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MANAGING PALM OIL RISKS

A BRIEF FOR FINANCIERS

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ABOUT THIS REPORT

This report has been commissioned by the Roundtable on Sustainable Palm Oil (RSPO).

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LIST OF ACRONYMS

| | |
|---------------|--|
| BRG | Peatland Restoration Agency (Badan Restorasi Gambut) |
| CFC | Controlled foreign company |
| CIFOR | Center for International Forestry Research |
| CPO | Crude palm oil |
| CRR | Chain Reaction Research |
| EBITDA | Earnings before interest, taxes, depreciation, and amortization |
| ESG | Environmental, social, and governance policies |
| EU | European Union |
| FCF | Free cash flow |
| GHG | Greenhouse gases |
| GRI | Global Reporting Initiative |
| HCV | High conservation value |
| HTI | Industrial plantation forests (Hutan tanaman industri) |
| ICRAF | World Agroforestry Center |
| ISPO | Indonesian Sustainable Palm Oil |
| IWG | Investor Working Group on Palm Oil |
| KPK | Corruption Eradication Commission (Komisi Pemberantasan Korupsi) |
| KUR | People's Business Credit (Kredit Usaha Rakyat) |
| NDC | Nationally determined contribution |

| | |
|----------------------|---|
| NDPE | No Deforestation, No Peat, No Exploitation |
| NGO | Non-governmental organization |
| NPLs | Non-performing loans |
| NPP | Procedures for New Plantings |
| OJK | Financial Services Authority (Otoritas Jasa Keuangan) |
| ORI | Indonesian Ombudsman (Ombudsman Republik Indonesia) |
| POJK | Regulation of the Financial Services Authority (Peraturan Otoritas Jasa Keuangan) |
| PP | Government regulation (Peraturan pemerintah) |
| PRI | Principles for Responsible Investment |
| RSPO | Roundtable on Sustainable Palm Oil |
| P&C | Principles and Criteria for Sustainable Palm Oil Production |
| SMEs | Small and medium-sized enterprises |
| SRI | Socially responsible investment |
| TuK Indonesia | Transformation for Justice Indonesia (Transformasi untuk Keadilan Indonesia) |
| UNGPs | United Nations Guiding Principles on Business and Human Rights |
| WACC | Weighted average cost of capital |

EXECUTIVE SUMMARY

The Indonesian financial sector faces sizeable reputational, regulatory, and financial risks if it continues to support non-sustainable palm oil companies.

The Indonesian financial sector faces sizeable reputational, regulatory, and financial risks if it continues to support non-sustainable palm oil companies. As such, it should join actions advanced by the Indonesian government, the global community, palm oil buyers, and international banks and investors in managing the detrimental environmental and social impacts caused by non-sustainable palm oil practices.

Such stakeholder actions are increasing, and include the Indonesian government's moratoriums on development in primary forests, peatland, and on further expansion of palm oil. They also include a commitment by European countries to purchase 100 percent certified sustainable palm oil by 2020. Further, many companies in the palm oil supply chain have committed to producing and sourcing only from areas and producers that comply with No Deforestation, No Peat, and No Exploitation (NDPE) requirements. These companies are also building traceability and monitoring systems and aiming for full implementation of their NDPE policies by 2020, a fast-approaching target.

Taken together, these measures translate into constraints on long-term growth prospects for the sector and increasing risks for palm oil companies that have not yet adopted sustainable practices. An estimated 75 percent of the land previously reserved for future palm oil growth cannot be developed under the present market and regulatory circumstances, as it is located in forest areas or peatland.

Traders, refiners, and consumer goods manufacturers may suspend their procurement contracts if the plantation companies they buy from cannot comply with sustainability policies. This may affect revenues, while costs may increase simultaneously, due in part to fines applied for the use of fires or other non-sustainable practices.

For banks financing Indonesia's palm oil sector, these developments imply an increasing risk of non-performing loans (NPLs). At the same time, the value of collateral - often in the form of undeveloped land - falls, meaning that

outstanding loans to this sector are in general underpriced. Regulatory pressure on banks to integrate sustainability criteria into their lending decisions is also increasing, and their continued exposure to sustainability issues in the palm oil sector may tarnish their reputation among both domestic retail clients and foreign investors. This will make it more difficult for banks to attract sufficient funding and meet solvency requirements.

Banks have benefited from the steep growth in the Indonesian palm oil sector. Indonesia is now the global leader in palm oil exports, which accounted for 12 percent of Indonesia's 2016 export value, and loans supporting the development of palm oil have yielded healthy returns for banks. The sector continues to grow and is a major driver of local economic development and poverty alleviation, directly employing approximately 5.6 million people.

However, these economic benefits come with high environmental and social costs, including the conversion of tropical forests and other areas with significant biodiversity into palm oil plantations. The devastating forest fires in 2015, estimated to have caused more than 100,000 premature deaths in Indonesia, Singapore, and Malaysia, emphasize the importance of healthy forests and peatland in our ecosystems. The hundreds of land rights conflicts between palm oil plantations and local communities across Indonesia are also drawing increasing attention, as is the potential corruption and the low tax compliance ratio of the palm oil sector, highlighted by the Indonesian Corruption Eradication Commission (KPK).

It is time for the Indonesian financial sector to join the growing ranks of those heading towards sustainability and secure for itself a stable and prosperous future.

Major stakeholders are taking measures to manage the sustainability risks, and this new environment is creating significant reputational, regulatory, and financial risks for Indonesian banks exposed heavily to the palm oil value chain, in particular to upstream production. Possible steps for banks to manage these risks include screening their portfolio, developing their own sustainability policy, and engaging with palm oil clients to support transformation. It is time for the Indonesian financial sector to join the growing ranks of those heading towards sustainability and secure for itself a stable and prosperous future.

This paper consists of three chapters and follows the structure in Figure 1, which explains how the actions of governments and the private sector to address unsustainable palm oil production could translate into financial risks for palm oil producers, and consequently for their lenders. **Chapter 1** examines the risks in the unsustainable palm oil sector for companies and financiers, and **Chapter 2** highlights the benefits of investing in sustainable palm oil. **Chapter 3** closes this brief by providing practical recommendations for banks intending to address the looming risks of their exposure to unsustainable palm oil.

