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Chinese Overseas Investment in Forestry and Industries with High Impact on Forests:

Official Guidelines and Credit Policies for Chinese Enterprises Operating and Investing Abroad

Duncan Brack

With support from

FOREST TRENDS

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On behalf of BMZ Federal Ministry for Economic Cooperation and Development

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Executive Summary

The explosive growth of the Chinese economy in recent years has led to a rapid rise in the volume of outward foreign direct investment (FDI) by Chinese enterprises. This was triggered in particular by the Chinese government's adoption of its Going Global (or "Going Out") strategy in 2001, a response partly to the country's rapid accumulation of foreign exchange reserves, and the accompanying upward pressure on the currency; outward FDI was seen as one way to relieve the pressures. The trend has been reinforced by the global financial and economic crisis from 2008, which has had significantly less impact on China than on Western economies. By 2012, China had become the world's third largest source of outward FDI, behind only the United States and Japan.[1]

The Going Global strategy has been stressed in successive Five-Year Plans, including the current version (2011–15), both directly and as part of a policy of promoting national champions (companies in key sectors which are expected to advance national interests). The government is gradually lightening the administrative burden on enterprises applying for examination and approval before investing abroad, though the process is still highly bureaucratic. However, as investments have become more widespread, inevitably some have been made in more risky environments; in addition, some countries have seen growing local resistance against Chinese labor and business practices.

As Chinese outward FDI projects have become larger and more numerous, they have also inevitably become more risky. The Chinese government has accordingly attempted to improve risk forecasting and mitigation — including making more efforts to encourage responsible business conduct on the part of Chinese companies abroad. In fact, as the compilers of one recent collection of related policy statements argued, "China, arguably more than any other country, has put a framework in place which sets out priorities and controls relating to foreign outward investment"[2] — though what real impact the framework has had is open to question.

The Chinese government has accordingly attempted to improve risk forecasting and mitigation and has made particular efforts to encourage responsible business conduct on the part of Chinese companies abroad, including encouraging compliance with local laws and regulations. This has resulted in the publication of numerous guidelines for businesses operating overseas and the use of lending guidelines to try and affect the behavior of Chinese enterprises accessing finance from Chinese banks and other financial institutions.

This paper examines the evolving framework for outward FDI in relation to legal compliance and responsible implementation of overseas investment projects affecting forestry and forest areas. The major conclusions are:

- China's importance in outward FDI has grown rapidly; it is now the third most important source in the world. A proportion of this investment has been devoted to ensuring supplies of raw materials from abroad, including timber and wood products.
- In 2010, total Chinese outward FDI in agriculture, forestry, animal husbandry, and fisheries amounted to $1.9 billion, or 1.7 per cent of total Chinese outward FDI.[3] Investment in other sectors which might affect forests includes mining ($0.7 billion), construction ($1.5 billion) and transport, warehousing, post and telecommunications ($2.2 billion).

[1] UNCTAD, *World Investment Report 2013* (UN, 2013), p. xv. If outward FDI from Hong Kong is included, the ranking rises to second, behind only the US.

[2] Nathalie Bernasconi-Osterwalder, Lise Johnson, and Jianping Zhang (eds.), *Chinese Outward Investment: An emerging policy framework – A Compilation Of Primary Sources* (IISD and IIER, 2012), p. vi.

[3] Ibid., p. 72.

- The majority of China's outward FDI originates from state-owned enterprises (national, provincial, and municipal) although the government is also encouraging outward FDI by private enterprises and individuals as well. Since a main focus of the Going Global strategy is to build national champions, and these are mainly state-owned enterprises, this dominance seems likely to continue.
- Geographically, Chinese coastal cities and provinces are responsible for the overwhelming majority of outward FDI. Provinces are developing differentiated strategies based on existing strengths in particular sectors. Provinces specializing in agriculture and forestry (among other sectors) include Shandong, in north China, and Yunnan, in the south-west, on the border with Myanmar.
- Successive guidelines for the behavior of Chinese enterprises abroad, including those covering silviculture and forest management, are clear on encouraging compliance with local laws, but are essentially voluntary, with no reporting or compliance mechanisms; it is not clear whether they have had any real effect. Nonetheless, SFA has started piloting these guidelines by training Chinese overseas enterprises in select countries, such as Russia and Gabon.
- The latest set of relevant guidelines, on overseas trade and investment in forest products, are currently in draft form. They aim to incorporate lessons learned from pilot assessments of the 2007 and 2009 guidelines, but in principle they remain voluntary. However, the SFA has expressed willingness to implement positive incentives for enterprises that follow the guidelines, as well as regular assessments and disclosures of non-compliance.
- A more powerful tool in regulating outward FDI than the voluntary guidelines are the financial incentives provided by the government. Chinese enterprises on an approved list benefit from the government's financial support in the form of access to below-market rate loans, direct capital contribution, and subsidies associated with official aid programmes. Successive sets of guidelines have been issued to banks and financial institutions to encourage them to ensure their clients comply with environmental and social standards, including host-country laws and regulations.
- The most recent green credit guidelines (2012) are the most comprehensive, but as with the other sets of guidelines considered here, their implementation has so far been patchy. However, the government apparently intends to enforce them more strictly, a move which is being accompanied by a centralization of the reporting mechanisms for companies breaching domestic environmental laws. It is not clear, however, how effectively they can be applied to Chinese companies operating abroad.
- All guidelines and policies share the basic and fundamental requirement that host-country laws and regulations must be followed, in keeping with China's commitment to respect national sovereignty.
- Despite these weaknesses, the most recent environmental protection and green credit guidelines offer clear opportunities for host-country governments, NGOs, and campaigners to highlight occasions where Chinese companies are operating in breach of their own government's guidelines and to put pressure on the Chinese government — which is clearly sensitive to accusations of poor behavior by Chinese business overseas — to rectify them.

