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Toward responsible and inclusive financing of the palm oil sector

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Key messages

- Many stakeholders, including governments, production and processing companies and non-governmental organizations (NGOs), are working towards a more sustainable palm oil sector. Although smallholders account for an important share of oil palm cultivation, the social and environmental challenges of smallholder practices receive relatively little attention.
- Financial Service Providers (FSPs), such as banks and pension funds, could play a more significant role developing a more sustainable and inclusive palm oil sector by tying Environmental, Social and Governance (ESG) conditions to the financial services they provide to palm oil companies that source products from smallholders.
- The majority of funds financing the major palm oil companies originate from FSPs based in Asian countries such as Japan, Malaysia, Indonesia and Singapore. Currently, these FSPs do not have adequate ESG policies.
- European and American FSP policies are more advanced in addressing such issues as deforestation and Roundtable on Sustainable Palm Oil (RSPO) certification. Nevertheless, they still pay very little attention to the inclusion of smallholders in sustainable supply chains.
- Due to the differences between ESG policies followed by European and American FSPs in comparison to Asian FSPs, palm oil companies still have ample alternatives to access financing with few conditions. As a result, the potentially significant contribution of FSPs to foster a more sustainable palm oil sector remains underutilized.
- Adoption of more adequate ESG policies by Asian FSPs could occur in the first place through an increased understanding by these FSPs of the financial risks involved in continuing business as usual. Second, peer pressure from European and American FSPs and sustainability initiatives would help. Third, financial regulators in the palm oil production countries increasingly look for instruments to stimulate the financial sector to contribute more to the sustainable development of their economies.

Introduction

The global palm oil sector faces on going sustainability challenges such as deforestation, peatland development (which is a major driver of climate change), labour rights violations and conflicts over land rights with local communities. Various stakeholders including plantation companies, consumers, processing companies, governments, and NGOs set up initiatives such as the RSPO[1] to push for sustainable transformation of the entire sector. However, it is questionable whether the specific social and environmental challenges of oil palm smallholders are receiving sufficient attention through these initiatives, despite the fact that smallholders account for 40% of the land planted with oil palm and 30% of the total production.

a Profundo

1 The Roundtable on Sustainable Palm Oil is an international multi-stakeholder initiative; involving companies, governments and NGOs. the RSPO adopted the Principles and Criteria for Sustainable Palm Oil Production and launched the RSPO Certification System. At present the RSPO Certification System is the only type of certification that is widely adopted by stakeholders in the palm oil sector

Independent smallholders receive limited technical and financial support, resulting in poor productivity. As they are dependent on traders, they often receive low prices for their fruit. To generate sufficient income, they are likely to expand into forest and peat areas. Smallholders organized into cooperative or company-managed schemes usually get more support, but face high credit costs, long delays in receiving allocated land and credit, inaccessibility of allocated plots, restrictions on traditional intercropping and high land reclamation costs. Often, they are unable to generate a living wage and have to cope with overexploitation of water resources and rising costs of living (Unpublished paper by Bronkhorst E et al. 2017. Current Practices and Innovations in Smallholder Finance - Long-term Financing Solutions to Promote Sustainable Supply Chains. Occasional Paper #, CIFOR, SNV, Financial Access. Bogor, Indonesia).

Integrating smallholders into sustainable palm oil supply chains, ensuring they generate a living wage, receive technical and financial support and apply more sustainable production practices to prevent further deforestation, continues to be a major challenge for the industry as a whole.

Financial Service Providers (FSPs) such as banks, pension funds, insurance companies and other institutional investors, could play a role in stimulating sustainability commitments from the oil palm companies they are financing, including agreeing to include smallholders in a more fair and sustainable way in their supply chains. Their potential influence stems from their capacity to set Environmental, Social and Governance (ESG) conditions for loans, investments and other financial services. Over the past 15 years, integration of ESG policies into the financing and investment decisions of FSPs has grown to tackle the reputational, financial, and compliance risks associated with socially and environmentally unsustainable companies and projects. These trends have been stimulated by such finance sector initiatives as the Equator Principles (EP)[2] for banks and the Principles for Responsible Investment (PRI)[3] for institutional investors.