FROM SUSTAINABILITY RISKS TO FINANCIAL RISKS

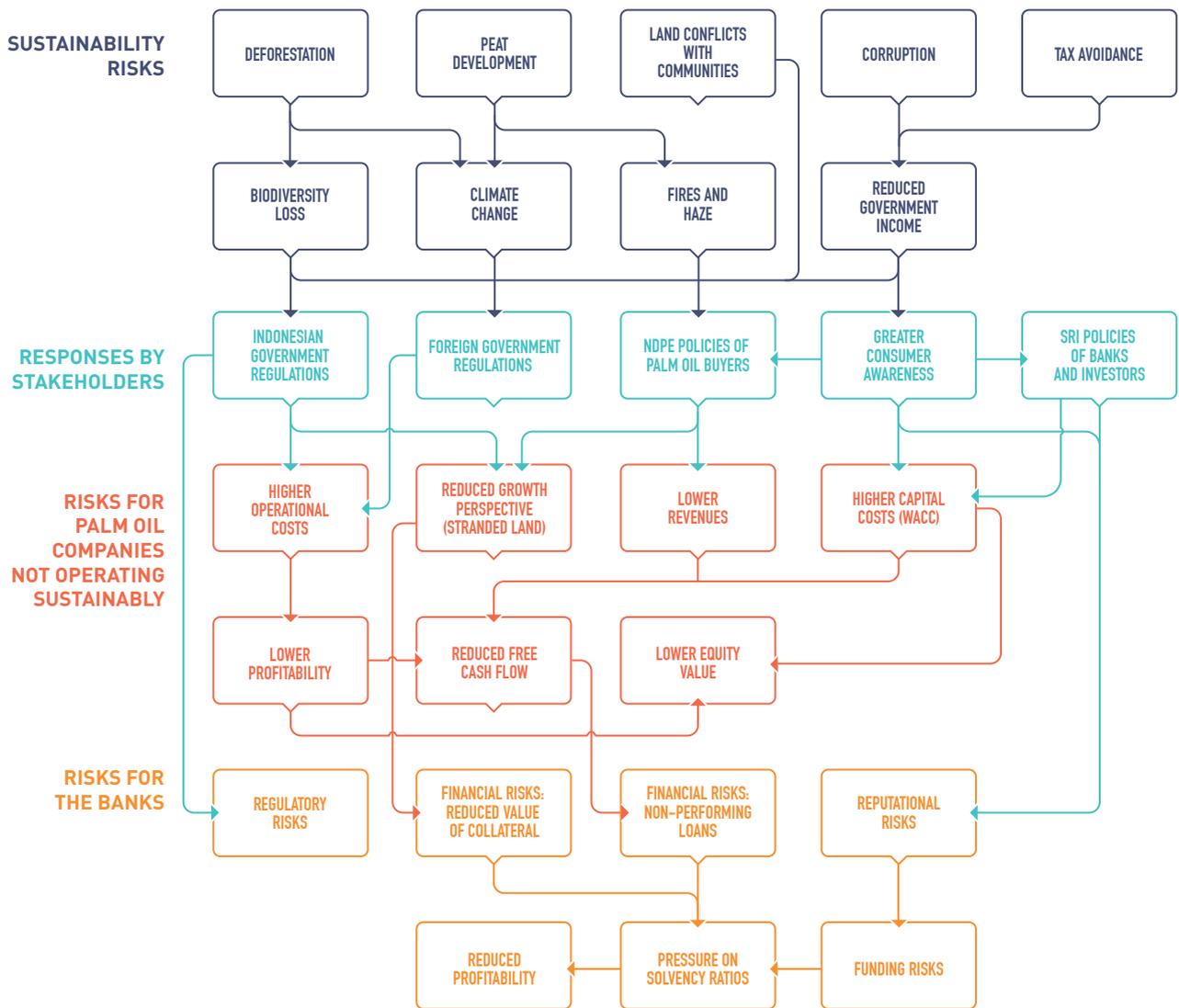


Figure 1. How stakeholders' responses to sustainability issues can turn into reputational, regulatory, and financial risks.

CHAPTER

1

HOW PALM OIL IS CREATING RISKS FOR BANKS

1.1

Key stakeholders in the palm oil sector are addressing sustainability issues

The swift development of the palm oil sector over the past four decades has brought significant economic benefit to Indonesia, but increasing attention is now focused on the high social and environmental price paid by the country. While these are public costs, measures taken by key stakeholders to manage and reduce them can translate into private risks for palm oil companies and their financiers.

Figure 2. Palm oil has contributed to job creation and economic growth in Indonesia.

Sources:

*United States Department of Agriculture (USDA) Foreign Agricultural Service¹;

**Tempo (2017).²



The Indonesian government, foreign governments, palm oil buyers and financial institutions - mainly international banks - are all taking bold steps to address the different sustainability issues in the palm oil sector. Steps taken by the Indonesian government have been accelerated by the devastating forest fires of 2015 and the country's global commitments to reduce its greenhouse gas (GHG) emissions. Actions by foreign governments, refiners, traders, and consumer goods manufacturers, as well as banks and investors, are propelled by the concerns of consumers and civil society organizations surrounding the negative impact of deforestation and peat development on climate change and biodiversity loss, as well as concerns over labour rights and local communities' land rights.

The following sections explain how the responses of different stakeholders to the impacts of unsustainable palm oil production could translate into risks for non-sustainable palm oil producers, and consequently for their lenders.

Indonesian government regulations

Since the 1970s, the Indonesian government has worked hard to stimulate the palm oil sector. A better understanding of the downside of this economic success and a willingness to address it has only recently begun to develop. The devastating forest fires and haze of 2015 have played a large part in this change, as has Indonesia's global commitment to reduce its GHG emissions under the Paris Climate Change Agreement, and its intention to raise sufficient state income to meet the Sustainable Development Goals, a United Nations initiative. International financial support for sustainable forest management also contributed to the change in attitude at the government level. Given these factors, the Indonesian government is now introducing more stringent regulations to limit the expansion of palm oil plantations into valuable forest and peatland ecosystems, to curb GHG emissions, to reduce tax avoidance, to ban corruption and to promote more sustainable production practices.

Figure 3. Indonesia's highly damaging 2015 forest fires lead to decisive government action to improve land use governance.



Sources:

*National Disaster Mitigation Agency (BNPB) (2015)³;

**Harvard University and Columbia Research (2015)⁴;

***World Bank (2016).⁵

The most important regulations recently enacted by the Indonesian government are discussed below. Collectively, they show that Indonesia is heading for a fundamental transformation of the sector, ensuring a stronger contribution of palm oil to the sustainable development of the country. The authors argue that this is a trend that will likely persist and intensify in the coming years, as Indonesia works within legally-binding global commitments under the Paris Agreement, and as national awareness of sustainability issues grows.

The capacity to enforce these regulations in Indonesia is still limited, but is on the rise. As with corruption cases, environmental crimes have also begun to meet legal consequences. In 2015, a palm oil company in Aceh was fined IDR 366 billion (USD 26 million) for instigating fires.⁶ A year later, another plantation company, not palm oil, was fined a record-breaking sum of IDR 1.07 trillion (USD 81 million), again in relation to fires.⁷ In the past, these companies may have got away unpunished. Whether this trend will continue beyond the current political cycle remains to be seen, but it appears likely.

Monitoring the compliance of various land use actors is also improving rapidly with the use of satellite images and geospatial information, some of which is now also available for public use and scrutiny on global platforms. As such, the authors argue that the regulatory and reputational risk for palm oil companies that continue to operate in an unsustainable way is increasing. Companies that do not live up to the regulations and commitments run the risk of being found out or reported, which may lead to fines or even to the revocation of their licences.

Figure 4. Indonesia responds to sustainability risks with various new regulations.

Sources:
See footnotes 8-19.



These regulations include:

Moratoriums on new licences in primary forest and peatland concessions

In 2011, then President Susilo Bambang Yudhoyono introduced a two-year moratorium on new licences in primary forests and peatland as part of an effort to reduce deforestation and emissions. The moratorium has been extended three times, with the current period running until 2019, following a renewal in 2017 by President Joko Widodo.⁸

Mandatory ISPO certification

Also in 2011, the Indonesian government established the Indonesian Sustainable Palm Oil (ISPO) certification, a legality standard that encompasses prevailing regulations only.⁹ The scheme is mandatory for palm oil producers and was updated in 2015, with an ongoing multi-stakeholder process to further strengthen its requirements.¹⁰

Maximum size of palm oil groups

To deal with corruption and power concentration in the palm oil sector, in September 2013 the Indonesian government implemented a regulation that allows a single company to hold oil palm concessions for a maximum area of 100,000 hectares per province.¹¹

Indonesia's global climate commitment

Indonesia announced its nationally determined contribution (NDC) under the Paris Climate Change Agreement in 2015, setting an unconditional emissions reduction target of 29 percent of the business-as-usual scenario by 2030. Stricter land use governance is to be expected, since 63 percent of Indonesia's GHG emissions are the result of land use change, peat and forest fires.¹² Indonesia ratified the Paris Agreement into law in 2016.¹³

Moratoriums on peat development and palm oil expansion

Following the 2015 forest fires and haze crisis, President Joko Widodo strengthened the ban on peat development, including in existing concession areas, and announced a five-year moratorium on all new palm oil licences.¹⁴ A new government regulation on peat development came into force in 2016¹⁵ and the Peat Restoration Agency¹⁶ was established that same year.