Acronyms

CBRC	China Banking Regulatory Commission
CNOOC	Chinese National Offshore Oil Corporation
Exim Bank	(China) Export and Import Bank
FDI	Foreign Direct Investment
IFC	International Finance Corporation
IISD	International Institute for Sustainable Development
IUCN	International Union for the Conservation of Nature
MEP	(Chinese) Ministry of Environmental Protection
MofCom	(Chinese) Ministry of Commerce
NGO	Non-governmental Organization
NDRC	(Chinese) National Development and Reform Commission
OECD	Organisation for Economic Cooperation and Development
SFA	(Chinese) State Forestry Administration
SMEs	Small- and medium-sized enterprises
UNCTAD	United Nations Conference on Trade and Development
WWF	World Wide Fund for Nature

Table of Contents

Trends in Chinese Outward Foreign Direct Investment

The Government of China's Going Global strategy, first discussed in 2000 and formally adopted in the eleventh five-year plan in 2001, set out seven aims, including:

- To encourage overseas investments to enhance China's competitiveness and expand the scope and modalities of China's economic and technical cooperation;
- To support companies in exploring resources overseas that were in short supply domestically and promote adjustment of the sectoral structure of resources trade.[4]

As a result, China's outward FDI flows have climbed steadily, from about $2.5 billion in 2002 to $27 billion in 2007 to $84 billion in 2012.[5] The 2012 figure represents 6 per cent of total global outward FDI and almost 20 per cent of total developing countries' outward FDI.

China's stock of FDI — the accumulated total of FDI flows and subsequent growth — amounted to $28 billion in 2000 and $509 billion in 2012.[6] The latter figure represents 2.2 per cent of the total global stock (11.4 per cent of total developing country stock) — China still has some way to go to catch up with developed countries with decades of outward FDI behind them.

The majority of China's outward FDI originates from state-owned enterprises (national, provincial, and municipal) as the government cannot use its own foreign exchange reserves for direct investment abroad. Since a main focus of the Going Global strategy is to build national champions, and these are mainly state-owned enterprises, this dominance seems likely to continue. However, the government is also attempting to encourage outward FDI by private enterprises and individuals.[7]

Geographically, the sources of outward FDI are very unevenly distributed. Provincial-level government data are difficult to get hold of, but the limited information available shows that provinces are developing differentiated strategies based on factors such as their existing strengths in particular sectors and their location, with coastal cities and provinces responsible for the overwhelming majority of outward FDI and inland provinces exporting little or no capital. Some common features are starting to emerge in leading provinces and cities, including a preference for joint outward investment promotion by firms and for clustering together in special economic zones (areas with lower levels of taxation and/or regulation) established in host countries. Provinces specializing in agriculture and forestry (among other sectors) include Shandong, in north China, and Yunnan, in the south-west, on the border with Myanmar.[8]

In 2010, total Chinese outward FDI in agriculture, forestry, animal husbandry, and fisheries amounted to $1.912 billion, 1.7 per cent of total Chinese outward FDI.[9] (Investment in other sectors which might affect forests includes mining ($0.684 billion (0.6 per cent), construction ($1.461 billion, 1.3 per cent) and transport, warehousing, postal services and telecommunications ($2.244 billion, 2.0 per cent).) China has been a net importer of timber for many years and, under the impact of its rapid domestic development and restrictions on domestic logging (to protect landscapes and allow for the expansion of domestic plantations), has now

[4] Huang Wenbin and Andreas Wilkes, *Analysis of China's Overseas Investment Policies* (CIFOR, 2011), p. 9.

[5] Ibid., p. 1; UNCTAD, *World Investment Report 2013*, p. 214.

[6] UNCTAD, *World Investment Report* 2013, pp. 217–18.

[7] Davies, *China Investment Policy,* pp. 34–56.

[8] Ibid.

