FINANCIAL INSTRUMENTS FOR SUPPORTING RESPONSIBLE FOREST INVESTMENTS: A REVIEW OF INTERNATIONAL EXPERIENCES

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Abstract: In the recent decades it has been demonstrated that timberland investments can be highly profitable. The paper discusses the causes and explores the potentials of timber- land investments at the international level. There are four main factors influencing tim- berland investment returns: biological growth, timber prices, land appreciation, and infla- tion. Timber investments are stable, and less risky; which is especially acknowledged in the recent years of financial crisis. The institutional portfolio investors from United States are among the first who recognized timberland as an attractive investment, and together with Timberland Investment Management Organisations (TIMOs) are still the leaders in this field. Nowadays, three decades later, the market of timberland investments is mov- ing from United States to a global scale, with a growing focus in the emerging markets region. Besides conventional timber investments, and due to the climate change politics and legislation, biomass projects, and carbon sequestration projects such as REDD, are also becoming attractive options. As a consequence of an enlarged set of forest invest- ments, also in the forest sector there is an interesting trend towards Socially Responsible Investing (SRI). An increased number of investors are using, apart from profit, additional criteria for investment design and selection that are usually explained as ESG criteria (En- vironment, Society, and Governance). In giving evidence on how responsible or ethical investing is influencing the forest sector. The paper presents the perspectives from vari- ous institutional forest investors, as well as other involved stakeholders; and various cri- teria for the selection of forest investments are analyzed and compared. Finally, the paper provides recommendations for developing more comprehensive criteria for responsible forest investment.

Key words: forest investments, corporate social responsibility, ethical standards, TIMOs

1. Introduction

Increased awareness of sustainability issues including, but not limited, to climate change, has enhanced the attractiveness of forest as an investment. As the evidence of that, there is an increasing flow of institutional and private capitals invested in the forestry sector; a growth in the number and range of forest investments can be observed both in developing and developed countries. As in other sector, also in forestry ethical/responsible finance criteria are applied in ranking the funds and in orienting the investors towards those economic activities that are promoting sustainable forest management practices. Leaded by the empirical evidence that there is a growing demand for ethical finance, this research investigates which ethical criteria are applied in forest finance (both profit and non profit oriented) and to which extend.

2. Background

Forests offer a wide range of potential investments. Timber is the one of the assets that has been historically attractive to private (profit oriented) financiers. Since three decades ago, the first institutional portfolio investors from the United States started investing in timber and the first Timberland Investment Management Organisations (TIMOs) were established (Binkley et al. 1996). TIMOs serve as intermediary between interested investors and potential investments. In the recent years it has been demonstrated that timberland are not as profitable investment as they were three decades ago. This is due to the fact that besides the range of positive characteristics, the timber investment has as well negative characteristics that might lower its profitability. The timber as an asset is a stable investment in the long term; it has manageable risk; and it is followed with an additional financial asset – the land. But timber is in the same time a highly illiquid asset, with a low flexibility (Block and Sample 2001, Brooks et al. 2007, Healey et al. 2005). Still, timberland investments remain important, especially among the United States institutional investors and TIMOs who are the leaders in this field (Maidell 2008). Although TIMO model of investment is limited to US, more recently the market of timberland investments is moving from US to a global scale, with a growing focus in tropical and emerging markets region.

Apart from timber, forests can be an attractive investment thanks to their multi functionality and numerous environmental and social services, such as carbon sequestration; watershed protection and landscape beauty; poverty alleviation for local people; creation of job opportunities and economic development. As such, forests also attract financiers who do not have profit as the main aim: international and national development agencies, foundations and nongovernmental organisations. According to (FAO 2005), through grants, loans, or equity fund, over six hundred public and private organisations invest in sustainable forest management.

If the general investment trends are observed in the global scale, it can be noticed that an increasing number of financiers are showing a significant interest in ethical, green, sustainable, and responsible investments due to the media and society pressure; or in some cases on a voluntary basis. Although the ethical finance has a long history, the high interest in recent years is probably a direct consequence of global concern in society for environmental and sustainability issues such as climate change. Because of the same reason, the finance in forestry sector became more attractive as well. Ethical finance has a great potential to change investors' conventional way of thinking, in which the profit is the only criteria for investing. An increasing number of investors are using other criterion apart from profit when they select their investments. Whether they are called triple bottom line, 3Ps (Planet, People, and Profit), or ESG (Environment, Society, and Governance), these additional criteria are based on two pillars of sustainable development: society, and environment. Thus, ethical finance can be considered as implementation of the sustainable development concept, because additional criteria ensure that economic development (profit) does not constrain social and environmental development.