Controlled Foreign Company Regulation

To tackle tax avoidance, in July 2017 a new controlled foreign company (CFC) regulation came into force.¹⁷ This authorizes the government to charge a dividend tax on companies incorporated in tax havens but controlled by Indonesians, and will make it more difficult to use such companies to avoid taxes.¹⁸

Regulation on Sustainable Finance

Also in July 2017, Indonesia's Financial Services Authority (OJK) issued its regulation on sustainable finance.¹⁸ The regulation requires all issuers of shares and bonds on the Indonesian stock market, which includes many palm oil companies, to start reporting on their sustainable business strategy and practice and their social and environmental risk management. Large issuers must comply by 2020.¹⁹

Foreign government regulations and initiatives

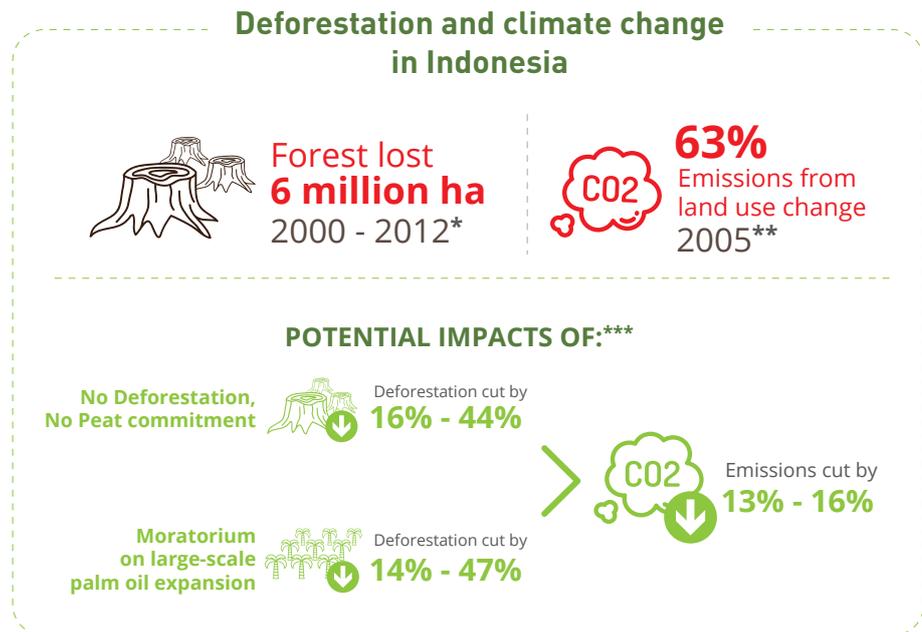
In the European Union (EU) and North America, two important palm oil export markets, non-governmental organisations have in the past ten years raised public awareness of the negative impacts of palm oil production. This has led governments in these regions to introduce initiatives to address sustainability issues linked to the sector, such as deforestation, peat development, labour rights' violations and community conflicts. These initiatives are gradually closing these markets to palm oil produced in an unsustainable way, and are also putting pressure on the Indonesian government to take its own actions to address the issues.

Some of the most recent examples of these initiatives are:

Amsterdam Declaration

The Amsterdam Declaration of December 2015 shows the commitment of six EU nations - Denmark, France, Germany, Norway, The Netherlands and the United Kingdom - to drive the entire EU towards 100 percent sustainable palm oil imports by 2020. The signatories commit to pushing all EU countries and private sector stakeholders towards complete palm oil sustainability and traceability.²⁰

Figure 5. Potential impacts of global commitments and Indonesia’s palm oil moratorium on deforestation and emissions reduction in Indonesia.



Sources:

*From all sectors, as estimated in Margono et al. (2014)²¹;

** Stated in Indonesia’s NDC (2016)¹²;

*** Compared with business-as-usual over the period of 2010-2030, as estimated in Palm Oil and Likely Futures, CIFOR (2017).²²

Paris Climate Change Agreement

In December 2015, representatives of 196 countries and multinational bodies adopted the Paris Climate Change Agreement; it came into force in November 2016.²³ The central aim of the agreement is to limit a global temperature rise this century to well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the increase to 1.5 degrees Celsius. The Paris Agreement also points out the critical role of the land use sector, including palm oil and other plantations, in reaching these long-term objectives. The agreement requires all countries to put maximum effort into attaining their NDCs, and to strengthen these efforts in the years ahead.

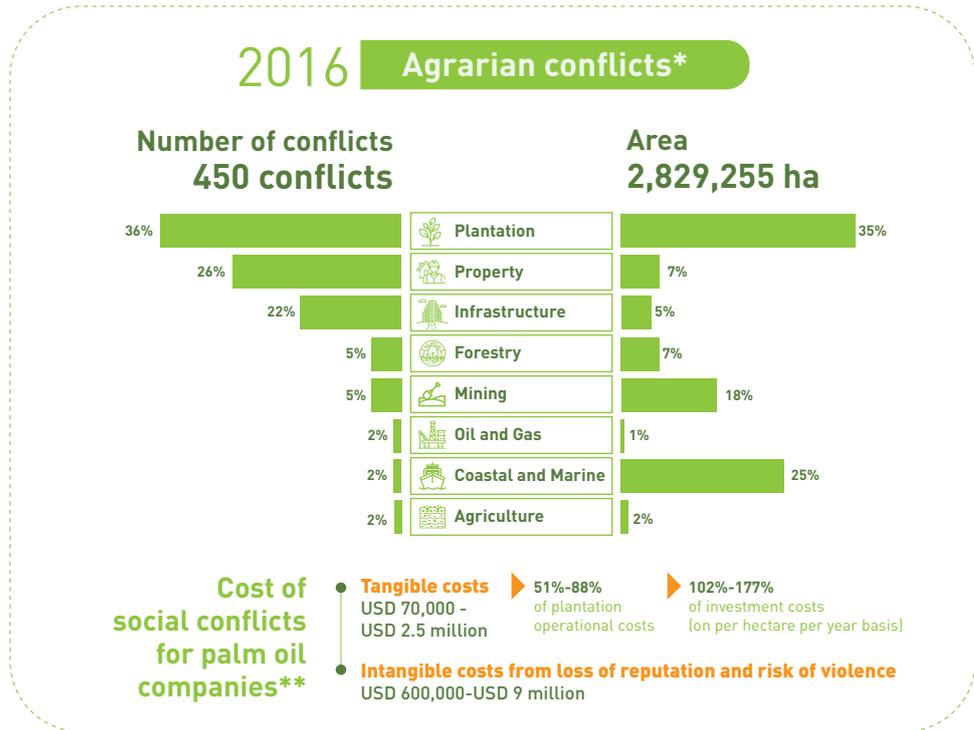
European Parliament Resolution on Palm Oil and Deforestation of Rainforests

The EU has a binding goal for 10 percent of transport fuel consumed in each EU country to come from renewable sources, such as biofuels, by 2020. In April 2017, however, the European Parliament voted in favour of a motion to ban biofuels made from edible oils, including palm oil; it feared the bloc’s renewable transport targets could unwittingly contribute to deforestation, peat development, labour rights’ violations and community conflicts. The motion is not yet legally binding, but EU lawmakers are attempting to make it so.²⁴

Figure 6. The costs of social conflict for palm oil companies in Indonesia.