[9] Ibid., p. 72.

grown to be the largest importer of timber in the world. In 2012, for example, China's imports of logs and the roundwood equivalent of imports of primary products such as lumber and pulp were equal to 10 per cent of the total global production of industrial roundwood.[10]

Accordingly, Chinese outward FDI is playing an important role in securing imports of timber for China's domestic industries. According to the overseas investment approval record kept by the Chinese Ministry of Commerce, investments in forestry and land use have been made in the following regions and countries:[11]

- **Africa**
  Fourteen countries in Africa have received Chinese outward FDI in agriculture and forestry, in particular Gabon (23 per cent of total investment), Zambia, Equatorial Guinea, Liberia, Republic of Congo, and Cameroon. Investments tend to target labor-intensive activities, such as logging and wood and rubber processing, rather than more capital-intensive activities such as paper-making or flooring. Large state-owned enterprises account for the bulk of outward FDI, though the importance of private SMEs is rising (and they prefer Africa to other regions for outward FDI). Joint ventures are common, as a means both of circumventing legal restrictions on foreign ownership and of reducing operational risks.
- **Asia**
  Outward FDI in logging and processing has been mainly directed to Laos, Myanmar, Thailand, and Korea, while particular efforts have also been made to establish plantations in border areas previously under opium poppy cultivation in Laos, Thailand, and Myanmar. In general FDI has been more capital-intensive than in Africa, with paper and paper products and palm oil production among the most prominent investments. Rubber plantations have been a particular target in Laos, designed to meet the need for rubber imports for China's growing vehicle industry.
- **Latin America and Caribbean**
  Less significant than Africa or Asia, though Chinese investments have been rapidly expanding, particularly in Brazil, Argentina, Venezuela, Peru and Guyana; the tax haven of the British Virgin Islands also hosts a number of Chinese forestry and land-invested enterprises. In some Latin American countries, restrictions on foreign investment in land have inhibited Chinese as well as other nations' outward FDI.
- **Russia**
  Chinese investment has focused on logging, timber processing, pulp and paper, and other categories, primarily in the border areas in Siberia and the Russian Far East. The products are mainly processed timber (though often only very crudely processed) — encouraged by higher Russian duties on the export of raw timber and lower duties on the import of timber-processing equipment — for export directly to China. Chinese outward FDI has been encouraged by the Russian and Chinese governments, with a series of supportive statements and programmes adopted since 1997.

10 *2013 China Timber Outlook* (RISI, 2013).

11 Chinese Academy of Forestry, "An Overview of China's Overseas Investment in Forestry and Land Use" (working paper, unpublished).

Regulating Chinese Outward Foreign Direct Investment

The expansion of Chinese outward FDI has been encouraged in large part by a relaxation of government controls. Since the adoption of the Going Global Strategy, the approval process for investments has been significantly simplified; in March 2011, for example, the threshold for examination and approval of large overseas investment projects in natural resources was raised from $30 million to $300 million (and for other categories from $10 million to $100 million). The approval process has been decentralized from central government agencies to their provincial branches, and key state-owned enterprises now simply have to file their overseas investments without having to submit them for examination and approval. On top of this, some private enterprises have accumulated enough capital overseas to invest without any oversight.[12]

One outcome, however, both of this deregulatory process and of the increase in the number of investments, has been a rise in the number of failed projects. This is partly due to fact that the wider spread of investment projects makes it more likely that some of them will be in risky environments; for example, the Arab Spring uprisings in 2011 saw a rapid departure of Chinese enterprises and workers from several countries. In addition, several countries have seen a backlash against perceived Chinese business and labor practices; reactions against Chinese investment in key industries have included the blocking of the attempts by CNOOC to take over US oil company Unocal in 2005 and by Chinalco to take a major investment in Rio Tinto in 2009. Some countries, particularly in Latin America, have adopted legal restrictions on foreign ownership, particularly of land, as a response to FDI (especially the so-called "land grabs") from China and from other countries.

The Chinese government has argued that since their enterprises have only been taking part in international competition for a relatively short time, they lack experience; as a result, there has been a certain amount of "blindness and disorderliness in the overseas investment process."[13] As a result, the government has increasingly focused on means of reducing the risks inherent in investment decisions: the key policy slogan is: "government guidance, enterprise decision-making."[14] This has included including making more efforts to encourage responsible business conduct on the part of Chinese companies abroad, particularly in terms of the environmental and social impacts of their activities and including compliance to domestic laws and regulations.

Two key government agencies are involved in this process and more broadly in implementing the Going Global strategy:

- *The Ministry of Commerce* (MofCom) approves, monitors, and manages enterprises engaged in outward investment (apart from financial services), monitors outward FDI in terms of both quantity and quality, and negotiates investment treaties. It also formulates and implements standards for the qualification of domestic enterprises engaged in outward investment and carries out performance evaluations and annual inspections of outward investments.
- *The National Development and Reform Commission* (NDRC) is responsible for international capital flows, foreign capital utilisation and outward investment, as well as strategic planning. It retains approval powers for major projects, although the applications are made initially to MofCom.

