Improving the Due Diligence of Financial Institutions to Combat Illegal Logging

The effects of weak due diligence on the part of financial institutions have been clearly illustrated by the 2008 financial crisis and its fallout. The failure of previous due diligence arrangements has revealed the gaps that allowed excessive risks to be taken to the detriment of investors. Such breakdowns also are what have permitted the proceeds of corruption, from illegal logging and other illicit activities, to flow and be laundered through the financial system.

The money garnered at each step in bringing illegally-logged timber to market has to be laundered and invested to make the endeavour worth the effort. Weak due diligence by financial institutions — local, national and international (including multilateral banks) — facilitates this process and illegal logging’s profitability. Moreover, the provision of financing to companies with dubious assets or operations, including fraudulent timber concessions, helps to keep illegal logging in business.
Improving the due diligence of financial institutions to combat illegal logging

1. Issue at stake

As part of due diligence and normal operating procedures in most countries, financial institutions are required to monitor and report suspicious transactions. Yet when it comes to illegal logging, this mechanism would appear not to be working effectively. The illegal timber trade is believed to account for between 40 and 61 per cent of Indonesian wood and 14 and 25 per cent of Malaysian logs that are exported.¹ These revenues, estimated at billions of dollars, are entering the regional and global financial system unchecked and undetected.

Strengthening due diligence standards would help to withdraw the financial system’s support for illegal logging by addressing:

- **Money laundering** – depositing in financial institutions the proceeds gained from trading in illegal timber; and
- **Investment in timber companies** – funding entities participating in the trade and/or transgression of regulations (local and international) relating to environmental impact, sustainability or prior informed consent laws with local forest communities.

In addition to these areas, better due diligence would also bring broader benefits for financial entities in terms of meeting their corporate responsibility commitments and reducing their risk exposure.

2. Manifestations

Analysing these breakdowns in due diligence arrangements, and the results, demonstrates the close relationship between corruption and illegal logging.

**Laundering of money:**

Money laundering is used to conceal the proceeds of crimes, such as illegal logging. Comparisons between illegal logging and the drugs trade have been made and in some cases the two crimes are even linked.² Both deal with illegal goods worth billions of dollars, which are laundered through banks, and whose proceeds often end up being used to fund further illicit activities, such as armed conflict.³

Laundering normally involves transferring money across international borders so that its origins — such as illegal logging operations — are obscured. The aim is to have the funds end up in legitimate financial institutions as deposits or other assets. Where due diligence is not properly conducted on suspicious funds, financial institutions become the channel for legitimising money earned from illegitimate forestry operations.

Due diligence on the part of financial institutions exposes those engaged in and benefitting from forestry crimes. In particular, it is able to reveal the actors at the top of the operation’s hierarchy rather than just those who do the work on the ground. Furthermore, the suspicious or illegal activities uncovered by due diligence can be used by anti-corruption agencies to justify further investigations into the origin of the laundered money.

**Investing in questionable timber companies:**

Financial institutions provide operational loans, credit guarantees and other forms of investment for companies that log or process timber. Good due
diligence arrangements would require that before providing such support, financial institutions would check that the company in which they are investing follows legal procedures in its country of operations (including those for forestry). Apart from ensuring that no fraud is taking place, this background check would provide a safeguard for the financial institution. It would help to satisfy its board and stakeholders that liabilities and/or losses would not be incurred in the event that any illegal practice by the company was found.

Not all financial institutions demonstrate exemplary due diligence, however. The Hong Kong Shanghai Banking Corporation (HSBC) in Malaysia applies social and environmental investment standards but it has been criticised for violating its own criterion for forestry. It is alleged that HSBC arranged for a public offer of the Samling logging company. Samling has been accused of logging primary forests without proper certification or compliance with forest stewardship standards by Innovest, a research firm that analyses company performance on environmental, social and governance issues.5

Among the international financial institutions, export credit agencies (ECAs), which provide considerable support for timber companies, appear to have some of the weakest social and environmental standards. It has been shown that projects backed by European ECAs have contributed to illegal forestry operations in Indonesia.6

**Reneging on corporate responsibility commitments:**

Financial institutions as well as other companies should assume responsibility for ensuring that their investments do not encourage or support corruption in forestry. This level of due diligence relates to broader issues of corporate responsibility such as embodied in the UN Global Compact, which is widely accepted as the world’s largest corporate responsibility initiative (and whose tenth principle addresses corruption).