This research was conducted to generate a better understanding of the way ESG policies of FSPs could stimulate a more sustainable palm oil sector, including better living standards and more sustainable cultivation practices among smallholders (Kusumaningtyas and van Gelder 2017).

The economic context of the palm oil sector

Although Malaysia has dominated the global export market for palm oil since the mid-1960s, Indonesia did not develop into a significant producer of palm oil until the 1990s. Combined exports for palm oil and palm kernel from both countries accounted for about 90% of global exports over the past five years (2012-2016) (USDA 2017).

The global demand for palm oil has been growing steadily over time, mainly due to a combination of increasing population and a rise in the gross domestic product of developing countries, particularly in India and China. In 2016, Asian countries accounted for about 66% of total palm oil consumption, far outweighing Europe and the United States (USDA 2017).

Indonesia is not only the largest producer and exporter of palm oil, but since 2010 it has also been the biggest consumer of palm oil and palm kernel oil. In 2016, Indonesian domestic consumption of palm oil and palm kernel was 11.7 million metric tonnes (approximately 17% of total world consumption), compared to a total production of 39 million metric tonnes. India was the second-largest consumer, followed by Europe. Malaysian domestic consumption in 2016 meanwhile, was 4.8 million metric tonnes (approximately 7% of total world consumption), compared to a production of 22.4 million metric tonnes (USDA 2017). Figure 1 presents consumption of the 10 largest consumer countries of palm oil.

In terms of growth in domestic consumption, Indonesia ranks third in the word with a growth of 120% over the past 10 years. Thailand has shown the biggest growth at 150%, with India ranking second with 130% growth in domestic consumption of palm oil over the same period (USDA).

2 The Equator Principles (EP) initiative was launched by a group of leading banks to provide sustainable principles in the project financing market. The Equator Principles relate to project financing, a specific type of company financing intended for large, complicated projects. EP follows the risk assessment procedures and the Performance Standards of the International Finance Corporation (IFC).

3 A significant part of the global asset management companies, investment funds and pension funds are members of the Principles for Responsible Investment (PRI). PRI focuses on environmental, social and governance (ESG) implications of investments and promotes the integration of ESG standards in their investment decisions.