The general situation is that an increasing number of different capital holders (potential financiers) are willing to invest in the forest sector if the investment is complying with criteria that will categorize it as ethical/responsible. Different ethical forest investors have different investment approaches. Some investors claim to comply with general social and environmental requirements by using International Financial Corporation Social and Environmental Sustainability Performance Standards (IFC 2006). Some investors demonstrate their responsibility by signing documents such as United Nation Principles for Responsible Investing, Equatorial Principles or the Collevecchio declaration (UNEP Finance Initiative 2006, Equator Principles 2006, Bank Track 2009). Although social and environmental issues are well covered in these documents, their criteria are too general, and as such not fully applicable to forest investments. The investors who have recognized this problem have developed their own criteria for ethical forest investments, sometimes making reference to on FSC, PEFC and other third party forest certification standards. However, due to the diversity of criteria used, it is difficult to distinguish between ethical and non ethical investments. This might confuse and discourage potential investors, but more importantly, the confusion of criteria is creating a room for scams and greenwash, that usually target smaller individual forest investors, but are importantly affecting the image of forest investment in general.

For the purpose of this research, the finance in forestry sector is distinguished in two groups, according to the type of investment. These are:

- Profit oriented finance in the forestry sector;
- Multifunctional finance in the forestry sector.

Profit oriented finance in the forestry sector refers mainly to timber investments, while more recently biofuel investments became attractive. Private, institutional investors such as pension funds, insurance funds or foundations are oriented towards profit finance. Multifunctional forest finance refers to investments that are not only profit oriented, but as well serve to provide additional environmental and social services. Public investors (governments, international bodies…) are mainly oriented towards multifunctional finance in the forest sector. The border between these two types of investments is not strict. For example, at the moment, REDD projects are financed by governments of developed countries. Six developed countries, leading by Norway and USA, invested (Lebedys 2008) $ 3.5 billion dollars for REDD projects, in developing countries (Kouchakji, 2010). However, this will change in the future; as REDD projects become eligible for carbon credits, they will be of interest to profit oriented investors involved in international carbon trading.

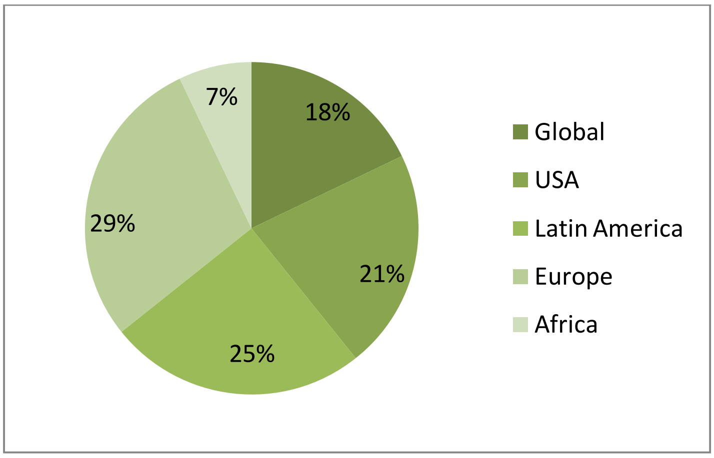
3. Research methodology

In order to examine the ethical finance in the forest sector, the following issues are investigated: the profile of forest investors, and investment managers; the profile and performance of forest investments; the strategies for forest investment, with a special focus on ethical finance strategies; market demand for ethical forest investment; and perception towards ethical finance. Therefore, both primary and secondary data are collected. Besides literature review, the study employs questionnaire survey. The questionnaire survey was conducted in order to examine how ethical finance is applied among profit oriented forest financiers (pension funds, banks, insurance funds, TIMOs…). The respondents were selected purposively, so the sample covers as much as possible different types of financiers, from different geographical regions (United States, Europe, Australia, Latin America…). The questionnaire was sent to respondents by e-mail, or they are contacted by phone. The respond from 28 forest financiers were collected.

