

# THE FINANCIAL SECTOR AND JAPAN'S CORPORATE GOVERNANCE CODE

A GUIDE TO APPLYING THE CODE IN THE PROVISION OF FINANCIAL  
SERVICES TO TROPICAL FOREST-RISK COMMODITY CLIENTS



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### **About Rainforest Action Network**

*Rainforest Action Network is an independent, non-governmental organisation that seeks to create lasting market and political solutions by inspiring corporations to embrace a deeper commitment to environmental and social justice. RAN's mission is to campaign for the forests, their inhabitants and the natural systems that sustain life.*

*RAN is headquartered in San Francisco, California with satellite offices in Tokyo, Jakarta and London.*

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# INTRODUCTION

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This guide has been produced by Rainforest Action Network to assist Japan's financial institutions in meeting their obligations under Japan's Corporate Governance Code (the Code), which came into effect June 1st, 2015. The guide identifies specific environmental, social and governance risks that financial institutions face in providing financial services to clients with links to tropical deforestation.

The Code is an important and welcome initiative requiring companies listed on the Tokyo Stock Exchange to implement reforms towards the achievement of long-term economic stability. Noteworthy is the Code's requirement for listed companies to integrate sustainability issues into business and investment decisions and to cooperate with and respect the rights and positions of a range of stakeholders, including local communities (Principle 2), and its promotion of better decision-making through disclosure of non-financial information, including environmental and social considerations (Principle 3). The Corporate Governance Code complements the Principles for Responsible Institutional Investors (Japan's Stewardship Code), which calls on institutional investors to consider risks arising from social and environmental matters in monitoring their investee companies.

Alongside market demand for the physical use of tropical forest-risk commodities such as timber, palm oil and pulp and paper, financial institutions help enable tropical deforestation by providing the loans, underwriting, bonds and share investments required by producer companies and traders of tropical forest-risk commodities to expand their operations. Many of these sectors require large amounts of capital for the development of plantations and associated infrastructure such as roads, mills and refineries.

Research carried out by Rainforest Action Network and Profundo indicates that Japan's banking sector is one of the largest sources of capital to Southeast Asia's major producers and traders of palm oil, pulp and paper, and tropical timber. Since 2010, Japan's banks have provided around one trillion yen in commercial loans to these companies, representing one-quarter of all documented loans. In contrast to a growing number of EU and US-based banks that have already published forest sector safeguard policies, no major Japanese bank has yet developed public policies or due diligence systems designed to identify the range of environmental, social and governance risks common in the tropical forest-risk commodity sector.

The measures called for by the Code and by this guide are consistent with an array of normative and regulatory developments internationally, such as new transparency and non-financial reporting legislation in Europe and the United States. Of particular note is the OECD Guidelines for Multinational Enterprises, which asserts that financial institutions providing finance to companies involved in harmful activities are also directly linked to the adverse harms, and therefore have a duty to use their influence to prevent such situations from arising and to secure remedy where and when adverse harms do occur.

Section One of this guide identifies specific environmental, social and governance risks in the tropical forest-risk commodity sector; Section Two highlights international policy developments consistent with the Code; and Section Three recommends how financial institutions can translate the Code's principles into practice through established policy standards and systems.



***The Code asks companies to examine whether there are issues in their corporate governance in light of the aim and spirit of the principles of the Code, and take self-motivated actions in response to those issues.***

***- The Council of Experts Concerning the Corporate Governance Code***

# KEY RECOMMENDATIONS FOR FINANCIAL INSTITUTIONS

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## 1

### **Publish a high-level statement with clear commitments to:**

- » Positively and proactively address sustainability issues, including social and environmental matters arising from client business operations;
- » Engage and cooperate with stakeholders, including on the issue of upholding the rights of local communities;
- » Disclose non-financial information relating to issues of sustainability and respect for stakeholder rights arising from client business operations.