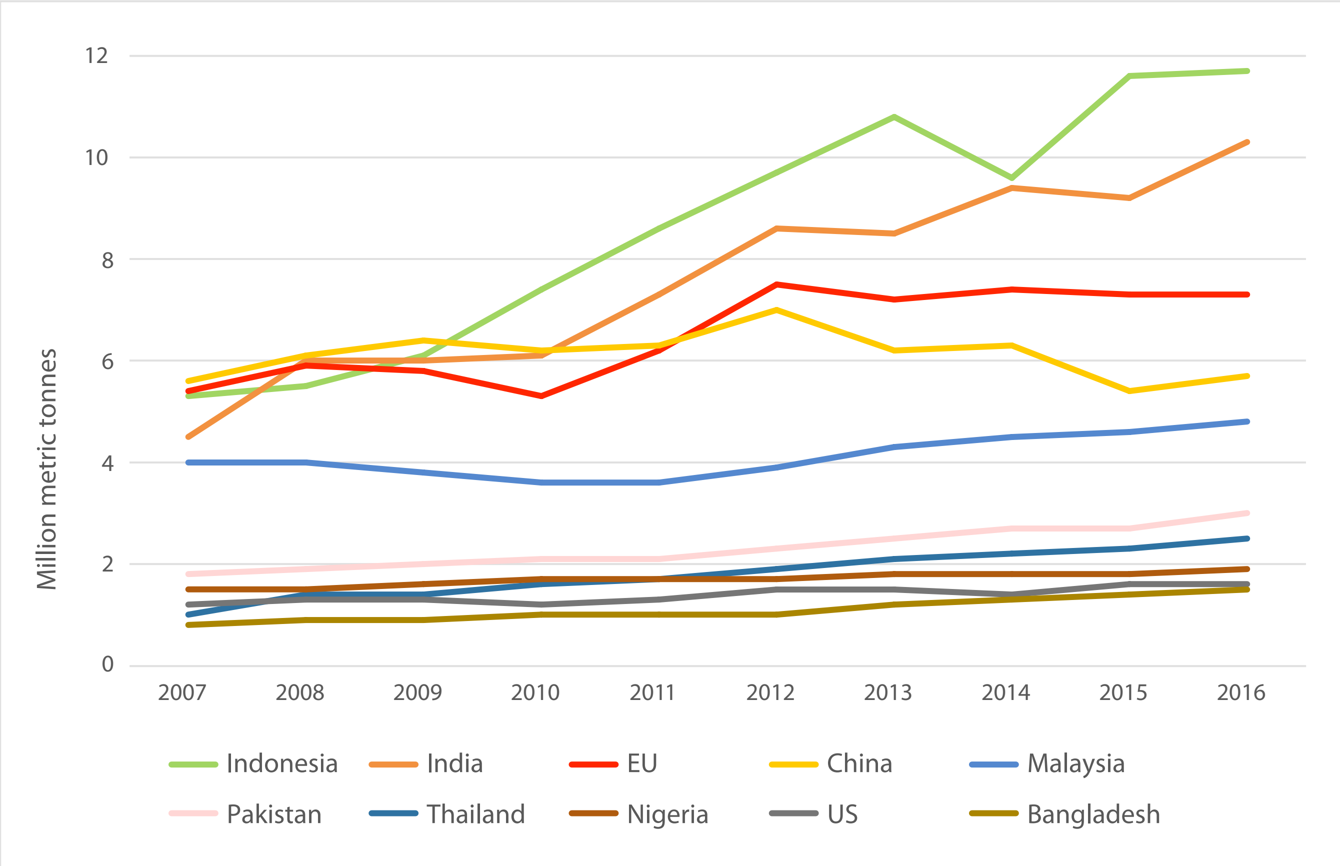

Figure 1. Palm oil consumption of ten largest consumers, in million metric tons

Source: PSDonline, "Oil, palm; oil, palm kernel – Export – 2012-2016", USDA Foreign Agricultural Service.

Financiers of the palm oil sector and their financing policies

The research analysed data to determine which Financial Service Providers (FSPs) are funding the 15 most important palm oil companies (all based in Indonesia, Malaysia or Singapore), through loans and services related to the issuance of bonds and shares. A total of 15 FSPs accounted for 72% of the total amount of loans to the selected companies between 2006 and 2015, and provided 88% of financial services related to the bonds and shares issued in that period. Among those 15 FSPs, Japanese FSPs provided the largest dollar value of loans, followed by those based in Singapore and Europe. Meanwhile, financial services for bond and share issuances were mostly provided by FSPs based in Malaysia, followed by those based in the United States and Europe. Figure 2 presents an overview of the distribution of sources of funds in the selected companies.

Research on the top 15 FSPs of the selected major palm oil companies showed that European and American FSPs are more advanced than their Asian counterparts in adopting policies to set Environmental, Social and Governance (ESG) criteria as a prerequisite for providing financial services to companies in the palm oil sector. Apart from RSPO certification, FSPs from Europe and the United States often have set other sector-specific criteria as requirement for financing. These policies are often presented within policy frameworks for agriculture and forestry, but sometimes they are also presented as separate policies addressing the palm oil sector.

Clearly, one of the main reasons for European and US FSPs to make environmental and social aspects of palm oil production part of their assessments for the financial services they provide, is the value they place on their domestic public profile. The reputational risks associated with deforestation, climate change (through peatland development) and land rights' conflicts, could deter private and institutional customers in their home markets.

