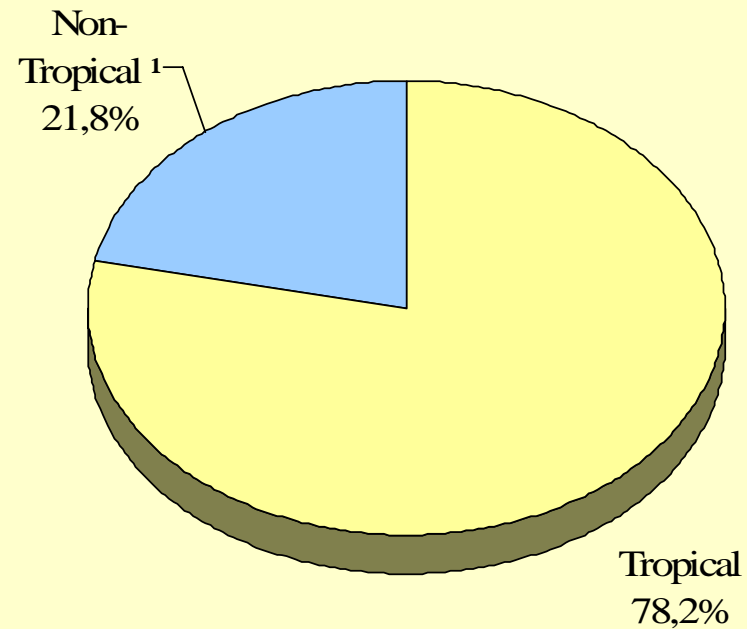
¹ PEFC – Includes CERFLOR (Brazil – 762,700 ha) and CERTFOR (Chile – 1.56 million ha) Schemes.

Sources: FSC, PEFC, others; adapted by STCP.





Certified Forest Area in Latin America by Type



TOTAL = 10.3 million ha

¹ Non-tropical: Argentina, Chile, and Uruguay
Sources: FSC, PEFC, others; adapted by STCP.





Responses: Certification Systems

- ◆ **Revision of system requirements**
 - FSC, PEFC, LEI, MTCC
- ◆ **Phased approaches: ITTO's work led to development of provisions for phased certification**
 - FSC, PEFC, LEI
- ◆ **Legal compliance**
 - FSC, Controlled wood standards
 - PEFC Guide for the avoidance of controversial timber
- ◆ **Tracking systems**





Forest and Economic Impacts

- ◆ **Forest management:** direct and indirect impacts
 - management system
 - loss of revenue (initial)
 - RIL, environmental protection
 - more impact in NTF than plantation management
- ◆ **Governance**
 - Key problem countries could be addressed through less extensive measures
- ◆ **Equity**
 - Small-scale private forests
 - Community forests
 - Tropical countries





Responses of Global Corporate Community



Corporate Social Responsibility

- ◆ CRS is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large (www.wbcsd.org).
- ◆ To demonstrate good business citizenship, firms can report compliance with a number of CSR standards, including:
 - Global Reporting Initiative's Sustainability Reporting Guidelines
 - AccountAbility's AA1000 standard
 - Social Accountability International's SA8000 standard (tool for assuring humane workplaces.)
 - ISO 14000 Environmental Management System standard



Global Reporting Initiative

- ◆ UN Global Compact/Global Reporting Initiative (UNEP): sustainability reporting guidelines for voluntary use by corporations principles and recommended report content (www.globalreporting.org); 24 forest industry members
 - covers raw materials supply chain and chain of custody
 - forest area, species, age, growth, volume
- ➔ **Many large forest industry companies are already applying CSR standards and principles in reporting on their performance but the reporting quality varies**
- ➔ **Spreading to companies which are experiencing difficulties with market acceptability and stakeholder critique**



Implications for Tropical Timber: From Reactive to Proactive Mode



Action Areas

Companies

- Minimum: to provide proof of legality, preference SFM
- Certification would be the most logical option
- Other options depend on target markets

Tropical Countries

- participation in the development of PPP and other requirements to avoid adverse impacts
- ensure acceptability of national certification schemes
- advocate for harmonization of requirements
- clarification of “alternative documentation” (national solutions)
- support to certification of smallholders and community forests



Opportunities and Ways Forward





Business Models of Tropical Forestry

Vertically integrated timber approach

- ◆ TIMBER Ltd. (basis for concession policy, taxation, etc.)
- ◆ TIMBER PLUS Ltd. (additional revenue from forest based services, NTFPs etc.; need for outsourcing)

SFM approach

- ◆ FOREST Ltd. (site-specific specialized business models, timber by-product, NTFPs, environmental services)
 - different economies of scale and area needs
 - different markets, skills, regulation and financing needs
- **Practical business models are still lacking**
- **Paradigm change needed?**





Avoided Deforestation Initiative

- ◆ Huge potential if Kyoto/CDM eligibility
- ◆ Deal-based pilot scheme under development in the WB

→ Technical issues

→ Policy issues:

- sustainable development and poverty reduction
- enabling conditions
- holistic approach to deforestation problem
- sustainability of investment flow
- property rights



Ways Forward: Possible Recommendations

1. **ITTO/WB policy forum** on NTF financing
2. House into order: improvement of **credibility** of responsible NTF investment
3. Better **due diligence**, risk assessment
4. Advocacy for convergence and **harmonization of requirements** for SFM investments and certification; fixing goalposts
5. **Case studies** on alternative business models
6. **Communication** to the public and decision makers: removing the myths and revealing the realities of SFM in NTF
7. **Investment forums**: from global/regional to country level, to be preceded by adequate analysis of constraints and opportunities



Thank You for the Attention !

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