

Corporate Finance: Forestry Products in Papua New Guinea

Conducting an environmental and social due diligence (ESDD) can prevent reputational damage to an international financial institution caused by an activity it financed half a world away.

An international bank provided a six-year \$100 million corporate loan to support the growth and expansion of a well-established paper and pulp operation in Papua New Guinea, whose plantations and mill provide paper products for export. Because of a significant, increased demand for the company's paper products (linked to a decline in single-use plastics), the company acquired adjoining blocks of land for expansion and obtained the necessary local approvals and permits for the expansion, including permits for felling existing trees. On receiving the financing, the company proceeded with its aggressive expansion plan that included harvesting existing timber and replanting with a faster-growing species.

Forestry operations often require careful review for potential environmental and social (E&S) issues, particularly because of concerns relating to:

- Biodiversity loss, including through clear cutting of forest, establishing single-crop plantations that reduce species diversity and habitat area, and habitat fragmentation.
- Using fire to clear land, causing greenhouse gas emissions and potentially uncontrolled fires.
- Land disputes and conflicts (because of traditional ownership and customary use by Indigenous Peoples, boundary disputes, and overlapping concessions).
- Soil erosion and damage from felling operations and heavy equipment movements, and run-off from bare soil, including to watercourses, causing silting and reducing water quality.
- Community health and safety because of heavy operations in their vicinity, such as noise and vibration nuisance and silting of watercourses used for fishing or water sources.
- Occupational health and safety to workers because of the inherently high-risk nature of forest operations.
- Hazardous materials (and disposal of empty containers), including agri-inputs such as fertilizer and pesticides, and fuels and oils used in equipment and machinery.



Photo: World Bank

- Legality of timber and supply chain risks from blending legal and illegally harvested timber.
- Cultural heritage through impacts to areas of archaeological, spiritual, or historic interest, including to local communities.

Not long after the company started clearing existing forest land, local communities and nongovernmental organizations (NGOs) raised concerns about two specific issues:

- Customary land use in the area by local communities, and
- The areas' remaining biodiversity value, including iconic species and part of a broader landscape fabric of interconnected forest providing a wider interconnected habitat for some species.

The bank's credit review confirmed that the permits and approvals were correct, and legal due diligence confirmed the company's allocated land concession boundaries—all of which the bank considered sufficient for the E&S review. However, conducting a proper ESDD would have reviewed a variety of E&S risks that may not have been apparent at first. An evaluation of existing consultation processes and grievance mechanisms, for example, would have captured community concerns, and potential biodiversity impacts should have been assessed. Because an ESDD was not conducted, the bank and the company experienced:

- Organized local protests that quickly drew negative attention to the company (and eventually the international bank) and forced the company to scale back its plans.
- International media attention that escalated into a well-coordinated campaign in the bank's home country, resulting in bank customers closing their personal accounts.
- Continued negative publicity that caused some of the company's existing customers to question the source of the timber used in its products and become wary of associating with the company.

To mitigate these issues, the bank commissioned an independent E&S assessment of the company, which included an immediate stop to all expansion activities and a public announcement stating the actions it was taking. The assessment showed that certain areas of higher biodiversity value should not be cut, and connectivity with nearby forest areas should be maintained to reduce habitat fragmentation. It also identified areas of customary land use and land disputes. Addressing these concerns resulted in a smaller area for the company's forestry operations than originally planned. Per the assessment's recommendations, the company implemented stakeholder engagement programs and established a grievance mechanism to support improving relations with stakeholders and local communities. The incident triggered an extensive internal review in the bank, requiring it to update its E&S requirements (particularly related to forestry).



Photo: World Bank

ESDD assessments help financial institutions and their clients avoid potential E&S issues and adverse events that could jeopardize financial and operational viability.

Conducting ESDD on transactions is a critical component of a financial institution's E&S management system. The assessment systematically identifies, quantifies, and evaluates any potential E&S risks associated with a potential client's business activities to ensure that the transaction won't present liabilities and risks to the institution. If the process finds E&S risks, it helps identify mitigation measures to reduce those risks. Thus, its outcome is important to the decision-making process for proceeding with a transaction, because E&S risks could present a credit, liability, or reputational risk to financial institutions.

The international bank suffered unexpected implications because of its failure to identify and manage E&S issues through an ESDD.

The bank thought that involvement in forestry (and indirectly supporting the reduction of single-use plastic) was a positive aspect of the proposed deal, but it failed to understand the E&S risks and impacts associated with the sector, the country, and the activity it financed. It also didn't understand that the transaction linking it to its client also links it to any risks associated with the client's operations. In this case, the company's E&S issues and the resulting delays and stoppage affected both the bank and the company:

- The bank had to review the financial models and restructure the financing, because the reduced development required a smaller loan.
- Both the company and the bank incurred significant legal expenses from the additional legal reviews required, dealing with negative publicity, and responding to stakeholders, and from the loan restructuring.
- The bank's involvement in controversial activities brought negative attention to it and residual reputational risks both at home and abroad.

These implications affected the bank in these ways:

- Disruption of client operations can endanger their prospects for staying in business, which puts the bank's investment at risk.
- Legal issues for failure to comply with a country's E&S requirements can result in fines and penalties or even loss of their operating permits, again risking the bank's investment.
- Negative public perception can damage a client's reputation, which could lead to less demand for their products, affect financial and operational viability, and damage the bank's reputation by association.



Photo: World Bank

Proper ESDD goes beyond a financial institution's routine due diligence process.

The bank's confirmation of local permits, approvals, and land concession boundaries for forestry wasn't an appropriate way to manage the level of E&S assessment and management required. Although it commissioned an independent E&S assessment retrospectively, doing so earlier as part of its due diligence would have identified the issues that should have been a key component of the credit review.

The bank confused a good story with the underlying basics of E&S. Even though an activity has positive benefits, other risks and issues can still compromise the viability of an investment. In this case, the bank's attempt to pursue an environmental business opportunity that could have shown good corporate responsibility and improve its reputation backfired instead, because it didn't include a proper ESDD as part of its risk management system.

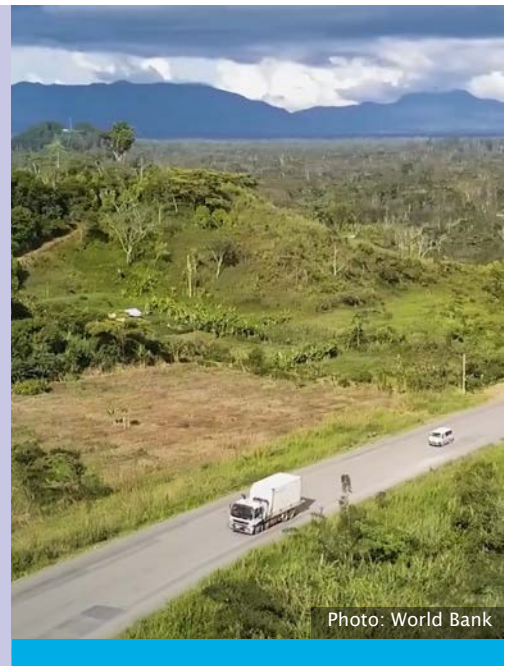


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