MANAGING PALM OIL RISKS

A BRIEF FOR FINANCIERS

EXECUTIVE SUMMARY

The Indonesian financial sector faces sizeable reputational, regulatory, and financial risks if it continues to support unsustainable 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 unsustainable palm oil practices.

These actions include the Indonesian government's issuance of several moratoriums on development in primary forests, peatland, and further expansion of palm oil, and European countries committing to purchasing 100% certified sustainable palm oil by 2020. Many companies in the palm oil supply chain have also committed to producing and sourcing only from areas and producers that comply with No Deforestation, No Peat, and No Exploitation (NDPE) requirements and building their traceability and monitoring systems to full implementation of such policies by 2020, a fast approaching target.

These measures translate into constrained long-term growth prospects of 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 the future palm oil growth cannot be developed under the present market and regulatory circumstances as it is located in forest areas or peatlands. Suspension of procurement contracts for plantation companies that cannot comply with the sustainability policies of the traders, refiners, and consumer goods manufacturers that buy their palm oil may affect revenues while costs may increase simultaneously, due in part to fines applied for the use of fires and other non-sustainable practices.

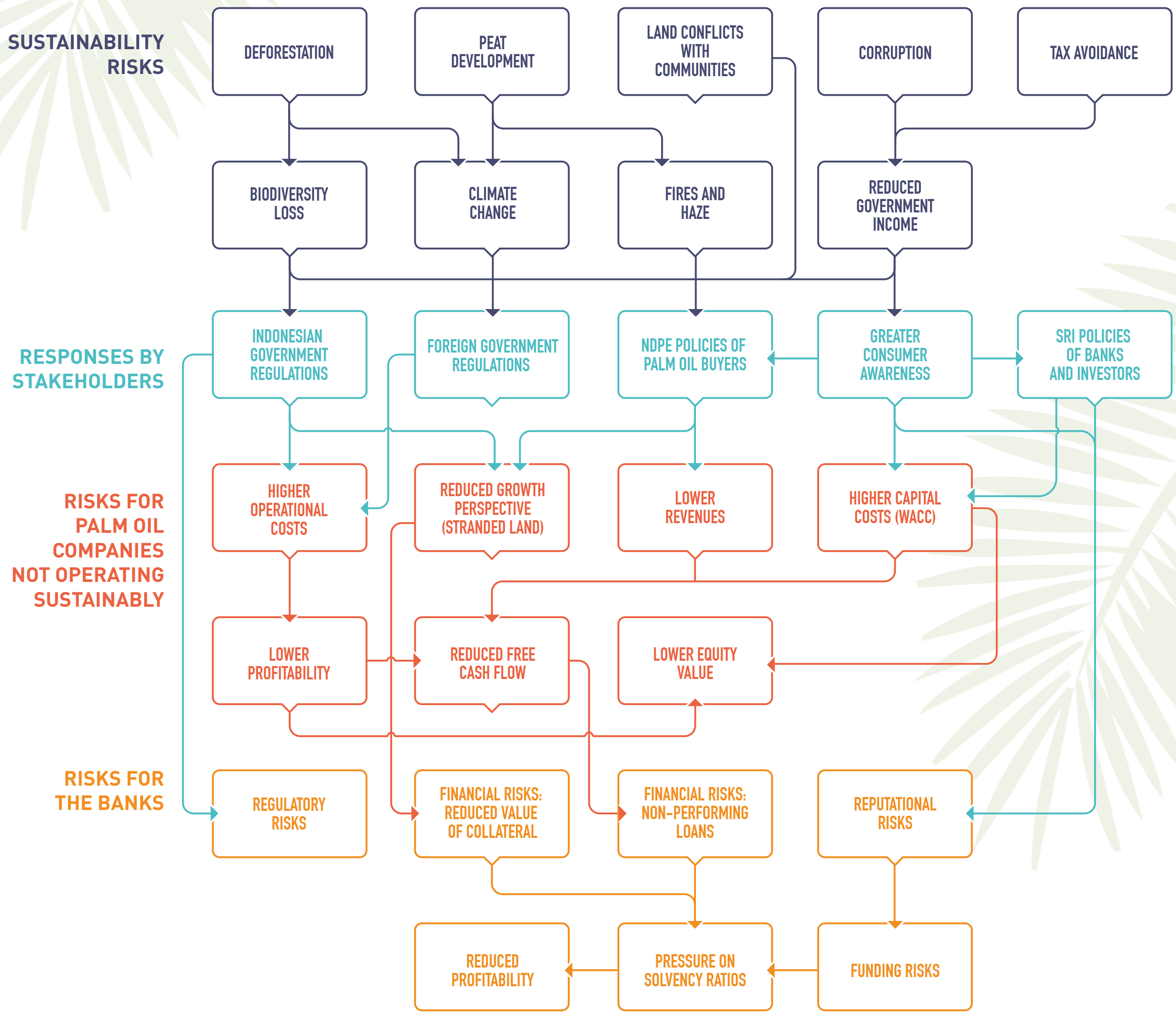
For the banks financing the palm oil sector in Indonesia, these developments imply an increasing risk of Non-Performing Loans (NPLs) . At the same time, the value of collateral, often in the form of undeveloped land, goes down, making outstanding loans to this sector in general under-priced. In addition, 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 might 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 stronger 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 this sector have yielded healthy returns for banks. Palm oil continues to grow and is seen as a major driver for local economic development and poverty alleviation, employing approximately 5.6 million people directly.

However, these economic benefits come to at high environmental and social costs like the conversion of tropical forests and other areas with significant biodiversity into partially palm oil plantations. The devastating forest fires in 2015, estimated to cause more than 100,000 premature deaths in Indonesia, Singapore, and Malaysia, emphasised the importance of healthy forests and peatlands in our ecosystems. More exposure is put on the hundreds of land rights conflicts between palm oil plantations and local communities across Indonesia, while the spotlight is also on potential corruption and low tax compliance ratio of the palm oil sector, as disclosed by the Indonesian Corruption Eradication Commission (KPK).

Major stakeholders are taking measures to manage these sustainability risks, and the new policy and market environment has created significant reputational, regulatory and financial risks for Indonesian banks that are heavily exposed to all segments of the palm oil value chain, and particularly for banks exposed to the risk in the upstream production side. Possible steps for banks to manage these risks include developing their own sustainability policy, screening their portfolio, and engaging with palm oil clients to support their 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.

FROM SUSTAINABILITY RISKS TO FINANCIAL RISKS



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