Sources:

*Indonesian Ombudsman, cited in Mongabay.co.id (2017)²⁵,
 **Daemeter (2016).²⁶

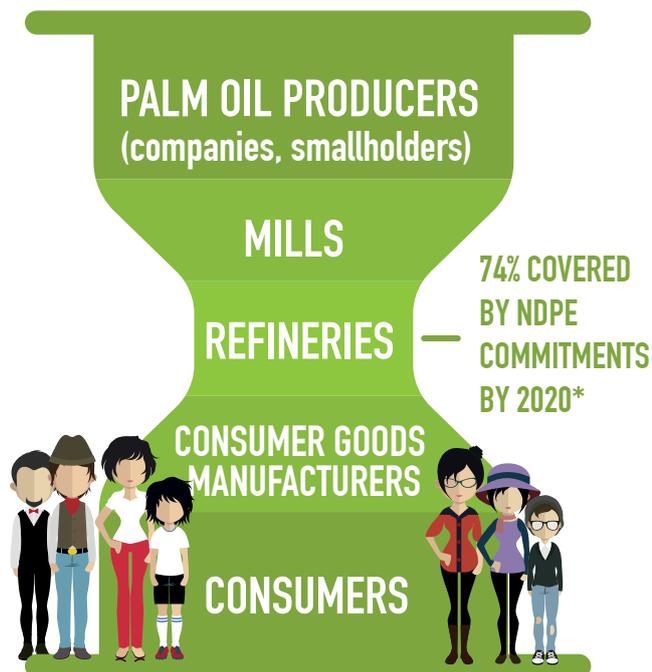


Procurement policies of palm oil buyers

The palm oil supply chain can be visualized in the form of an hourglass in which the traders and refiners - numerically the smallest group within the market - are implementing sustainable palm oil policies and creating a bottleneck for non-sustainable suppliers. As more and more traders and refiners demand sustainable palm oil, the non-sustainable oil palm growers will find that fewer and fewer buyers are willing to buy their products. It is the actions of this small, powerful group in the middle of the hourglass - the refiners and traders, as well as the consumer goods manufacturers - that have most influence on demand for sustainable palm oil.

Figure 7

Refineries' NDPE policies will squeeze non-sustainable producers out of the market.



Source: Steinweg, T., Drennen, Z. and Rijk, G. (2017, November 1).²⁷

Certification schemes aiming to promote sustainable palm oil have also been set up, including the International Sustainability and Carbon Certification²⁸, which focusses on sustainable production and use within the supply chains of various commodities used for biofuels. In 2004, the Roundtable on Sustainable Palm Oil (RSPO) was established by various stakeholders, who aimed to promote sustainable palm oil through credible global standards.²⁹ An RSPO certification scheme for sustainable palm oil was launched in 2007 in line with this goal, and remains the most significant system. The RSPO has 3,583 members and has certified 19 percent of the global palm oil market. Many palm oil buyers in established markets in Europe and North America are now sourcing exclusively RSPO-certified palm oil.³⁰

A further step in the transition of the palm oil market has been taken in recent years by companies - representing a large portion of the market - that have established NDPE policies. Since 2013, when the first corporate NDPE policy was launched by Wilmar International, at least 365 palm oil refiners and traders, including Musim Mas³¹, and consumer goods companies, such as Unilever³² and Kraft Foods³³, have embraced such arrangements. Via these schemes, they demand their palm oil suppliers stop clearing forests or developing plantations on peatland, and uphold labour and community rights. Most companies are intending to apply these NDPE policies by 2020, and have given themselves a transition period.

When a supplier is in violation of a refiner or trader’s policy, the trader or refiner can cease purchasing. This has already happened multiple times over the past few years, with many oil palm plantation companies losing substantial revenues because of this.³⁴

Figure 8. Major global players have committed to produce, source, and invest in sustainable palm oil.

Sources: Seymour, F. and Busch J. (2016)³⁵; except for Musim Mas and Unilever (see footnotes 31 and 32).



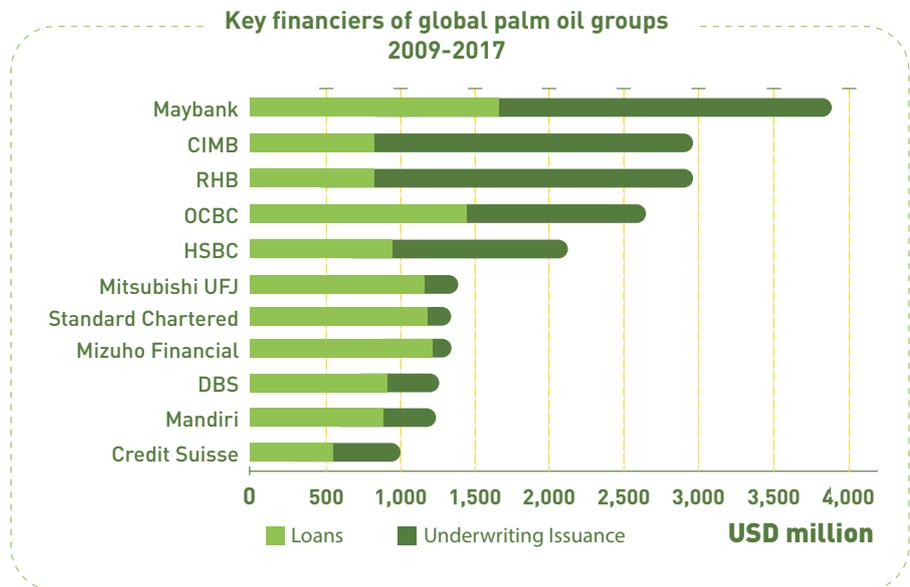
As many refineries make NDPE commitments, plantation companies will have to follow within a few years to retain access to the market. According to a study published in November 2017 by Chain Reaction Research (CRR), 29 company groups controlling 74 percent of the palm oil refining market in Indonesia and Malaysia, have adopted NDPE policies which require them to source only from compliant suppliers by various target dates. Further, 65 percent of the refining capacity of the rest of the world has NDPE policies that will be fully implemented in the coming years.³⁶ Finding a market for unsustainable palm oil remains possible in the short term, but with a limited number of risky buyers - in the Indonesian domestic market, China, India and Pakistan - as well as increased transportation costs, and lower prices. The number of refineries covered by NDPE policies is likely to continue to rise in the coming years.³⁷

Sustainability policies of investors and banks

Worldwide, institutional investors such as pension funds, insurance companies, and asset managers are adopting socially responsible investment (SRI) policies. These policies set social, environmental and other sustainability preconditions to their investments. These investors also collaborate in the Principles for Responsible Investment (PRI), which now has “more than 1,750 signatories, from over 50 countries, representing approximately USD 70 trillion.”³⁸ This is a very significant part of the global investment market, as total assets under management amounted to USD 78.5 trillion in 2015, according to PwC.³⁹

Figure 9. The global financial sector invests heavily in palm oil.

Source: Forests and Finance (2017).⁴⁰



Under the PRI umbrella, a number of institutional investors set up the Sustainable Palm Oil Investor Working Group (IWG) in 2011, with the aim of using their influence as shareholders to support the development of a sustainable palm oil industry.⁴¹ The IWG initially focused on palm oil buyers and in 2013 redirected its attention to growers, traders and processors. It has engaged with 14 palm oil companies since 2013, focusing on improvements in disclosure of sustainability risks in annual reports and stock exchange

filings, and stronger sustainable policies and performance. The IWG is led by insurance company Allianz (Germany), pension fund APG Asset Management (Netherlands), and asset managers Hermes Asset Management (United Kingdom) and Kempen Capital Management (Netherlands).