In contrast, there is little awareness in Europe and the United States of the serious social and environmental

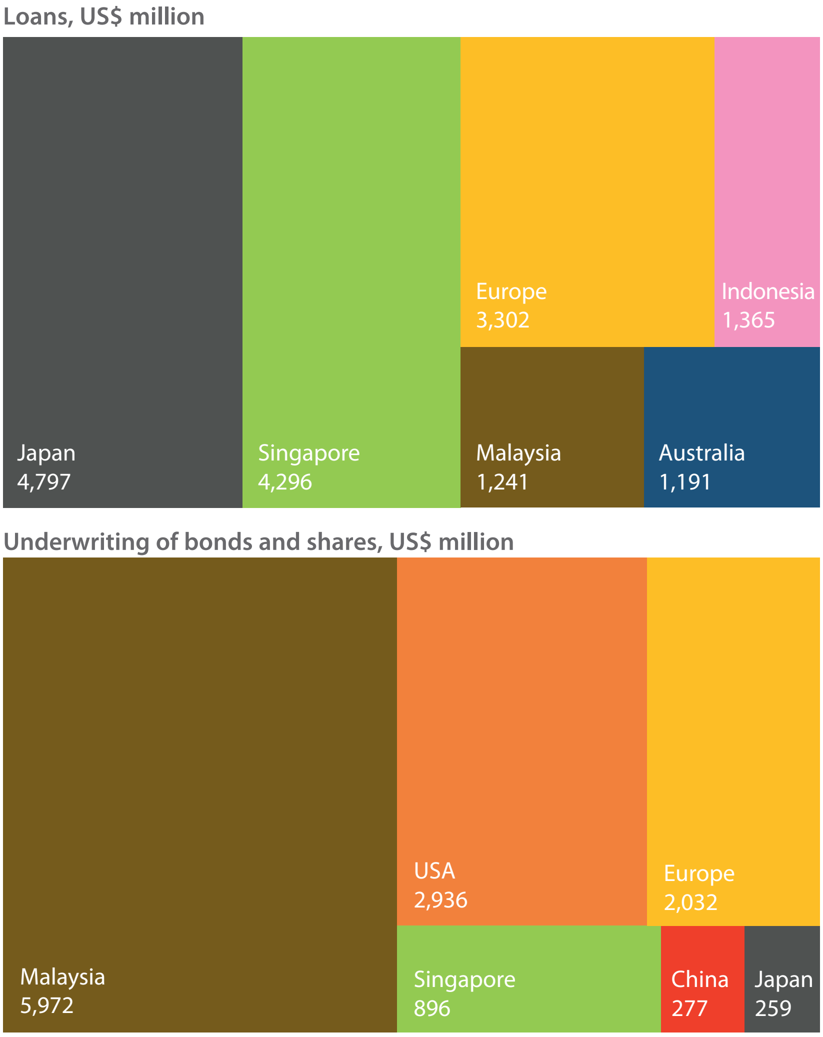

Figure 2. Distribution of financial services provided by the top 15 FSPs to the 15 largest palm oil companies

Source: Adapted from CRR (2017, February 3), Banks finance more palm oil than investors. Data from Thomson Reuters and Bloomberg.

issues linked to the position of smallholders in the palm oil supply chain. This, in turn, is reflected in the focus of the ESG policies of FSPs from these regions. Without sufficient awareness of the role of smallholders in their home markets, it is unlikely that FSPs will adopt more comprehensive policies that will take into consideration the risks and opportunities that smallholder practices in the palm oil sector provide.

In comparison with their counterparts from Europe and the United States, FSPs from Japan and Singapore, have less adequate ESG policies to limit the risks of financing unsustainable practices in the palm oil sector. Most Japanese FSPs have adopted the Equator Principles and follow general forest-related ESG policies, however, these policies are very non-specific and do not provide sufficient safeguards for their financial services to companies in the palm oil sector.

The FSPs from Indonesia and Malaysia were found to completely lack adequate ESG policies to limit the risk of financing unsustainable practices in the palm oil sector. For example, one FSP from Malaysia stated it has adopted responsible lending guidelines for financing, while another FSP from Indonesia stated that it has set up a guideline for technical analysis of environmental and social risk in lending. However, neither guideline is publicly available. Transparency on policies and policy execution is a key aspect of the process towards achieving a sustainable palm oil sector, an argument for active membership in the RSPO and all the associated requirements and responsibilities. At present, several Asian FSPs selected for this research state that they have policies that address ESG issues, without actually making these policies publicly available. This lack of transparency raises serious questions about the quality and credibility of these ESG policies.