## 2

### **Develop safeguard policies applicable to all types of financial services for high-risk commodity sectors. For clients operating in the tropical forest sector:**

- » Full compliance with all relevant local, national and international laws;
- » No deforestation or degradation of High Conservation Value Forest<sup>1</sup>, High Carbon Stock Forest<sup>2</sup>, or peatland areas<sup>3</sup>;
- » Respect and uphold local communities' and Indigenous Peoples' customary land rights, including their right to give or withhold permission based on Free, Prior and Informed Consent (FPIC) principles and procedures;<sup>4</sup>
- » Demonstrate compliance with free and fair labor practices, including no use of forced or child labor<sup>5</sup> and prohibit the use of specified toxic pesticides;<sup>6</sup>

## 3

### **Implement internal compliance systems and external reporting procedures to ensure institution-wide achievement of improved standards:**

- » Clearly define Board and management structures, roles, resources and responsibilities to ensure oversight mechanisms and incentive tools for the effective integration of sustainability issues and stakeholder engagement;
- » Establish internal whistleblower and external grievance mechanisms to identify and remedy incidents of non-compliance and to promote continual improvement of standards and systems;
- » Disclose sufficient company and client information to enable independent monitoring and meaningful dialogue with all stakeholders on measures taken to address environmental and social issues.<sup>7</sup>

# 1. ENVIRONMENTAL, SOCIAL AND GOVERNANCE RISKS IN THE TROPICAL FOREST-RISK COMMODITY SECTOR

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Between 2000 and 2012, the world lost 1 million km<sup>2</sup> of tropical forests, an area nearly three times the size of Japan, with some of the highest losses occurring in the tropical rainforests of Southeast Asia. Tropical deforestation and degradation worldwide accounts for 14-21% of annual global greenhouse gas emissions, pollutes fresh water systems, and causes species extinction through habitat loss.

More than 1 billion people around the world directly rely on forests for their survival, food security or livelihood. Local and indigenous communities can suffer serious rights violations through the expansion of industrial logging and plantation development, including loss of rights over their lands, evictions, forced labor, child labor, intimidation, conflict, rape, and even killings.

How forests and forest-dependent communities are treated has wide-reaching and often irreversible social and environmental consequences. In addressing environmental, social and governance issues, the Code establishes both the framework and the mandate for Japanese financial institutions to strengthen their policy and due diligence relating to the commercial commodity sectors that are driving deforestation, forest degradation and human rights violations.



## ENVIRONMENTAL RISKS

- » **Biodiversity Loss:** Tropical deforestation and degradation is one of the leading drivers of biodiversity loss and extinctions - Southeast Asia's remaining tropical forests sustain many iconic species, including critically endangered tigers, pygmy elephants, rhinos and orang-utans that are found on the IUCN Red List;<sup>8</sup>
- » **Climate Change:** Tropical deforestation and degradation releases massive amounts of carbon stored in trees and is estimated to contribute to 14-21% of annual global greenhouse gas emissions.<sup>9</sup> An additional 1-2.5% of global emissions comes from peatland degradation in Indonesia, largely from palm oil and pulp plantations.<sup>10</sup>
- » **Water:** Deforestation impacts water flows, flood protection and can disrupt rainfall patterns at regional, national and international scales, with water value losses far in excess of the forest timber values.<sup>11</sup>
- » **Pollution:** Logging and plantations for palm oil and pulp and paper, and associated mills and refineries, cause soil erosion and chemical contamination of freshwater systems.

## SOCIAL RISKS

- » **Displacement:** Hundreds of distinct Indigenous cultures and languages across Southeast Asia are dependent upon healthy forests and access to traditional territories - displacement for logging and plantations causes social upheaval, food insecurity and poverty.
- » **Human Rights Violations:** Local and Indigenous communities routinely experience serious rights violations involving private company and state intimidation, violence, rape, and sometimes killings.<sup>12</sup>
- » **Land conflict:** Conflicting legal claims over land tenure between customary land owners and logging or plantation companies is common, and may be associated with government failure to recognize or protect indigenous and customary land rights. Additionally, companies often fail to conduct full and fair procedures providing local and indigenous communities the option of providing or withholding their Free, Prior and Informed Consent (FPIC) to development on customary lands;<sup>13</sup>
- » **Exploitation:** Exploitative labor standards in the logging and plantation sectors are common including forced labor, child labor, and exposure to toxic pesticides and fertilizers, without adequate health and safety protections. Many of the palm oil industry workers in Malaysia and Indonesia are victims of serious labor exploitation, constituting modern forms of slavery.<sup>14</sup>
- » **Health hazards:** Southeast Asia suffers annually from fire haze resulting from the deliberate burning of forest to develop palm oil plantations, causing major public health impacts across Malaysia, Indonesia and Singapore.<sup>15</sup>