A similar development is ongoing among the major international banks from Europe, North America and Asia. Almost all are collaborating in initiatives such as the Equator Principles⁴² and the United Nations Environment Programme Finance Initiative⁴³ to develop and implement detailed environmental, social and governance (ESG) policies. Some banks have only general ESG policies, which deal with issues like human rights, climate change and deforestation, but many have also developed more detailed sectoral policies - for instance on the palm oil sector.⁴⁴

The website Forests and Finance, set up by the non-governmental organisations (NGOs) Transformasi untuk Keadilan Indonesia (TuK Indonesia) and Rainforest Action Network, has assessed the palm oil policies of all international and Indonesian banks operating in the palm oil sector. The assessment evaluates how their policies address the major sustainability issues in the sector: climate change, deforestation, biodiversity loss, peatland development, community conflicts, labour rights' violations, corruption and tax avoidance. Table 1 shows the scores of the eight top-ranking banks (scores range from 1 to 30, with 30 the highest), and internet links to their policies.

Table 1.
Global banks leading the way in sustainability and their policies.

Sources:

*Forests and Finance (2016)⁴⁵, bank websites (click [] in the table)

| Bank | Country | Forests & Finance score (out of 30)* | ESG policy | Palm oil policy |
|--------------------|---|--------------------------------------|--|--|
| ABN Amro |  | 24 |  |  |
| Rabobank |  | 23 |  |  |
| Credit Suisse |  | 20 |  | No palm oil specific policy, however its ESG policy mentions adherence to RSPO P&C for financing in palm oil sector. |
| Citigroup |  | 18 |  | No palm oil specific policy, however its ESG policy mentions adherence to RSPO P&C. |
| Standard Chartered |  | 17 |  |  |
| HSBC |  | 15 |  |  |
| Deutsche Bank |  | 15 |  |  |
| JP Morgan Chase |  | 14 |  | No palm oil specific policy, however its ESG policy states that for transactions involving palm oil production, RSPO P&C will be used for sustainability assessment. |

1.2

Non-sustainable palm oil companies face serious financial risks

The plantation, refining, and trading companies operating in the palm oil sector have new risks to deal with, because of the responses of stakeholders - governments, buyers, and financiers - to the various sustainability issues in the sector. As described above, the new policy steps of stakeholders are creating a rapidly changing environment for the palm oil sector. The authors argue that the palm oil companies that do not adapt to this changing reality and that fail to deal with the sustainability challenges face a number of new risks, as described in the following sections.

Higher operational costs

The operational costs of palm oil companies can rise if they neglect sustainability issues, because of the actions of other stakeholders. One plantation company had to pay damages of almost USD 3 million in a case brought by a smallholder over fraud surrounding the oil extraction rate in 2010. In 2016, the company still had similar legal cases pending for a total value of USD 600 million, and had land disputes over more than 2,500 hectares, some of which resulted in monetary or land development compensation.⁴⁶

Land development compensation is a potential cost derived from the RSPO Remediation and Compensation Procedures. This requires companies to restore high conservation value (HCV) forest areas cleared after November 2005, or pay USD 2,500 per hectare for conservation efforts. As plantation companies will need to comply with RSPO regulations to continue their access to the most lucrative export markets, they may face significant costs. One RSPO member for instance may have to pay USD 5.2 to 6.1 million to compensate for the 260 hectares of HCV area cleared by one of its subsidiaries and the peatland developed (1,800 hectares) by another subsidiary since April 2016.⁴⁷ The company has an option not to pay if it can show that it is protecting land elsewhere.

Fines can also drive up costs; these can be imposed by the government if a company breaches the regulations. In August 2016, a single plantation company operating in Riau was fined USD 81 million for forest fires occurring in 2014 on 3,000 hectares of its concessions. The value of the fine was only slightly less than the company's revenue for the first six months of 2016.⁴⁷

Reduced growth perspective as land becomes stranded

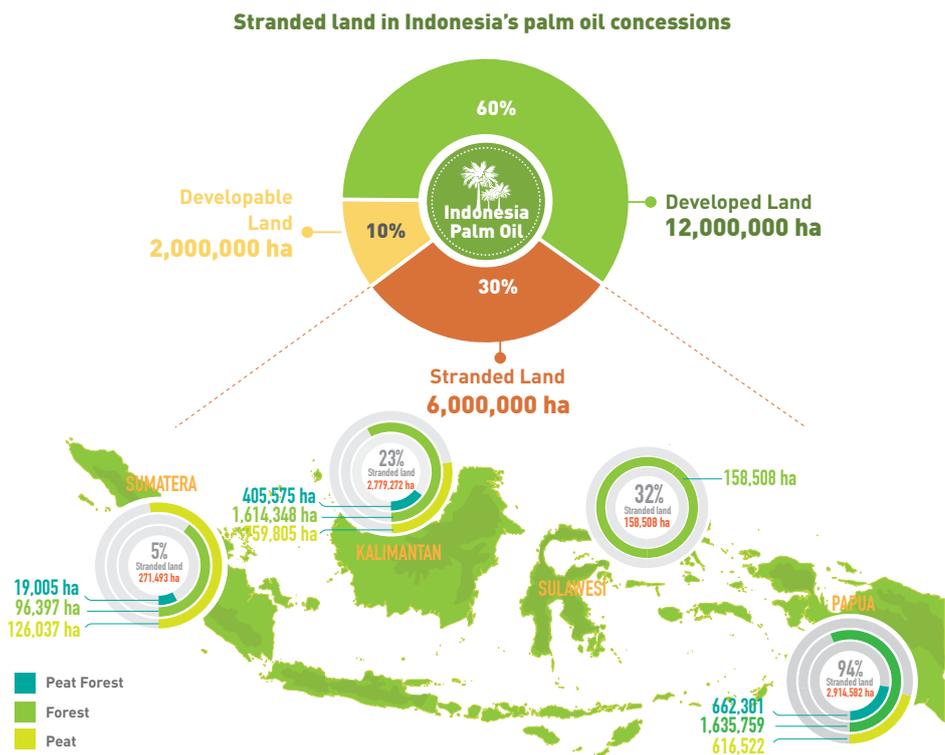
The changes to the environment in which palm oil companies operate also have long-term impacts. The changes mean that undeveloped concessions which have forest cover or are located on peat soil can probably never be developed without incurring the risk of losing customers or financiers. Developing these concessions will also increase the risk of government intervention. A Malaysian plantation company at the end of October 2016, for example, announced that the Indonesian government had revoked the cultivation rights of its Indonesian subsidiary, even though the subsidiary had already planted its concession area with oil palms. The government charged that the rights granted to the subsidiary had been improperly issued in 2003, resulting in parts of the concession area overlapping forest areas.⁴⁸

A recent CRR study analysed all 20 million hectares of palm oil concessions in the hands of plantation companies. Of this 20 million, 12 million hectares have already been developed and eight million hectares are still awaiting development. However, the study found that six million hectares of these undeveloped oil palm concessions can never be developed, because they are located in forest areas or on peatland. Government regulations and the policies of major palm oil buyers and financiers make it impossible to develop these concessions - which therefore become stranded assets.⁴⁹

In essence, 75 percent of the land previously reserved for the future growth of the palm oil sector can now not be developed. This severely limits the growth opportunities of plantation companies, unless they can expand to other countries suitable for palm oil production. Any such expansion, however, will require high investments and it is questionable whether it will lead to a similar productivity level.⁵⁰

Figure 10. Current regulations prevent development of a significant portion of land assigned to palm oil.