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12 Davies, *China Investment Policy*, pp. 38–39.

13 Ibid., p. 38.

14 Ibid., p. 39.

As noted above, provinces and municipalities also play an important role in promoting outward FDI, but in general their policy frameworks are not made public. A MofCom report on outward FDI published in 2010 only contained information on the situation in eleven provinces and major cities (there are thirty-one provinces in total), suggesting that even the central government finds it difficult to acquire this kind of information.[15]

MofCom and NDRC, together with other central agencies such as the State Council, central finance agencies (considered in more detail below) or the State Forestry Administration (SFA), have published a wide range of documents and policy statements regulating outward FDI. A compilation by IISD, published in 2012, contained eighty-nine such documents, dating back as far as 1964, though the vast majority were issued from 2000 onwards, as part of the Going Global strategy.[16] These various instruments target Chinese outward public and private investors and determine which sectors are to be promoted and the circumstances under which investors can benefit from financing and other support.

These efforts have been focused on two main areas: the publication of guidelines for enterprises to follow in their activities abroad; and the application of criteria to the provision of finance for outward FDI. The rest of this section looks at each of these activities in turn.

Guidelines for Chinese Enterprises

The key policy statements relating to forestry activities are set out below. Commitments relating to Chinese companies' compliance with domestic laws and regulations are highlighted; allegations have often been made about Chinese companies behaving illegally abroad, and indeed to a certain extent this lies behind the publication of the guidelines.

A Guide on Sustainable Overseas Silviculture by Chinese Enterprises[†]

- *Year of publication*: 2007
- *Developed by*: MofCom and SFA
- *Applicable to*: All Chinese enterprises engaged in silviculture and related activities in foreign countries

[†] Available at http://www.chinafile.com/guide-sustainable-overseas-silviculture-chinese-enterprises.

These guidelines require relevant host-country laws and regulations to be observed, including relevant international conventions and agreements signed by China and the host country. Companies must possess up-to-date texts of relevant regulations and ensure that they pay all relevant taxes and fees. In particular:

3.3.5 Logging shall be conducted according to the law. Forest destruction or any other unauthorized activity shall be strictly prohibited.

3.3.6 Forestland shall be protected according to law. The high conservation value forest shall be strictly protected and no illegal transformation of forestland for other purposes shall be tolerated.

Schemes are to be formulated and implemented in accordance with local authorities' long-term plans and local conditions. Local communities are to be informed of the schemes and encouraged to participate in decision-making; also, employment, training, and other services are to be offered. Measures are to be adopted to protect the local environment, including biodiversity and habitats, and activities are to be sustainable.

[15] Ibid., p. 43.

[16] Bernasconi-Osterwalder et al. (eds.), *Chinese Outward Investment: An emerging policy framework.*

This was the first set of guidelines issued by MofCom and SFA together, and the first to introduce the principle of sustainability into overseas involvement in forestry. However, the guidelines are essentially voluntary; there are no reporting requirements or compliance mechanisms.

Guide on Sustainable Overseas Forests Management and Utilization by Chinese Enterprises†

- *Year of publication:* 2009
- *Developed by:* MofCom and SFA
- *Applicable to:* Chinese enterprises engaged in forest harvesting, wood processing and utilization, and related activities in foreign countries

† Bernasconi-Osterwalder et al. (eds.), *Chinese Outward Investment: An emerging policy framework*, pp. 196–202. All guidelines included in this document have been edited to improve the English; words in [ ] are added by the editors.

Produced in collaboration with a number of NGOs (WWF, The Nature Conservancy, IUCN, and Forest Trends) the aim of the guide is to "guide Chinese enterprises to rationally manage, utilize, and protect overseas forests in order to play a positive role in [the] sustainable development of global forest resources" and to provide the industry with a "management criterion and self-discipline basis activities overseas" — i.e., to enhance self-regulation. Section 2, on basic principles, opens with:

> 2.1.1 The principle of national sovereignty: Chinese enterprises shall fully respect the ownership of the host country to its forest resources and strictly observe its laws, regulations, and policies when managing and utilizing the forest resources in foreign countries.

Section 3 goes into more detail on laws and regulations: Companies shall comply with any relevant agreements signed between China and the host country, the laws and regulations of the Chinese government on overseas investment and economic cooperation, and the laws and regulations of the host country on forest resources, the management of investment, export of labor services, contracted projects, and other business operations. "Once an illegal act is discovered, prompt measures shall be taken to correct it according to the laws, and such an act shall be placed on record" (**Section 3.3.3**). In addition, the principles of sustainable development, environmental protection, and cooperation with local communities are reflected throughout the document.