4. Results and discussion

The respondents in questionnaire survey were various forest investment organisations: from different countries, with different investment strategies, both specialized in forestry and diversified who have forest investment as one of the assets in diversified portfolio. Organisations oriented towards institutional investors represent almost 90% of the respondents. The rest are investment organisations oriented towards individual investors, who are described as ordinary people. Figure 1 illustrates the geographical origin of surveyed organisations. Those with geographic origin stated as “global” are big, multinational companies who have offices in several countries.

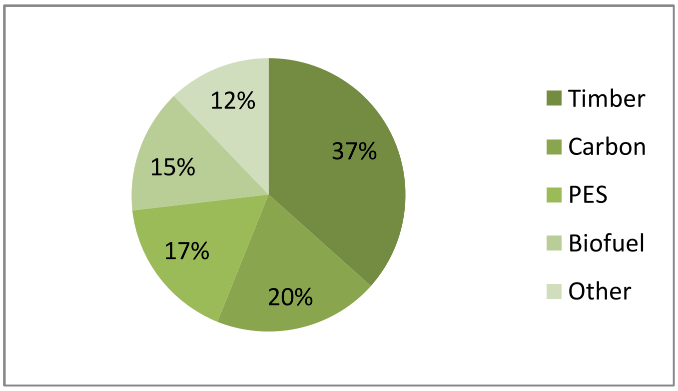
Figure 1: Geographic origin of forest investment companies



Most of organisations are specialized in forest investment (78%). Domestic forest investment is characteristic for organisations from North America. However most of organisations are oriented towards foreign forest investments, especially in Latin America which 40% of investors characterised as the most important location, following by Australia (21%), Europe and Russia (14%), Asia and Africa (14%). Investment located in North America represents 20%.

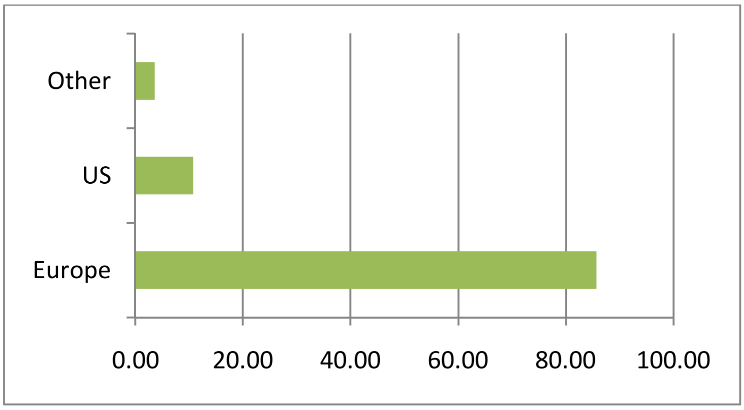
It is important to mention that a significant number of investment organisations is characterised by a diversified forest investment portfolio (eg. timberland, carbon and PES together). Therefore, survey participants were asked to select the most important type of investment. The majority of investors have chosen timberland investment as the most important, followed by carbon investment, PES, and biofuel (see Figure 2). Other investment fields mentioned as important by investors are community development and sustainable livelihoods, as well as timber industry related investments in sawmills, pellet plant, or nurseries.

Figure 2: Type of forest investments



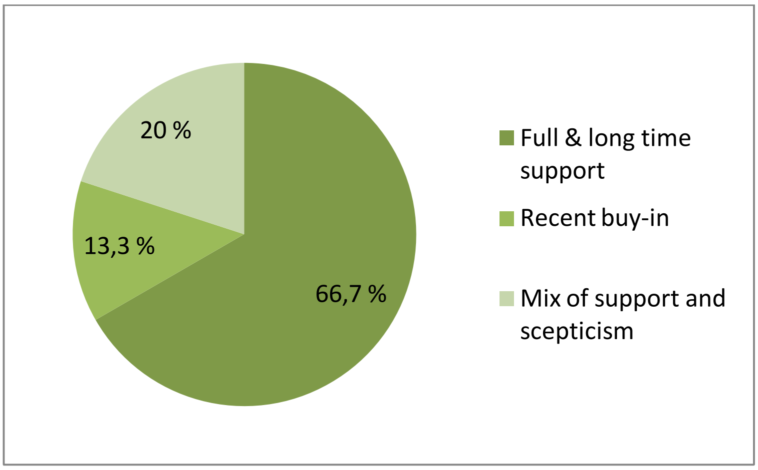
The key issue of the survey was to explore who are the clients of forest investment organisations; to answer who invest in forests through these organisations? As already stated, these are mainly institutional investors. As the respondents considered confidential to state the name of their clients, only the geographical origin of clients was assessed. This revealed very interesting issue: the investors are almost exclusively from Europe (85.7%) and US (10.7%), while the investors from other regions represent 3.6% (see Figure 3).