Source: CRR (2017).⁵¹



Lower revenues

More than 70 percent of Indonesian palm oil refineries are implementing NDPE commitments now and in the coming years, meaning that companies with unsustainable practices risk losing revenue because their customers or trade partners will demand compliance. Finding replacement customers is still possible, but takes time and comes with a cost. A recent CRR report analyses three oil palm plantation groups which have suffered 15 percent, 10 percent and up to 5 percent quarterly revenue loss because major traders stopped buying from them due to their involvement in deforestation or peat clearance.⁵²

In another example, Unilever suspended purchasing CPO from one of its Indonesian suppliers in June 2017 because the supplier did not comply with Unilever's supply chain commitments.⁵³ With the suspension of this contract, the oil palm plantation company lost a buyer that was equivalent to 8.4 percent of its 2016 revenue. The suspension therefore created a strong and immediate financial risk for this plantation company.⁵⁴

Higher financing costs

If oil palm plantation companies ignore sustainability issues, their financing costs are likely to go up. Fewer banks will be interested in lending money to companies which violate their ESG policies and fewer institutional investors will buy their bonds and shares. The banks still prepared to invest in these plantation companies will demand a higher interest rate or return on investment to compensate for the additional risks they are exposed to. Institutional investors will look for a higher return on investment. This means that costs of both debt and equity will go up, increasing the weighted average cost of capital (WACC).

Reduced profitability

The combination of a (temporary) reduction in revenues as a company loses buyers, together with higher operational and higher financing costs, could lead to reduced profitability. This risk is compounded by the fact that less sustainable palm oil companies also have a less diversified customer base, making the impact of losing one buyer more severe. It often takes more than three months to find substitute buyers and recover profitability. When companies are pressured to negotiate new delivery contracts on short notice, they cannot always achieve the same terms and conditions enjoyed with prior trading relations.⁵⁵ This reduced profitability will also reduce the company's liquidity, its free cash flow (FCF). The risk that the company will have to default on its interest payments or its loan repayments therefore increases.

Lower equity value

When stock exchange-listed oil palm companies cannot develop the concessions they have already acquired, their valuation by equity analysts and investors will go down. This is because the equity valuation is based on discounted cash flow models, which translate future, expected profits into the present share price.

A CRR study shows that equity markets react positively to the acquisition of new concessions by palm oil companies. If, under current market conditions, a significant part of these concessions can no longer be developed, the equity markets will have to adjust share prices downwards. For any 10 percent of a company's total concessions which cannot be developed, it risks losing 3.5 percent of its market capitalisation. If 30 percent cannot be developed - the average across Indonesian oil palm plantation companies - a loss greater than 10 percent can result.⁵⁶ In turn, this will limit the company's ability to issue new shares and will drive up its financing costs.

1.3

Unsustainable palm oil creates risks for banks

Banks providing loans to companies in the palm oil sector will be affected by the increased risks faced by these customers. Indonesian national banks are generally involved in financing all types of oil palm operators, including state-owned plantations, international, vertically-integrated palm oil groups, small and medium-sized plantation groups, and smallholders. The authors of this study argue that this exposes them strongly to the risks created in the oil palm sector by the poor management of sustainability issues. The following sections describes how these risks will affect banks.

Table 2. Global and national sources of financing for Indonesia’s palm oil producers.

Sources:

*Ministry of Agriculture (2017)⁵⁷;

**Daemeter (2016).⁵⁸

| Area* | Producer | Type of financing |
|---|-------------------------------------|--|
|  6.8 million ha | Globally integrated palm oil groups | <ul style="list-style-type: none"> • Cash-flow • Shares issuance • Private and institutional investors • Loans from Indonesian and international banks • Domestic and global bonds |
| | Small and medium sized plantations | <ul style="list-style-type: none"> • Family capital • Loans from Indonesian banks |
|  4.8 million ha | Smallholders | <ul style="list-style-type: none"> • Micro and small credits from Indonesian banks (for smallholders with land title)** • Company partnerships (for schemed smallholders)** • Credit unions (for members)** |
|  0.75 million ha | State-owned plantations | <ul style="list-style-type: none"> • Cash-flow • Domestic bonds • Bank loans from Indonesian state-owned banks |

Regulatory pressure

Banks will be confronted with increased regulatory pressure if their customers in the palm oil sector ignore sustainability issues. In December 2014, Indonesia’s OJK launched a Sustainable Finance Roadmap⁵⁹, which made clear that the finance sector is expected to stimulate the sustainable development of Indonesia. In late July 2017, this was followed by a regulation on sustainable finance, (see section 1.1.1) which required banks to produce a sustainability report and sustainable finance action plans, and also contains a discussion of penalties to be applied upon non-compliance. Banks are expected to ensure their corporate customers meet all government regulations aimed at protecting the environment.⁶⁰

Reputational and funding risks

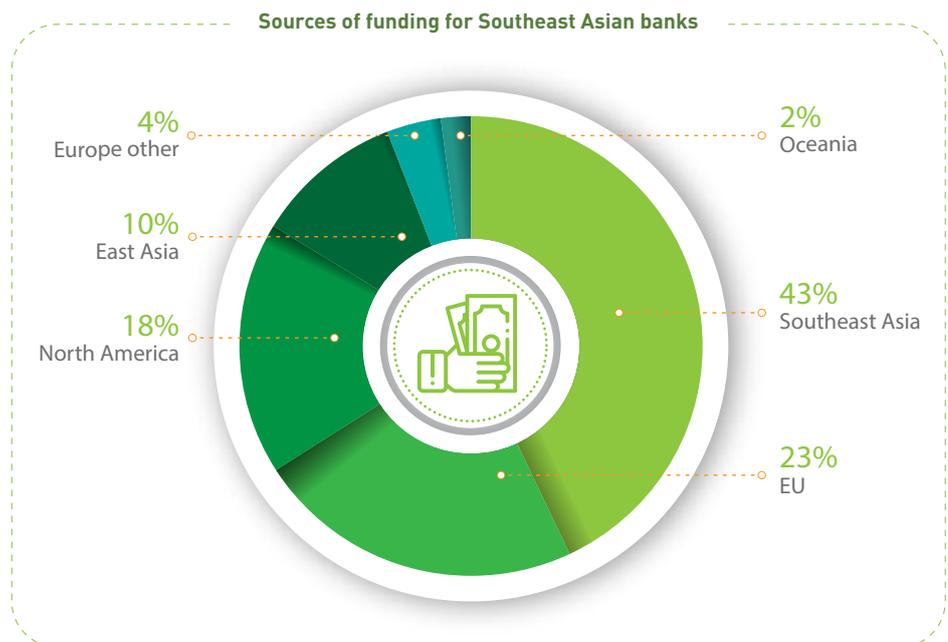
Banks’ exposure to the sustainability issues in the palm oil sector creates strong reputational and funding risks. A bank’s reputation, among both domestic retail clients and foreign investors, will be tarnished if it continues to be linked to deforestation, peat development, community conflict, corruption, and tax avoidance.

Thus far, domestic retail clients have not paid much attention to the sustainability reputation of banks when choosing where to open their account and deposit savings. But this cheap source of funding is likely to be at risk, due to two trends in particular. First, Indonesian consumers are starting to look more closely at sustainability issues in their consuming decisions. Almost eight million Indonesian consumers are ready to support and shift to sustainable palm oil products, according to a market survey commissioned by the RSPO.⁶¹ Second, civil society is increasingly turning its attention to banks. NGO websites such as Forests & Finance⁶² and Responsibank⁶³ allow (prospective) bank customers to compare Indonesian banks on their sustainability performance. Through social media, NGOs are able to influence young Indonesians, the bank customers of the near future.

These trends may affect a bank's ability to raise funding from the domestic retail market, and its ability to attract funds from international investors will also be hurt. As a result of bad reputation and exposure to rising NPLs, finding funding and international business partners can become more difficult and costly for banks. Considering that 23 percent of all funding going to Southeast Asian banks comes from the EU and 18 percent from North America, Asian banks must seriously consider funding risks when engaged in activities that may be controversial sustainability-wise.