As with the 2007 document, there are no reporting requirements or compliance mechanisms; adherence to the Guide is effectively voluntary. Pilot assessments of compliance with the guidelines with some individual state-owned companies in Russia and Africa have reportedly been positive,[17] but recent independent investigations in Russia show that illegal behavior by Chinese enterprises overseas remains widespread.[18]

[17] Ibid. Also see *China's Effort to Tackle the Trade in Illegal Timber*, presentation by Fu Jianquan (SFA) at Chatham House, 8 July 2013.

[18] See, for example, Environmental Investigation Agency, *Liquidating the Forests: Hardwood Flooring, Organised Crime and the World's Last Siberian Tigers* (EIA, 2013); and D. Y. Smirnov (ed.) et al, *Illegal logging in the Russian Far East: global demand and taiga destruction* (WWF Russia, 2013).

Guidelines for Environmental Protection in Foreign Investment and Cooperation†

- *Year of publication:* 2013
- *Developed by:* MofCom and Ministry of Environmental Protection (MEP)
- *Applicable to:* All Chinese companies' activities in foreign investment and cooperation. Commerce departments and environmental protection departments of governments at all levels (provinces, regions, municipalities, etc.) are requested to promote the Guidelines

† Available at http://english.MofCom.gov.cn/article/policyrelease/bbb/201303/20130300043226.shtml

The aim of this newest set of guidelines, developed by MofCom and MEP, is set out in Article 1:

> These *Guidelines* are hereby formulated in order to direct enterprises in China to further regularize their environmental protection behaviors in foreign investment and cooperation activities, timely identify and prevent environmental risks, guide enterprises to actively perform their social responsibilities of environmental protection, set up good international images for Chinese enterprises, and support the sustainable development of the host country.

Article 5 specifies that "Enterprises shall understand and observe provisions of laws and regulations of the host country concerning environmental protection." Most of the Guidelines deal with protecting the local environment, conducting environmental monitoring and due diligence, risk and impact assessments, and publishing full information. Environmentally sound practices — such as resource use and waste minimization, recycling, and green procurement — are encouraged.

The Guidelines are similar in some ways to the environmental provisions of the OECD Guidelines for Multinational Enterprises. Even though the OECD Guidelines have been relatively widely adopted, in general China prefers to draw up its own guidelines in areas such as these rather than accept codes of conduct drawn up by organizations in which it does not participate.

As with the forestry documents, these guidelines are voluntary, with no reporting requirements or compliance mechanisms. Reportedly, the Ministry of Environmental Protection (MEP) had argued for a mandatory code of conduct, but had failed to convince MofCom.[19] The possibility of making the guidelines mandatory, or of extending the reach of the domestic Environmental Impact Assessment Act to cover Chinese enterprises operating overseas, apparently remains under consideration if the Guidelines should fail to have an impact.[20] NGOs have encouraged host-country communities and NGOs to put pressure on their own governments to apply the Guidelines to Chinese (and other foreign) enterprises, and possibly incorporate them in bilateral investment treaties.[21]

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[19] See International Rivers, *Interview with Dr Hu Tao on China's Overseas Investment Guidelines*, 24 April 2013; and Hu Tao, *A Look at China's New Environmental Guidelines on Overseas Investments*, World Resources Institute (WRI), 3 July 2013. Dr Hu formerly worked for the Ministry of Environmental Protection, and is now at WRI in the US.

[20] Ibid.

[21] International Rivers, *Interview with Ren Peng [Global Environmental Institute] on China's Overseas Investment Guidelines*, 24 April 2013.

Guidelines for Overseas Sustainable Forest Products Trade and Investment by Chinese Enterprises [draft]

- *Year of publication:* to be determined
- *Developed by:* SFA, to be issued jointly by SFA and MofCom
- *Applicable to:* Chinese enterprises engaging in forest product trade and investment and related activities in foreign countries.

SFA began development of these guidelines in 2013, in close collaboration with the Chinese Academy of Forestry and Beijing Forestry University and in consultation with various NGOs, with the aim to incorporate lessons learned from pilot compliance assessments in Russia and Africa.[22] The guidelines set out to improve upon the 2007 and 2009 versions and provide an updated platform for enterprises' understanding of legality and sustainability measures. They will potentially serve as a precursor to a binding timber legality assurance system in China.

As with the 2009 guidelines, these require relevant host-country laws and regulations to be observed, adhering to the principle of national sovereignty (**Section 2.1.1**).[23] Section 2 continues with:

> 2.1.2 Principle of Cooperation for Win-Win Progress: Chinese enterprises are supposed to positively facilitate the local economic and community development and cooperation on the mutual benefits basis while carrying out the overseas trade and investment of forest products.

Enterprises must also comply with the international conventions and agreements ratified by China or the host country, several of which will be annexed in the final version. Sections 4 and 5 delve into extensive detail on fundamental requirements for trade and investment activities, respectively: Enterprises should procure and transport timber through legal channel and carry out business "strictly in line with the permitted form of investment" (**Section 5.2.1**). Broad principles of environmental protection and community development are included, but remain vague despite the above-quoted principle of cooperation.