*The Guidelines expect enterprises to identify general areas where the risk of adverse impacts is most significant and to prioritise due diligence on their clients accordingly, screening and monitoring clients when the risk is high, and/or when a risk is brought to the attention of the enterprise.*

*- OECD Guidelines for Multi-National Enterprises*

## GOVERNANCE RISKS

- » **Bribery:** Companies may be engaged in bribery and corruption at the local, regional or national levels, often in relation to concession licensing and permitting processes. Corruption in Indonesia's forestry industry has cost the government 2 billion USD annually;<sup>16</sup>
- » **Illegal activity:** Typical illegalities in the sector include flouting of national laws designating what forest landscapes are permitted for development, failure to adhere to restrictions on the size and species for permitted logging, operating outside of permitted areas, beginning operations in areas prior to completing full environmental and social assessments;
- » **Economic/Financial crime:** Practices such as tax evasion, transfer pricing, and money laundering are a major source of illicit financial flows out of Southeast Asia;
- » **Reputational harm:** illegal and/or unethical business standards can give rise to lasting reputational damage that can have a significant financial effect on shareholder value.

## THE FINANCIAL CASE

Underpinning the value of financial assets is a “deeper pool of stocks and flows, most fundamentally the health of human and natural resources.”<sup>17</sup> This includes the natural capital stock of forests and their flow of goods and local, regional and global ecosystem services that help to regulate the global climate, sustain billions of people, and underpin the economy. Natural capital stocks are reported to be declining, often precipitously, in 116 out of 140 countries.<sup>18</sup> Multiple environmental stressors are now considered to be at levels that exceed safe planetary boundaries.<sup>19</sup> These issues are becoming an area of increasing concern among financial system regulatory agencies. Advisors to the international Basel III Capital Accord agreements for banks<sup>20</sup> have identified climate change and natural resource depletion as a looming source of systemic risk for the financial sector, requiring global regulatory attention and action.

Successfully addressing this challenge will necessitate internalizing and operationalizing across the finance sector many of the key thematic elements in the Code – integrating ESG factors into financing decisions, taking a medium and

long term view, Board and senior management leadership, greater transparency on ESG policies, and wider engagement with stakeholders.

In the forest sector, recent sustainability commitments by some of the world's largest producers, traders, and retailers of tropical forest commodities have significantly shifted international market expectations concerning the sourcing standards for palm oil and pulp and paper in particular. As 'zero-deforestation' and 'zero-exploitation' commitments begin to be implemented, financial institutions have a critical role in supporting and accelerating this transition by making the provision of financial services dependent on their clients meeting these new ESG standards. In consideration of the dominant market share of the major commodity traders adopting these new standards, clients not able to meet higher standards of commodity production may find their market access shrinking with a corresponding increased risk of default on debts.

## 2. INTERNATIONAL POLICY RESPONSES

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At the international level, several initiatives are setting important standards for responsible business conduct. Financial institutions should already be following, or be urgently incorporating, the following standards into their internal systems:

- » **The Equator Principles** have established relatively strong safeguards for project-related financing,<sup>21</sup> but do not reach many of the corporate loans that are provided to the forest sector.
- » **Performance Standards of the International Finance Corporation**, which forms the basis of the Equator Principles, prohibits financial intermediaries from financing “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.”<sup>22</sup> In addition, IFC will “not support any oil palm plantation project that would convert high-carbon-stock peatlands, due to their ecosystem services, as well as high carbon and/or biodiversity value.”<sup>23</sup>
- » **UN Principles for Responsible Investment**, which now number 1368 institutions including 30 from Japan, have committed to “incorporate ESG issues into investment analysis and decision-making” and “seek appropriate disclosure of ESG issues” by the entities they invest in.<sup>24</sup>
- » The **Global Reporting Initiative**<sup>25</sup> and the **CDP**<sup>26</sup> are helping to streamline sustainability reporting and are providing investors and companies with critical information on the social and environmental risks of their business activities.
- » The **UN Guiding Principles on Business and Human Rights** mandates corporations to act with due diligence to avoid infringement of human rights and to address any negative impacts on human rights.<sup>27</sup>
- » The **OECD Guidelines for Multinational Enterprises**, which has incorporated the UN Guiding Principles, calls on multinational financial institutions, to “avoid causing or contributing to adverse impacts through their own activities,” and “seek to prevent or mitigate adverse impacts” caused by companies to whom they provide financial products or services.<sup>28</sup> Financial institutions are expected to adopt systematic measures to identify risk and prevent or mitigate potential adverse impacts, and to conduct ongoing monitoring of business relationships and related operations.<sup>29</sup>

National and regional authorities have also adopted a variety of ESG-related regulatory measures,<sup>30</sup> including a requirement to disclose ESG risks:

- » The **US Securities and Exchange Commission (SEC)** first addressed disclosure of material environmental issues in 1971 with the issuance of an interpretive release stating that publicly traded companies should consider disclosing in their SEC filings the financial impact of compliance with environmental laws.<sup>31</sup> In 2010, the SEC issued additional guidance instructing companies to disclose material climate change risks to investors in their SEC filings, including impacts on the company’s financial condition or results of operation due to climate-related legislation, regulation or international accords; indirect consequences of regulation or business trends; and physical impacts of climate change.<sup>32</sup>
- » In 2014, the **European Parliament** passed a Directive which requires certain large companies, including banks and insurance companies, to disclose in their annual reports information relating to “environmental matters, social and employee-related matters, respect for human rights, anti-corruption and bribery matters.”<sup>33</sup> The disclosure must include “a description of the [company’s] policies, outcomes and risks related to those matters” as well as due diligence processes that have been taken. This law will take effect in 2016.



# 3. INTERPRETING THE CODE

## CORPORATE GOVERNANCE CODE

## INTERPRETATION AND GUIDANCE

### **GENERAL PRINCIPLE 2**

#### **Appropriate Cooperation with Stakeholders Other than Shareholders**

Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavor to appropriately cooperate with these stakeholders.

The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured.

*“Local communities”* – Communities local to a company’s operations and/or impacted by its core business activities.

#### **Recognize provision of resources and contributions made by stakeholders and appropriately cooperate**

- » Recognize the land and tropical forest resources are often customarily owned by Indigenous Peoples and forest-dependent local communities, and provision of these resources has been made possible by their stewardship of these resources.
- » Respect and uphold the customary and traditional tenure rights of Indigenous Peoples and forest-dependent local communities.<sup>34</sup>
- » Recognize that stakeholders (customers/business partners), including the client companies with whom financing relationships are entered and maintained, may have positive or negative contributions to tropical forest resources.
- » Consider how clients are managing reputational, environmental and social risks in their supply chains, including consumer companies using forest risk commodities, and support clients to implement supply chain policies and measures to address them.<sup>35</sup>

#### **Rights and positions of stakeholders are respected**

- » Respect stakeholder rights and positions of Indigenous Peoples consistent with the UN Declaration on the Rights of Indigenous Peoples;<sup>36</sup> Forest-dependent communities, Subsistence small holders and family farmers;<sup>37</sup> Women; Labor;<sup>38</sup> and Non-governmental civil society organizations.<sup>39</sup>
- » Establish a framework to allow for an objective assessment and appropriate response when external stakeholders bring to the attention of the financial institution a risk or occurrence of adverse ESG impacts by a financially linked company.<sup>40</sup> Appropriate responses include procedures for:
  - » Assessment of the adverse impact for non-compliance with the financial institution policies and relevant guidelines;
  - » Discussion with the company on the particular issues and the actions the company is taking to work with stakeholders to address and/or remedy these impacts;
  - » Exiting financial relationships where the company fails to halt, remedy and/or prevent the continued occurrence of the adverse social and environmental impacts.