Figure 11. Over 40 percent of funding to Southeast Asian banks comes from investors committed to sustainability.

Source: Profundo (Bloomberg loans and underwriting data, 2010-2016).⁶⁴



Financial risks
Non-performing loans

Banks exposed to the palm oil sector also run the risk that borrowers will fail to meet their obligations. As palm oil companies that are ignoring sustainability issues run the risk of reduced FCF, they may default on interest payments or loan repayments. Banks thus run an increasing risk that their loans to the palm oil sector turn into NPLs.

This NPL risk has increased rapidly over the past years, because of the different actions of the Indonesian government, foreign governments, major palm oil buyers and financiers. Many loans to palm oil companies were extended before most regulations came into force, which means that the increased NPL risk is not factored into the interest rates charged, nor into the reserves for non-performing loans.⁶⁵

Financial risks
Reduced value of collateral

To protect themselves against the risk of their customers defaulting, banks demand collateral. The concession rights of these companies might serve as collateral, but under present market conditions many of these cannot be developed and will thus become worthless. The value of other collateral, such as CPO mills, may also be reduced if the capacity of these assets was designed to be supplied from future concession areas which might now be undevelopable. If the debtor defaults, such collateral will also be difficult to sell - or only at a strong discount.

Solvency ratios and profitability

Indonesian banks active in the palm oil sector risk more NPLs with poor collateral, while external funding opportunities decrease. This will have a negative impact on the bank's solvency ratio. Based on the Basel capital requirements, implemented by OJK, Indonesian banks have to meet higher capital adequacy ratios than before the 2007 financial crisis. This will force banks to add a much larger share of their profits to their reserves and push their net profitability downwards.

CHAPTER

II

BENEFITS OF SUSTAINABLE PALM OIL PRODUCTION

Indonesian banks are facing significant risks if their clients in the palm oil sector continue with business as usual. Banks may be confronted with NPLs, poor collateral, regulatory pressure and funding risks. To manage and avoid these risks, it is crucial that their palm oil clients operate in a more sustainable way. Both for the palm oil sector and for the banks financing this sector, a switch to more sustainable practices will not only reduce their risks but have other benefits as well. These are detailed in the following sections.

2.1

Palm oil companies will profit from sustainability

Reduced risk to revenues and profits

The main benefit of switching to sustainable practices is that the risks for palm oil companies - as described in section 1.2 - will be reduced. Revenue reductions and cost increases can be avoided, resulting in higher profits. A German meta-study evaluated all 2,250 academic studies published worldwide between 1970 and 2014 on the correlation between sustainability and corporate financial performance. It found that 63 percent of the studies reported a positive correlation, and only 10 percent found a negative correlation.⁶⁶ The latest study from financial information provider Morningstar shows that sustainable indices outperformed conventional ones for 16 out of the 20 indices studied.⁶⁷

A CRR study confirms this finding for the oil palm sector: companies with a higher sustainability score had on average less revenue at risk. The study shows there is a clear stimulus for companies to move towards sustainability, including by adopting NDPE policies, because implementing sustainable practices is associated with higher revenue growth and greater stock returns.⁵⁵

Price premium

Sustainable palm oil can lead to optimized risks and returns. Most notably, there is a significant price premium for RSPO-certified palm oil, which is quoted as circa USD 15 per tonne - around 2 percent over the market price.⁶⁸ A further study in 2015 covering 34 oil palm oil growers found a CPO price premium of 7 percent.⁶⁹

Figure 12. RSPO-certified palm oil supply has more than tripled since 2010.

Source: RSPO (2017).⁷⁰



Higher efficiency and higher productivity

Another important factor is that the application of sustainability standards will improve management practices across the board. The RSPO Procedures for New Plantings (NPP), for instance, reduce the risk of deforestation and community conflicts, and can also lead to very many small improvements across a company’s operations, thereby improving productivity.⁷¹ A study commissioned by RSPO found that RSPO certification can lead to a 35 percent efficiency gain in the net CPO yield per hectare, resulting in an increase of 45 percent in the revenue per hectare. For each US dollar invested in the RSPO certification process, the gain was USD 150.⁷²

Subsidies for sustainable palm oil

Sustainable palm oil production can also attract subsidies. The Indonesian CPO Fund awards subsidies to smallholder cooperatives employing sustainable practices and can, for example, cover more than 40 percent of the cost of replanting per hectare.⁷³ Another opportunity is offered by the RSPO Smallholders Support Fund, which covers the costs of RSPO certification for smallholders.⁷⁴

2.2

Banks will benefit

Risk reduction

By adopting more sustainable practices, palm oil companies address the risks of reduced revenues and increased costs. This will improve their profitability and FCF, while the value of their assets will increase. For their banks this means that NPL risks decrease and collateral improves, and this will ultimately benefit the profitability of banks.

Optimizing risks and returns

The rapid changes in the environment in which palm oil companies operate means that banks may have not optimized their risks and returns in lending to this sector. By better understanding their risk exposure, banks can better price their loans or demand more - and more stable - collateral. When risks and returns are better optimized, it will be easier for banks to meet their capital adequacy requirements.

Developing the bank's business

By integrating sustainability criteria into lending decisions, banks have better opportunities to build long-term relationships with their clients. If clients operate in a more sustainable way, the risk that they default will be minimized, while the opportunities for them to grow in areas deemed suitable for oil palm development by the government and palm oil buyers will be maximized. Helping clients to secure their long-term viability by adopting sustainable practices will therefore also create more long-term lending opportunities for banks.

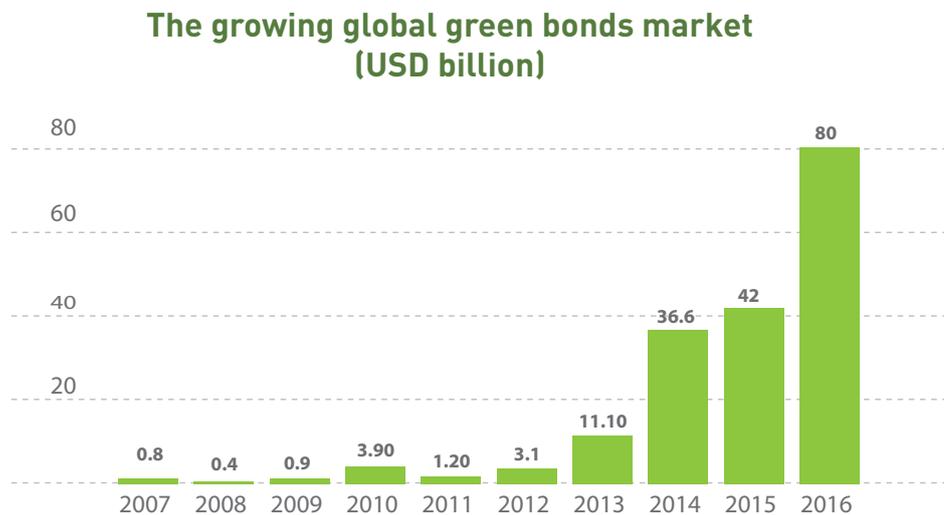
Better reputation and more funding opportunities

By ensuring the bank is not implicated in issues like labour rights' violations and community conflicts, it strengthens its reputation and its funding options. A better reputation among both retail clients in Indonesia and foreign financiers will help Indonesian banks to attract sufficient funds and prevent a squeeze on solvency ratios.

An interesting market that could open up for Indonesian banks is the rapidly growing green bond market. Banks could issue specific bonds on the international capital market to attract funding earmarked for loans to palm oil companies operating sustainably. Green bonds are enjoying strong international investor demand and enable the financing of companies at a lower cost of capital. Issuing green bonds would also help to develop the bank's brand name and reputation. In the last five years the size of this global market has increased more than 25-fold.⁷⁵

Figure 13. The size of the global green bonds market has jumped more than 25-fold since 2012.