Figure 3: Geographic origin of investment institutions



Commitments towards ethical finance in the forestry sector. The survey assessed the commitments of investment organisations towards ethical finance, in general. Almost 68% of respondents stated full and long time support towards ethical investments in their organisational culture, followed by 20% who expressed a mix of support and scepticism, and around 13% who stated that their organisation considers ethical finance as a recent buy-in (see Figure 4).

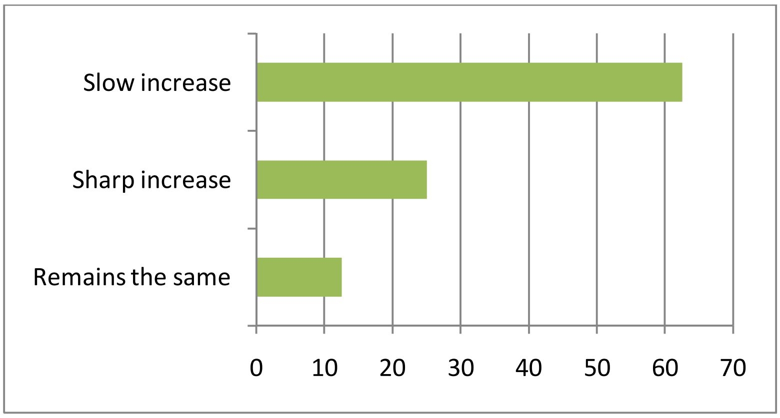
Figure 4: Commitments towards ethical finance



Current market demand for ethical finance in the forestry sector. According to 81% of survey respondents, in the last three years, there has been an increasing interest for ethical investment in forest. From this group, two thirds believe that this growth is mainly driven by market demand, and one third thinks that demand is driven by suppliers push.

Perceptions towards future role of ethical finance. Additionally, perceptions on the future role of ethical finance in the forest sector were surveyed: 62.5% of them believe that the role of ethical forest investment in the market will increase slowly, and 25% think that it will increase sharply. Only 12.5% think that the interest for ethical forest investments will remain the same, and none think that this interest will decrease (see Figure 5).

Figure 5: Perceptions towards future role of ethical finance in the forestry sector



In 60% of cases, positive perception towards ethical finance is consequence of global financial crisis. Additionally, more than a half of survey respondents stated that their ethical investments performed better in the light of financial crisis.

Ethical forest finance practises. Surveyed organisations demonstrated high commitment towards ethical forest finance: 83% of respondents quantified more than a half of their current investment assets as ethical (socially responsible/sustainable) investments. More importantly, 94% claimed the appliance of ethical criteria in investing. Ethical investment strategies that investors are using are various. The respondents counted both negative screening and positive (best-in-class) screening (88%). As an addition, a majority described other ethical investment strategies that they are applying, mainly related to FSC, and PEFC forest certification standards, as well as VCS and CCB carbon certification standards. Some organisations developed their own policies and standards used in screening of potential investments (such as Dasos capital, and International Woodland Company) which are based on ethical initiatives mentioned in chapter 2.

5. Conclusions

Considering the assessed data, it could be concluded that there is an increase demand for responsible/ethical investment in the forestry sector among institutional investors. Perceptions towards ethical finance are highly positive and the market demand for ethical finance in the forestry sector is growing. The investors and investment organizations acknowledged that potential risks of forest investment to environment and people could be managed if the ethical finance criteria are applied. However, ethical performance is not a major issue for selection of forest investments. Country risk, weak management, illegality, lack of suitable collateral, weak business planning and skills, lack of (local) demand (for sustainable products and services) combine to overwhelm the case for responsible forest finance; and thus these risks effect forest finance. Many financial institutions have made, or are under pressure to make, commitments to the sustainable, ethical forestry finance. The remaining challenge to the financial sector is in developing consistent and effective policies and criteria for ethical financing in the forestry sector.

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