**PRINCIPLE 2.1*****Business Principles as the Foundation of Corporate Value Creation Over the Mid- to Long-Term***

Guided by their position concerning social responsibility, companies should undertake their businesses in order to create value for all stakeholders while increasing corporate value over the mid- to long-term. To this end, companies should draft and maintain business principles that will become the basis for such activities

**Position on social responsibility**

Finance sector institution's position concerning social responsibility must include the social responsibility it has for the medium and long-term impacts of its financing.

To guide its business principles effectively, financial institutions' position concerning social responsibility should express its commitment to the ***“creation of economic and social value through [our] financial models, products and markets that are sustainable over time”, and “promote, or do not harm, economic prosperity, environmental protection, and social justice.”***<sup>41</sup>

**Business principles**

Guided by its position concerning social responsibility above, business principles for financial activities linked to tropical forests and landscapes include:

- » Full compliance with all relevant local, national and international laws;
- » No deforestation or degradation of High Conservation Value Forest, High Carbon Stock Forest, or peatland areas ;
- » Respect for local communities' and Indigenous Peoples' human rights, including customary land rights and their right to give or withhold permission based on Free, Prior and Informed Consent (FPIC) principles and procedures;
- » Compliance with free and fair labor practices, including no use of forced or child labor or use of specified toxic pesticides



***[A Code of Conduct is defined as] principles, values, standards, or rules of behaviour that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations.***

***- The International Federation of Accountants***

**PRINCIPLE 2.2**  
**Code of Conduct**

Companies should draft and implement a code of conduct for employees in order to express their values with respect to appropriate cooperation with and serving the interests of stakeholders and carrying out sound and ethical business activities. The board should be responsible for drafting and revising the code of conduct, and should ensure its compliance broadly across the organization, including the front line of domestic and global operations.

Good practice dictates that the Code of Conduct should “(a) **contribute[] to the welfare of its key stakeholders, and (b) respect[] the rights of all constituents affected by its operations.**”<sup>42</sup>

- » The Board should draft / revise a code of conduct, articulating the long term environmental and social values it seeks to uphold through its financing, which serve the long term shared interests of stakeholders and society to secure climate stability, the conservation and maintenance of biological diversity, respect for human rights, labor rights and the rights of forest-dependent communities and Indigenous Peoples, poverty alleviation and inclusive and equitable economic development.
- » The Board should determine that the correct management structures, staff and resources, roles and responsibilities, incentives and oversight mechanisms and incentive tools for effectively integrating ESG issues broadly and for specific high risk sectors across its core financing business lines and activities are in place to implement its code of conduct and express its values.
- » To ensure its compliance, the Board should task its Risk Management and Compliance Audit Committees to include assessments of its implementation across key functions covering risk management, reputation management, client selection and engagement, transaction approval and credit processes at a range of levels, including as carried out by client relationship managers, analysts, and brokers on the frontline of domestic and global operations.
- » Given the high frequency of un-ethical business activities prevalent in sectors operating in tropical forest landscapes, financial institutions should carry out thorough customer checks to avoid any financial relationship with a client where they are at risk of being connected to:
  - » bribery of public officials,
  - » corruption,
  - » tax crimes,
  - » illegal activities,
  - » transfer pricing,
  - » money laundering,
  - » environmental crime,
  - » other designated categories of offenses;<sup>43</sup>

**PRINCIPLE 2.3**  
**Sustainability Issues, Including Social and Environmental Matters**

Companies should take appropriate measures to address sustainability issues, including social and environmental matters

**SUPPLEMENTARY PRINCIPLE 2.3.1**

with the recognition that dealing with sustainability issues is an important element of risk management, the board should take appropriate actions to this end. Given the increasing demand and interest with respect to sustainability issues in recent years, the board should consider addressing these matters positively and proactively.