In March 2014, the SFA held a workshop to solicit feedback on the draft guidelines from international NGOs, representatives from producer countries, and industry leaders.[24] Workshop participants, particularly those from Africa, voiced their desire for improved social and environmental standards, inclusion of due diligence principles,[25] and for the guidelines to be made applicable and accessible to importers, small and medium enterprises (SMEs), and other stakeholders in the wider forest product supply chain. Participants also supported more stringent reporting requirements and compliance mechanisms in the form of an incentive structure and regular, transparent assessments. In response, the SFA expressed willingness to selectively incorporate positive incentives, and to conduct more regular assessments to expose cases of non-compliance. A new draft is expected later this year.

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22 *Overview of China's forest product trade in 2013 and summary of annual report of CINFT*, presentation by Chen Shaozhi at the International Workshop on Promoting Legal and Sustainable Trade and Investment of Forest Products, 25 March 2014.

23 Section numbers are drawn from the draft released in December 2013, and included to give an indicative structure only. This draft is currently embargoed and subject to change prior to finalization and release.

24 Workshop report forthcoming.

25 See Global Witness, *Submission to the State Forest Administration regarding the forthcoming Timber Trade and Investment Guideline* (Global Witness, January 2014) pp. 5-11.

Provision of Finance for Outward Foreign Direct Investment

Probably a more powerful tool in regulating outward FDI than the voluntary guidelines outlined above is the financial incentives provided by the government. Chinese enterprises on the approved list benefit from the government's financial support in the form of access to below-market rate loans, direct capital contribution, and subsidies associated with official aid programs. This provision of finance for outward FDI also, of course, offers the government a means of affecting the behavior of Chinese enterprises investing overseas. Several government agencies are involved:[26]

- The *People's Bank of China* (the Chinese central bank) is responsible for overall financial policy and rules and supervises China's foreign exchange reserves.
- The *State Administration of Foreign Exchange* (SAFE), which is overseen by the People's Bank, makes foreign exchange policy recommendations and carries out foreign exchange transfers.
- The *Ministry of Finance* drafts laws and regulations on fiscal, taxation and accounting management and manages central government's revenues and expenditures.
- The *China Securities Regulatory Commission* approves and supervises Chinese companies' overseas stock issues and debenture activities, stock market listings and so on.
- The *China Banking Regulatory Commission* (CBRC), which falls directly under the State Council, approves outward FDI projects by Chinese banks.

A number of financial institutions are also key:

- The *China Export and Import Bank* (Exim Bank) provides credit for overseas investments and is the sole provider of government concessional loans.
- The *China Development Bank's* primary role is to provide finance for investments in natural resources abroad to meet China's domestic needs, though its investments are not limited to this sector.
- The *Industrial and Commercial Bank of China* (the largest bank in the world, by assets and market capitalization) provides investment banking services and financial support to Chinese corporations for both acquisitions and greenfield projects overseas and is a major outward investor in its own right.
- The *China Export and Credit Insurance Corporation* (Sinosure) provides insurance cover for exports and investments.

A combination of these agencies have issued a series of relevant guidelines and documents, of which the main ones are outlined below.

Green Credit Policy†

- *Year of publication:* 2007
- *Developed by:* CBRC, People's Bank of China and State Environmental Protection Agency††
- *Applicable to:* Banks lending to companies operating within China

† Adina Matisoff and Michelle Chan, *The Green Evolution: Environmental Policies and Practice in China's Banking Sector* (Friends of the Earth US and BankTrack, November 2008), pp. 9–12.

†† Now the Ministry of Environmental Protection (MEP).

[26] See Davies, *China Investment Policy*, pp. 41–42; and Wenbin and Wilkes, *Analysis of China's Overseas Investment Policies*, pp. 3–5.

The first of a trio of green financial policies,[27] the Green Credit policy issued in July 2007 aimed to regulate bank lending. The policy was aimed at companies operating within China; it did not apply to outward FDI, but is included because it played a part in the development of later, broader guidelines.

The policy established a "credit blacklist" of companies that failed to meet environmental standards due to high levels of energy consumption, pollution, or environmental risks. Banks were prohibited from lending to companies on the list until remedial action was taken and until their names were removed from the list. Even at the start, the policy was regarded as likely to be insufficient; while, during the time of its launch the deputy chief of the State Environmental Protection Agency said that the credit blacklist was the most forceful measure the agency could impose to clean up rivers in China, he also observed that "it cannot fundamentally contain the trend of worsening pollution, and we need the force of even more combined economic levers."[28] Implementation was slow and piecemeal; enforcement of the policy was the responsibility of local environmental protection departments, responsible to local authorities, who were often reluctant to deny credit to major local industries. Nevertheless, it helped pave the way to the Green Credit Guidelines issued in 2012 (see below).

Guidelines for Environmental and Social Impact Assessments of the China Export and Import Bank's Loan Projects[†]

- *Year of publication:* 2007
- *Developed by:* Exim Bank
- *Applicable to:* Loans made by Exim Bank.