Financiers of the palm oil sector and sustainability initiatives

Various global initiatives have been established to provide guidelines and promote the adoption of ESG standards by FSPs towards sustainable financing. In recent times, these initiatives have moved away from addressing general environmental, social and governance issues, to consider palm oil sector specific issues. Some initiatives of note include the Equator Principles (EP), the Principles for Responsible Investment (PRI), the RSPO, the Ceres Coalition (CC)[4] and the Soft Commodity Compact (SCC)[5].

Participation of FSPs in the aforementioned initiatives indicates whether or not they pay attention to the environmental and social risk of the financial services provided to the palm oil sector. Although being a member of an initiative, or stating adherence to its principles, does not guarantee sustainable financing practices, it does at least show awareness of some of the issues that need to be considered when investing in the palm oil sector in a more responsible way.

Results of research into the way FSPs participate in sustainability initiatives mirrored findings from research into their ESG policies. Among those financing major companies in the palm oil sector, most European financiers are signatories or have adopted related initiatives in the palm oil sector. All European financiers are signatories of PRI and most of them are also signatories of EP, have adopted SCC and are RSPO members. Most financiers from the United States covered by this research are signatories of PRI and EP. Among the US financiers, one is a RSPO member and one has adopted SCC.

All of the Japanese and Australian financiers are signatories of both EP and PRI. However, only one financier from Australia is a member of the RSPO. Other financiers from these countries are neither members of RSPO nor have they adopted SCC. Meanwhile none of the financiers from China, Indonesia, Malaysia or Singapore is active or participating in these initiatives. Table 1 presents an overview of ESG policies and participation in the aforementioned initiatives of the most important 15 FSPs providing financing to the 15 largest major palm oil companies.

4 The Ceres Coalition is a multi-stakeholder coalition that promotes the inclusion of environmental and social factors in financing. In January 2017, a group of nonprofit organizations and investor groups, convened by Ceres, launched the Reporting Guidance for Responsible Palm.

5 Soft Commodities Compact is an initiative of the banks that are involved in the Banking Environment Initiative (BEI) and the Consumer Goods Forum (CGF). This Compact aims "to lead the banking industry in aligning with the CGF's resolution to help achieve zero net deforestation by 2020."

We found no relationship between the value of the loans provided by FSPs to major companies on the one hand, and the results of the assessment on FSP policies on the other hand. Policies and conditions set by FSPs appear to be influenced by the region from which the FSP originates. Figure 3 shows the relationship between our policy assessment and the value of loans and underwriting services (for share and bond issuances) provided by the FSPs to the selected companies per country or region.

Gaps and opportunity analysis

The palm oil sector requires a significant transformation in production and business practices. FSPs have the potential to help forge change by setting ESG conditions for the provision of financial services. Since oil palm companies are dependent on FSPs to finance their expansion plans, ESG conditions could stimulate the avoidance of deforestation, peatland development and community conflicts. They could also lead oil palm companies to pay fair prices to smallholders supplying palm oil mills while providing them with the technical and financial means to improve cultivation practices.

In practice, however, only some FSPs active in the palm oil sector have set adequate ESG conditions for their financial services. The European and American FSPs are more advanced than their Asian counterparts in adopting ESG policies, although they still show limited awareness of the importance of integrating smallholders in sustainable supply chains. Also, the research shows that the relative importance of European and American FSPs in providing financial services to the palm oil sector is smaller than that of Asian FSPs.

Financial drivers tend to dominate the decision-making processes of Asian FSPs, as most of the palm oil production is going to Asian domestic and export markets where sustainability concerns are still less prominent. Asian FSPs have adopted less stringent ESG policies and are less involved in sustainability initiatives than their European and American counterparts.

Despite differences between European/US and Asian FSPs, palm oil companies still have ample access to finance regardless of their business practices. The possible contribution of FSPs towards fostering a more sustainable palm oil sector therefore remains underutilized.