**Appropriate measures to address sustainability issues including social and environmental matters**

- » Develop, regularly update and make public policies to govern financing approaches and guidelines for cross-cutting issues including human rights, climate change, conservation and management of natural resources, biodiversity protection, resource use efficiency and pollution prevention.
- » Develop, regularly update and make public financing policies for sectors with significant risks of adverse impacts on tropical forests. Sector policies should do the following:
  - » Elaborate the adverse social and environmental impacts particular to the sector and outline expectations for clients on how these are to best be prevented and addressed as relevant.
  - » Articulate clear financing exclusion criteria for activities that will not be financed
- » Include in financing documents and agreements with client companies covenants covering ESG compliance responsibilities.
- » Conduct risk-based due diligence in line with the OECD Guidelines for Multi-National Enterprises.<sup>44</sup> Environmental and social due diligence should not just be “out-sourced” to any particular certification scheme in a “check box” manner, although they can inform due diligence efforts. Due diligence screens and procedures for financing to all forest-risk sensitive sectors should include assessment of clients’ business as regards to:
  - » Full impacts on biodiversity, and associated mitigation measures, and full accounting of GHG emissions and/or depletion of natural capital, by client business activities.
  - » Respect for international human and labor stakeholder rights through compliance with human and labor rights international norms and agreements, and with the rights to Free, Prior and Informed Consent (FPIC) of forest-dependent communities and Indigenous Peoples;
  - » Respect for the conditions of stakeholders, through assessment of social impacts for disadvantaged groups including women, small-holders, family farmers, Indigenous Peoples and rural communities dependent on their access to forest resources to meet basic food security and subsistence livelihood needs;
- » Positively and pro-actively address sustainability concerns, through valuation of the impacts of financed activities on Natural Capital stocks and services of tropical forests and their integration into financial analysis.

**GENERAL PRINCIPLE 3****Ensuring Appropriate Information Disclosure and Transparency**

Companies should appropriately make information disclosure in compliance with the relevant laws and regulations, but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance.

The board should recognize that disclosed information would serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, particularly non-financial information, is accurate, clear and useful.

**Actively provide information beyond that required by law**

- » Consistently identify, assess, and disclose sector specific sustainability issues, including adverse environmental and social risk factors in prospectus related to equity and bond offerings, syndicated loans and other financial reporting of client companies.
- » Include full assessments on how human and labor rights are respected and upheld, including procedures for implementing the right to Free, Prior and Informed Consent of forest-dependent local communities and Indigenous Peoples whose resources, culture and livelihoods will be affected.
- » Include full impacts on biodiversity, and associated mitigation measures, and full accounting of GHG emissions and/or depletion of natural capital, by client business activities.
- » To promote constructive dialogue, financial institutions should:
  - » Actively provide accurate, clear and useful non-financial information, including disclosure of the the issue and sector specific ESG policies financial institutions have in place.
  - » Create timely opportunities for review and input from social and environmental civil society organizations with relevant ESG expertise to contribute to the development and integration of ESG factors into issue and sector specific financing policies and monitoring systems.



PHOTO: PMIKE GRIFFITHS

# CONCLUSION

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Financial Institutions, guided by sound public policy, have a critical role to play in supporting Japan's transition towards a more sustainable, responsible and stable economy. A sustainable financial system must fulfill the economic needs of society while respecting the rights of all people and the environmental limits of the natural world.

The tropical forest-risk commodity sector is routinely linked to illegalities and fails to achieve any notion of sustainability or respect for those people most directly affected. Considering Japan's banking sector is a major source of finance to companies causing associated social and environmental harms, how these banks respond to this challenge will prove to be a critical test of corporate compliance with Japan's Corporate Governance Code.

Financial institutions need to know whether or not their clients comply with responsible forest practice and respect the rights of local and indigenous communities. They will otherwise not be able to meet their obligations under the Code, and will remain vulnerable to claims of being complicit in environmental and social harms.

The only way in which financial institutions with exposure to these risks can confidently fulfill their range of responsibilities is if they themselves establish forest-sector policy standards that they require their clients to meet and implement robust due diligence procedures. Ultimately, financial institutions must require bad performing clients to improve within strict timeframes, or avoid financial relationships with non-compliant clients altogether.



*How Japan's banks respond to this challenge will prove to be a critical test of corporate compliance with Japan's Corporate Governance Code.*

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