[†] Bernasconi-Osterwalder et al. (eds.), *Chinese Outward Investment: An emerging policy framework*, pp. 181–84.

Drawn up in line with Chinese domestic legislation on environmental protection, the aims of these Guidelines are to promote sustainable development and control credit risk. Social benefits and environmental demands are to be considered alongside economic benefits in the assessment of loan projects. **Article 12(2)** states that:

> The host country's environmental policies and standards are the basis for evaluation. Offshore projects of the host country should abide by the requirements of their laws and regulations, and obtain corresponding environmental permits. When the host country does not have a complete environmental protection mechanism or lacks environmental and social impact assessment policy and standards, we should refer to our country's standards or international practices.

Local rights to land and resources should be respected and public consultation followed. Before approving offshore projects, Exim Bank requires environmental and social impact assessments issued by the host-country authorities, and if necessary, can require the "inclusion of environmental and social responsibilities in the loan contract, in order to monitor and restrain the behavior of borrowers" (**Article 14**). A monitoring process is also included.

[27] The other two, both published in February 2008, were the Green Securities policy, regulating China's capital markets, and the Green Insurance policy, regulating insurance companies.

[28] "Green credit: To fight pollution, China takes the capitalist route," *New York Times*, 30 July 2007.

Environmental Assessment Framework†

- *Year of publication:* 2011
- *Developed by:* Exim Bank
- *Applicable to:* Originally designed for the financing of a major domestic energy-efficiency project, but also now used for the financing of overseas projects.

† Bernasconi-Osterwalder et al. (eds.), Chinese Outward Investment: An emerging policy framework, pp. 210-18.

This framework, which built upon World Bank and Asian Development Bank guidelines, specifies the screening, documentation, public consultation, and supervision procedures which should be followed. The sub-project screening procedure lists a series of activities which rule out sub-projects from any further consideration; this includes "commercial logging operations for use in primary tropical moist forest" and "production or trade in wood or other forestry products other than from sustainably managed forests."

Green Credit Guidelines†

- *Year of publication:* 2012
- *Developed by:* CBRC
- *Applicable to:* All Chinese banking and financial institutions are encouraged to follow the Guidelines.

† Bernasconi-Osterwalder et al. (eds.), Chinese Outward Investment: An emerging policy framework, pp. 230-34.

The aim of these Guidelines is to encourage "banking institutions to, by focusing on green credit, actively adjust credit structure, effectively fend off environmental and social risks, better serve the real economy, and boost the transformation of economic growth mode and adjustment of economic structure" (**Preamble**).

Banking institutions are to promote green credit, increase support to green, low-carbon, and recycling activities and measure, monitorr, and control environmental and social risks associated with their activities, including those of their clients and "key affiliated parties thereof." They will develop client environmental and social risk criteria and "consider the results as important bas[es] for credit rating, access, management and exit" (**Article 11**). Clients facing major environmental and social risks will be required to take mitigation actions, and the compliance of clients to whom credit is granted will be examined. Banking institutions will innovate in the provision of green credit products and services and conduct capacity-building and training.

Specifically for outward FDI:

> Banking institutions shall strengthen the environmental and social risk management for overseas projects to which credit will be granted and make sure project sponsors abide by applicable laws and regulations on environmental protection, land, health, safety, etc. of the country or jurisdiction where the project is located. The banking institutions shall …. promise in public that appropriate international practices or international norms will be followed as far as such overseas projects are concerned, so as to ensure alignment with good international practices. (**Article 21**)

These requirements are placed directly on senior management, who are instructed to assign a senior officer and department to the role and aim constantly to improve their bank's performance, both in identifying and managing risk and in promoting green credit. Banks' green credit strategies and green credit business will be made public. The performance of banking institutions in line with these guidelines is to monitored; a green credit self-evaluation is to be carried out at least every two years, and the report submitted to the competent supervisory authorities. The assessment results are to be treated "as important bas[e]s for supervisory rating, institution licensing, business licensing, and senior officer performance evaluation" (**Article 28**).

The Guidelines were developed together with the International Finance Corporation (IFC) and to a certain extent were based on IFC standards. In May 2012 the IFC and CBRC organized an International Green Credit Forum in Beijing, involving about 200 regulators, commercial bankers, and NGO representatives. The Guidelines were in general welcomed by NGOs, though it was also noted that they suffered from a lack of specific guidance. CBRC has subsequently worked on developing further details, including key performance indicators, training, and other supporting systems.[29]