Table 1. FSP policies and participation in related sustainable financing initiatives

Country	Financial service provider	Has an ESG policy	Policy is palm oil specific	Policy requires RSPO certification	Policy addresses small-holder inclusion	FSP is member of or adheres to				
						EP	PRI	RSPO	CC	SCC
Australia	ANZ	•	-	-	-	•	•	•	-	-
	Commonwealth Bank	•	-	-	-	•	•	-	-	-
China	CITIC	-	-	-	-	-	-	-	-	-
Europe	Deutsche Bank	•	•	•	-	-	•	-	-	•
	Credit Suisse	•	•	•	-	•	•	•	-	-
	BNP Paribas	•	•	•	•	•	•	•	-	•
	HSBC	•	•	•	-	•	•	•	-	-
	Rabobank	•	•	•	-	•	•	•	-	
Indonesia	BCA	-	-	-	-	-	-	-	-	-
	Mandiri	•	-	-	-	-	-	-	-	-
Japan	Mitsubishi UFJ	•	-	-	-	•	•	-	-	-
	Mizuho	•	-	-	-	•	•	-	-	-
	Sumitomo Mitsui	•	-	-	-	•	•	-	-	-
Malaysia	CIMB	-	-	-	-	-	-	-	-	-
	Maybank	•	-	-	-	-	-	-	-	-
	RHB	-	-	-	-	-	-	-	-	-
	Public Bank	-	-	-	-	-	-	-	-	-
Singapore	DBS	-	-	-	-	-	-	-	-	-
	OCBC	•	-	-	-	-	-	-	-	-
	UOB	•	-	-	-	-	-	-	-	-
USA	Citigroup	•	•	•	-		-	•	-	-
	Morgan Stanley	•	-	-	-	-	•	-	-	-
	JPMorgan Chase	•	•	•	-	•	•	-	-	•

FSPs and palm oil: What is next?

Although the potential impact of European and US FSPs on sustainable practices is lower than Asian FSPs, it is encouraging that they are setting ESG conditions as an integral part of the financial services provided to oil palm companies. These FSPs thereby contribute to the pressure exerted by consumers, processing companies, governments and NGOs to commit to a sustainable transformation of the palm oil sector. However, European and American FSPs must still show greater awareness of the needs and business practices of smallholders. More comprehensive ESG policies would help to pressure their customers – the large palm oil companies – to address the challenges smallholders face in their supply chains.

To effectively pressure the palm oil sector, greater scrutiny must be placed on the role of Asian FSPs because they are the most significant source of financial services to the palm oil sector. Failure to do so will perpetuate the current situation in which palm oil companies do not comply with sustainability standards and maintain unconditional access to finance. As these companies continue to have access to Asian markets where sustainability standards are given less emphasis by consumers, processing companies and governments, there is a danger of a two-tier marketplace emerging. One part of the palm oil sector will adopt sustainable practices, focusing on European and US export markets and access to finance from Europe and the United States. The other part of the market will continue with a business-as-usual scenario, focusing on Asian markets and attracting financing from Asian FSPs.