Source: Panerai, A. and Giudice, E. (2016).⁷⁶



Operating in a more sustainable way will also help Indonesian banks to join initiatives such as the Equator Principles⁷⁷ and the United Nations Environment Programme Finance Initiative.⁷⁸ This in turn would help them to learn from the best practices of international market leaders in the financial sector and to find new partners for collaboration and business opportunities.

CHAPTER

III

WHERE TO START? AN ACTION PLAN FOR INDONESIAN BANKS

In Chapter 1, the authors argued that Indonesian banks face significant risks because of the actions undertaken by the Indonesian government and other significant stakeholders - foreign governments, palm oil buyers and banks and investors - who are alarmed by the large sustainability risks and costs within the palm oil sector. As a result of both government and private sector actions, the authors argue that the risks for palm oil companies that have not yet adopted sustainable practices are increasing, because these actions may reduce their turnover, increase their costs and constrain their growth.

For the banks financing the palm oil sector in Indonesia, the risks to their customers translate into increased NPL risk and a decline in the value of collateral, making loans to this sector in general underpriced. At the same time, the regulatory pressure on banks to integrate sustainability criteria into their lending decisions is increasing, and their continued exposure to the sustainability issues in the palm oil sector could tarnish their reputation among both domestic retail clients and foreign investors. This will make it more difficult for banks to attract sufficient funding and meet solvency requirements.

In response to these looming risks, Indonesian banks should play an important role in supporting the transformation of the palm oil sector towards more sustainable practices. This would require banks to integrate sustainability criteria into their lending decisions and implement these throughout the credit process. Indonesian banks are therefore recommended to take the following steps:

1

Define a sustainability vision

The first step would be to define how the bank looks at sustainable development and how this could be integrated into its overall strategy, in line with the sustainability regulation recently introduced by the OJK.⁷⁹ This could be a broad vision covering all the bank's activities, but it could also start with priority sectors, such as palm oil. For the palm oil sector, the vision should define which practices the bank wants to support and which practices it wants to avoid or discourage.

2 Conduct Portfolio analysis

As a next step, an analysis should be made of the loans the bank has outstanding to state-owned plantations, to international, vertically-integrated palm oil groups, small and medium-sized plantation groups and smallholders. The bank should also analyse loans outstanding to independent traders and refiners and to consumer goods companies that are buying large volumes of palm oil. Existing policies and practices should be compared with the bank's vision for sustainability in the palm oil sector.

Risks and problems need to be identified, along with priority issues and clients. Engagement with clients in this phase - to ask for their input regarding the bank's palm oil policy - will prevent clients being scared away at a later stage.

3 Develop a sustainable palm oil policy

The bank's vision on which practices the bank wants to support in the palm oil sector and which practices it wants to avoid or discourage needs to be elaborated further. A practical and realistic approach needs to be formulated in the bank's policy, taking into the account the composition of its portfolio and the priority issues identified in the analysis of the portfolio. All this should be defined in a palm oil policy which would guide its lending decisions, which needs to be transparent for the bank's staff and clients.

In the policy the bank obviously should demand its palm oil clients to live up to all Indonesian government regulations (see section 1.1.1), but additional criteria should be included in the policy to avoid the bank becoming implicated in any further issues surrounding peat development, community conflict or tax avoidance. The more advanced palm oil policies of US and European banks can be used as a starting point (see Table 1).

4 Train relevant staff

Relevant staff, such as relationship managers and risk managers, do need to be aware of the contents of the palm oil policy and do not to support its objectives and approach. Training will be needed to let key staff understand different sustainability issues related to the palm oil sector and enable them to work with clients to find practical solutions for the challenges they are confronted with.

When the policy is clear, more in-depth due diligence of all palm oil clients need to take place. This requires gathering information on how their (prospective) clients deal with sustainability issues and if they live up to the criteria in the bank's palm oil policy. With this screening, the bank is able to identify risks and act upon them. This screening should use varied information sources, such as government data, reports by specialized service providers, NGO reports and media sources.

5 Undertake due diligence to identify risks

The RSPO is also an important information source: if a palm oil company is RSPO-certified it is dealing in a better way with many sustainability issues. But the due diligence process should not limit itself to verifying if a company is RSPO-certified.

6 Engage with clients

When sustainability risks are identified in relation to a palm oil client, the bank should start engagement with the client to support it in addressing the issues and changing its practices. These engagements can result in a mutually-agreed improvement plan, with clear and time-bound targets.

To ensure that the company lives up to the commitments made during the engagement process, especially when these are detailed in an improvement plan, the bank can include a covenant in the financing agreement. In principle, this would give the bank the right to ask for early repayment of its loan if the company defaults on the agreements made in the covenant.

7 Offer incentives

A bank may wish to consider offering incentives, such as a reduced interest rate, for palm oil clients that meet the bank's policy requirements. This could help speed up the transition of the sector and ensure the compliance of the bank's clients with its palm oil policy. While offering incentives might reduce revenues in the short-term, these costs can be justified given the crucial role they can play in managing the bank's reputation risks: it would be very damaging to a bank's reputation were NGOs or media to uncover and report on a massive non-compliance of a client with its policy.

A specific group of clients for which such incentives could be very useful are palm oil smallholders, as this group has limited options to finance from their own cash flow the investments needed for more sustainable practices.⁸⁰

8 Monitor progress

An agreed improvement plan with clear and time-bound targets requires proper monitoring. The bank should act as a partner and coach of its palm oil clients, supporting them to make the necessary transformation. The progress towards targets should be monitored, based upon reporting by the company, but also with input from government and civil society. Where necessary, the improvement plan may be adjusted.

9

Participate in multi-stakeholder initiatives

Banks may also wish to participate in multi-stakeholder initiatives, such as the RSPO, to share sector knowledge and to encourage their clients to meet certification standards. A concerted approach to improving the sustainability of palm oil companies is more likely to lead to results. Indonesian banks are in a position to develop intense engagement with small and medium-sized palm oil groups, which do not attract funding from abroad. International banks and investors on the other hand are more advanced in developing and implementing SRI and ESG policies when lending to and investing in large, vertically integrated palm oil groups. If actors in the financial sector cooperate, best practices can be shared.

10

Report transparently on the bank's efforts

To improve its reputation and gain support for its efforts from civil society, the bank should be as transparent as possible in how it identifies and manages the sustainability risks in the palm oil sector. This can be done by reporting on the indicators developed by the Global Reporting Initiative (GRI) in the bank's sustainability report. The general GRI Reporting Principles and GRI Standard Disclosures are complemented by GRI's Sector Disclosures; these go into further detail on the transparency requirements for specific types of companies and industries.⁸¹

Additionally, the United Nations Guiding Principles on Business and Human Rights (UNGP) Reporting Framework can be used. This is a comprehensive framework under which companies report on how they respect human rights in practice.⁸² Both the GRI and UNGP reporting guidelines are consistent with Indonesia's new sustainability reporting requirements for banks (see section 1.3.3).⁸³

11

Review and amend the policy as necessary

After the bank has worked with its palm oil policy for some time, it may wish to consider evaluating lessons learned and amending the policy accordingly to ensure more effective and efficient implementation.

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MANAGING PALM OIL RISKS

A BRIEF FOR FINANCIERS

This publication sets out the considerable and growing risks of unsustainable palm oil to producers, and consequently to the financial institutions supporting them. The report also demonstrates the clear economic benefits to all stakeholders of producing palm oil in a sustainable manner, and is a call to action for Indonesian banks.