Individual banks have put the Green Credit Guidelines into practice — for example, the Industrial and Commercial Bank of China (ICBC) has developed industry green credit policies covering 85 per cent of all of its corporate loans and has refused to lend to projects and customers falling short of the bank's standards — but these have varied in quality and coverage.[30] The 2012 China Green Credit Annual Report published by the Ministry of Environmental Protection ranked the top fifty Chinese banks in terms of green credit performance; the Industrial Bank Co. (CIB) was the only one given a "Class A (above 80)" ranking.[31] Only 12 per cent of the banks examined were fully implementing a green credit policy, implementation was "not ideal" at over half of the banks and 18 per cent had no information available on their policy at all.[32] As a Ministry official put it:

> China's fifty banks all have green credit policies in place, but generally these policies are just hung on the wall. They don't actually influence credit ratings and lending decisions … In the sector as a whole, lending to polluting, energy-hungry and resource-extracting industries is still high, and that's particularly the case at city-level commercial banks. Those banks are strongly influenced by local governments, which prevent the local environmental authorities from providing information on breaches of environmental law by some companies, or in some projects. Some local governments require local banks to lend to environmentally risky companies … Compared with other countries, the financial sector in China is under a lot less, almost negligible, pressure to protect the environment.[33]

By May 2013 Chinese media was reporting that CBRC had developed nineteen indicators to evaluate the impact of the Green Credit Guidelines, including accountability and performance indicators on the issue of green credit and project management. A credit blacklist mechanism was to be established in conjunction with other government agencies; companies which failed the green credit evaluation system could also face a suspension or halt in their loan disbursement.[34] In an interview in August 2013, a senior CBRC staff member explained that Chinese banks lacked the expertise needed to build effective systems to evaluate environmental

[29] See Yiting Sun (WWF China), *China's Green Credit Guidelines and their impact on the forest sector*, presentation to Chatham House, 8 February 2013.

[30] CleanBiz.Asia, *Three steps toward green finance in China*, 23 August 2013.

[31] *China Sustainable Finance Newsletter* issue 17, October 2012 (BankTrack and Friends of the Earth).

[32] *Chinese banks under 'almost negligible' pressure to protect the environment*, chinadialogue, 21 March 2013.

[33] Ibid.

[34] *China Sustainable Finance Newsletter* issue 18, May 2013 (BankTrack and Friends of the Earth).

risk and to ensure compliance on the ground, the legal rights to enforce their credit policies among customers, and adequate incentives to develop green finance if faced with a conflict between environmental sustainability and profitability.[35]

By October 2013 it was reported that the CBRC was intending to toughen up implementation of the Guidelines. They had been prepared to allow banks time to implement the Guidelines and establish reporting systems, but now intended to start proper enforcement.[36] For domestic companies this would until recently have depended on the provision of information on environmental performance from provincial environment protection agencies, which, as has been seen, is highly variable in quality. However, the recent decisions to remove provincial environmental protection agencies from the control of provincial governments and make them responsible to the central government, and also to add agencies' notifications of companies in breach of environmental laws automatically to the National Credit Bureau database (so that all Chinese banks are immediately informed of companies they should not be lending to), can be seen as part of the determination by central government to enforce the rules.[37] It is not clear how equivalent information would be obtained about the performance of Chinese companies overseas, but this may open up a route of influence for overseas governments, NGOs, and campaigners.

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[35] CleanBiz.Asia, *Three steps toward green finance in China*, 23 August 2013.

[36] Sean Kidney, *Regulator update: China's excellent green credit guidelines are … mandatory! A whole new set of worry lines for bank compliance staff :)*, Climate Bonds Initiative blog entry, 16 October 2013.

[37] Sean Kidney, pers. comm.

Conclusions

On paper, the Chinese government's framework for regulating the behaviour of its forestry (and other) enterprises overseas is impressive. Commitments to respect the host country's laws and regulations and to consult fully with local communities are clear. However, the successive sets of guidelines have all been voluntary, and no real information is available on the extent to which Chinese enterprises comply with them. In contrast, there are plenty of examples of situations where they do not.

Nevertheless, clearly these commitments matter to the Chinese government; otherwise, it would not continue to issue them. Resistance in some countries to Chinese investments, including the blocking of some major proposed investments, is a genuine problem; one way of helping to reduce this resistance is to demonstrate clearly that Chinese companies are good corporate citizens, particularly in reference to compliance with the laws and regulations of the countries in which they operate. Thus the various sets of guidelines — particularly the most recent Guidelines for Environmental Protection in Foreign Investment and Cooperation — provide a tool for overseas governments, NGOs, and others which can potentially be used to apply pressure to the Chinese government to regulate their industries better.

The various green credit guidelines provide a similar tool. Again, on paper they are impressive; but their implementation so far has clearly been poor — though this seems to be changing, particularly in regard to the new Green Credit Guidelines, which the government appears to be serious about enforcing. It is not clear, however, how they can be applied effectively to Chinese companies overseas; and, of course if a company is not reliant on Chinese banks for finance, it is effectively beyond the influence of the guidelines. Nevertheless, they provide another potential tool for campaigners to use to apply pressure to the Chinese government in the case of poor environmental behavior on the part of Chinese companies overseas.

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