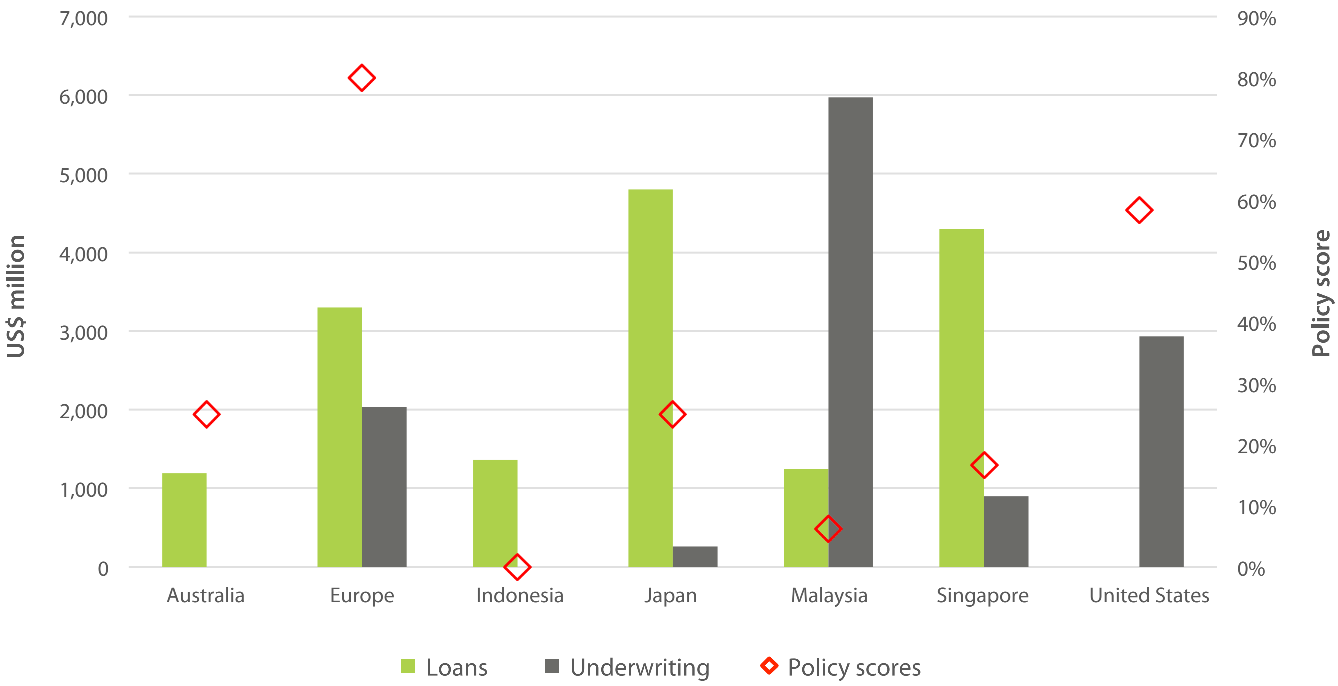

Figure 3. Value of loans and underwriting by FSPs per country compared with average policy scores

Note: The policies of FSPs were scored on four topics, namely: whether they have an ESG Policy; whether they have a palm oil specific policy; whether they require RSPO certification; and whether they require smallholder inclusion. For each identified policy a score of 25% was awarded. They were also scored on whether or not they participated in EP, PRI, RSPO, CC and SCC, receiving a grade of 20% for each. The country/region scores are the average scores of FSPs in that particular country/region.

This worrying trend is, nonetheless, too complex to be addressed solely by interventions from the finance sector. It would certainly help if Asian FSPs were to follow the example of their European and US peers by adopting ESG policies, which set conditions for their financial services. This would in the interest of the European and US FSPs as well, as it would help to create a level playing field for all FSPs. It could be stimulated by three developments:

First, more in-depth research and risk analyses could raise the awareness among Asian FSPs of the importance of setting ESG conditions to access financial services because the business-as-usual scenario is untenable in the long term. Consumers and processing companies in Asia, as well as governments, will make it increasingly difficult for companies to expand if the result is further deforestation, peatland development and community conflicts. Companies pursuing such strategies, will run out of expansion opportunities and risk seeing their concession areas converted into stranded assets, resulting in greater financial risks for FSPs that have not adopted ESG policies.

Second, FSPs from Europe and North America – as well as global sustainability initiatives such as RSPO, PRI and EP – could exert more concerted peer pressure on the Asian FSPs to adopt stringent ESG policies. Financial markets are interlinked at the global level and Asian FSPs are just as dependent on collaboration with their European and US counterparts as vice versa. The challenge for the European and US FSPs is to use this interdependency in a strategic way.

Third, encouraging policy developments are underway, such as at the Financial Services Authority of Indonesia (OJK). Increasingly, the OJK and financial regulators in other countries recognize that domestic financial sectors could play a more active role in fostering the sustainable economic development of national economies, focussing on using natural resources in the most efficient and effective way to create lasting employment and added value. Through this lens, a sustainable transition of the palm oil sector, including the integration of smallholders in sustainable supply chains, is a high priority. Financial regulators are therefore looking for ways to demand local FSPs to set appropriate ESG conditions for their financial services.

These three developments - improved understanding of the risks of business-as-usual, peer pressure from international banks and domestic regulatory pressure – could result in the adoption of adequate ESG policies by Asian FSPs and create a level playing field for FSPs from different regions. These considerations are a precondition to fully utilize the possible contribution of FSPs towards fostering a more sustainable palm oil sector.

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