As part of meeting corporate responsibility commitments, financial institutions should apply due diligence to ensure that corruption has not played a part at any stage of the process in a forestry project (see side bar). This due diligence is very important as many times a company may enter the project at a point where it is seemingly ‘free’ from corruption. However, corruption may have played a role at an earlier stage such as during the government review and approval process. Good due diligence will help to identify any of these concerns. Before moving forward with an investment, past problems should be effectively dealt with and future risks mitigated. Moreover, if corruption is discovered as a result of due diligence, it should be reported to the authorities. Beyond corruption, financial institutions should also perform due diligence checks on various other aspects of corporate responsibility, such as environmental or human rights practices.

**Increasing the riskiness of investments:**

Investments that are based on bribery or may subsequently involve bribery are risky investments, whether in forestry or any sector. Corrupt partners are unreliable and dishonest, and present a corruption risk for the financial institution. Moreover, if any illegality is involved in a project and is discovered, the project could be jeopardised or even terminated. Even working with corrupt associates may make a financial institution liable and open to investigation and prosecution. Due diligence will not only help to prevent a financial institution from entering a risky forestry project, but it will allow the mitigation of other risks. These risks include exposure to penalties in the case that an incident does occur in a project that a financial institution has backed.
Improving the due diligence of financial institutions to combat illegal logging

3. Recommendations

When due diligence processes reveal issues and concerns related to corruption in forestry, there are different recourses for investors.

If the problems are found prior to an investment decision, then a financial institution must decide whether it is better to withdraw from the project. If they are already committed to an investment, then the company must determine how to mitigate the identified concerns. Actions on the part of financial institutions can include choosing environmental and social alternatives that are feasible to continue the project, remediying the cost of past corruption to damaged communities, and implementing controls and monitoring to ensure that corruption does not take place in the project. Companies may also choose to remove corrupt associates from the project and consult with affected communities before making an investment decision.

In addition to these reactive steps, there are a number of proactive measures that the financial sector should take to move in the right direction on better due diligence.

Setting standards: Standards should be set to ensure that any financial institution that knowingly operates with forestry companies that break the law, or social or environmental standards, is considered complicit in the crime. While enforcement may be challenging, it would create a strong measure of reputational risk for banks and other financial institutions adopting this working principle if they were to be found lending money to dubious timber companies.

Making due diligence of the forestry sector more effective: In order to maintain high due diligence standards, financial institutions should apply more effective and comprehensive reviews of their norms. Standards should also adequately cover forest activities to ensure that a financial institution is not providing funds for illegal or unsustainable practices. More effective due diligence measures would include agreeing on how to best open up raw material supply chains to independent verification.

Adopting corporate responsibility standards: Standards such as the Equator Principles Code of Conduct for private lending institutions could be adopted. Under these principles, which were adopted in 2003, banks pledge not to lend money to projects that would damage the environment in developing nations. Currently only around 60 banks have signed these voluntary principles and there is no recourse to apply direct sanctions for non-compliance. Such principles, however, provide a means to pressure financial institutions to act more responsibly, particularly when they are concerned about the negative publicity associated with violating the standards.

Extending due diligence abroad: Although many governments already have anti-money laundering laws that require financial institutions to report unusual transactions such as large cash deposits or withdrawals, many do not pursue these investigations abroad. Since the illegal timber trade relies on the use of third party transit countries and shell companies, it is critical to extend official due diligence requirements to operations outside the country of registration. Governments also should use their anti-money laundering and anti-corruption laws to assist in asset recovery for crimes committed in foreign jurisdictions. In order to encourage this, memoranda of understanding between timber producing
countries and financial centres in the Asia Pacific region, such as Singapore or Hong Kong, could help to track the assets from illegal logging and corruption.

**Extending current legislation and agreements to the forestry sector:** Financial crime experts have highlighted the advantage of using anti-money laundering legislation to tackle forestry issues, in order to avoid designing new measures. Similarly, existing memoranda of understanding between countries could be extended to include the forestry sector, and to enhance monitoring of money laundering cases from illegal logging activities.

**Engaging civil society for advocacy and monitoring:** Civil society has a role in advocating for more effective financial monitoring mechanisms, especially those which are transparent and can be scrutinised by independent bodies and non-governmental organisations. Civil society is in a position to push for transparent processes and the implementation of anti-money laundering legislation, asset recovery, and most importantly for the forestry sector, regional cooperation between producing, processing and consuming countries.
Improving the due diligence of financial institutions to combat illegal logging

References


9. Please see the annex to this project paper which includes the full list of questions at: www.transparency.org/fgi

10. For more information, see: www.equator-principles.com


© 2011 Transparency International. All rights reserved.

Transparency International (TI) is the civil society organisation leading the global fight against corruption. Through more than 90 chapters worldwide and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption, and works with partners in government, business and civil society to develop and implement effective measures to tackle it. For more information go to: www.transparency.org