PART II: DEVELOPING A RESPONSIBLE PALM OIL FINANCING AND INVESTMENT POLICY

We suggest that you read all of Part II if you are charged with developing or reviewing your financial institution's responsible palm oil policy. Other readers need only read the key points summary at the end of Part II.

Developing the policy and procedures

This part of the handbook presents a model example of a responsible palm oil policy, which you can use as the basis for developing or reviewing your financial institution's own policy. This part also outlines the process involved in developing the policy and the essential elements that need to be included.

This handbook uses the RSPO definition of sustainable palm oil production: "Sustainable palm oil production is comprised of legal, economically viable, environmentally appropriate and socially beneficial management and operations."

One way to go about developing your financial institution's policy is to establish a working group to consult widely on the appropriate parameters of the policy and to develop a draft policy for consideration by the board of directors. Financial institutions that have developed palm oil or similar policies have found it useful if this working group comprises:

- senior management;
- those units responsible for developing operational procedures;
- business teams with responsibilities for palm oil sector transactions;
- the legal department, and
- any units dealing with environmental or social issues.

Additionally, it may be useful to have external inputs from clients, NGOs and others.

The working group could first set out to learn from the experiences of other financial institutions in developing responsible palm oil policies. The working group can draw on this handbook and the experience and resources of the Roundtable on Sustainable Palm Oil (RSPO).

Your working group will need to:

1. Draw up the policy. The document should clearly state the environmental and social conditions your financial institution places on its investments in and financial services to the sector. These conditions could be based on the RSPO criteria. The policy needs to be consistent with other policies of your financial institution.

2. Develop a set of procedures for implementing the policy that are integrated with existing operating procedures for each business area of your financial institution. The procedures should cover how your financial institution will screen companies, how it will work with companies that have not or cannot achieve compliance, and how it will communicate the policy to clients, prospects, investees and other stakeholders. See Part III of the handbook for detailed guidance on such procedures.

3. Manage the internal roll-out of the policy and procedures. This will involve training staff (for example credit risk officers, asset managers) who will be directly involved in screening companies against the policy. The working group should also create feedback mechanisms that will assist them to refine the procedures to make them more effective. For example, as experience is gained, the procedures should be adapted to integrate better with other processes in your financial institution or to give additional guidance where needed to make them more user-friendly.

4. Manage communication with external stakeholders. This will involve outreach activities and the development of written materials (for example guidance notes and leaflets) to explain the policy to clients and other palm oil companies that are likely to apply for financing. Ideally, your financial institution will make this information available in an information pack containing clear explanations of all the policy requirements and procedures, key changes to your financial institution's previous financing conditions and procedures, and information on where companies can get technical support to address the sustainability requirements in the policy. Your financial institution will also need to communicate its policy to other external stakeholders and its shareholders via its website, brochures, corporate social responsibility reports, conference presentations etc. As appropriate, your financial institution can translate the policy and related materials into languages understood by local stakeholders.

5. Set up a monitoring and reporting system. Your financial institution will need to monitor its financing and investment operations to ensure the policy is applied universally across all transactions falling within its scope. Stakeholders will also expect your financial institution to report its performance in implementing the policy. The reporting mechanisms will be similar to those mentioned above for communicating with external shareholders.

Defining the scope of the policy

In developing your financial institution's responsible palm oil policy, you will need to clearly define its scope in terms of:

- geographic reach;
- coverage of downstream operations;
- application in cases of partial or indirect links to the palm oil sector; and
- which of your financial institution's activities are bound by the policy.

Geographic reach

To be meaningful and credible, the policy should apply to all of your financial institution's activities in the palm oil production chain, irrespective of geographical location. The cultivation of palm oil is limited to the tropical areas of Asia, Africa and South America, with Malaysia and Indonesia accounting for nearly 90 percent of global output at present. Much smaller, but still significant and potentially increasing, producers are Colombia, Costa Rica, Ecuador, Honduras, Ivory Coast, Papua New Guinea, Nigeria and Thailand.

Refining, trading and manufacturing companies all over the world can be involved in the palm oil production chain. Also, companies listed in one location will often have operations or source materials from other regions. It is therefore important to make your policy globally applicable.

Coverage of downstream operations

The policy should apply to both upstream companies (i.e. those directly involved in growing oil palm and primary processing to produce crude palm oil) and downstream companies (i.e. those involved in refining palm oil or trading, manufacturing or using products containing palm oil). However, the requirements for upstream production units will need to be different from those applicable to operations downstream in the supply chain – this is explained on pages 19 to 20.

Application in cases of partial or indirect links to the palm oil sector

The application of your financial institution's policy to clients or investees only partly, or indirectly involved in the palm oil sector should depend on the materiality of risk. A client's business may only include a small proportion of exposure to the palm oil sector, yet that exposure may still create material risks for your financial institution and the client.

Your policy will thus need to acknowledge the different degrees to which clients or investees can participate in the palm oil sector. Where funds are to be used for a known purpose, directly linked to palm oil (for example lending to a specific mill or plantation, or investment in a single new greenfield project), the approach will be different to circumstances where the funding is not directly tied to palm oil projects or operations (for example general corporate financing, or letters of credit).

How important does oil palm need to be for a company, before that company is included in the scope of your responsible palm oil policy? In answering this question, your financial institution will need to balance the merits of certainty in the policy (for example through use of a percentage-based threshold) with the need for flexibility to cover many different risk scenarios (for example a client mining company might own a single plantation that is a minor item in the client's overall asset base, yet exposes your financial institution to reputation risk because the plantation is highly controversial). Your policy may be more effective if its applicability in cases of marginal connection to palm oil production is not based on an arbitrary threshold but rather on preliminary, case-by-case assessment of the materiality of risk. Linked to this, you may also wish to create discretion in your policy to treat a corporate conglomerate as a single unit for screening purposes, where the group operates as a single business and/or the outside world perceives it as a single entity. To limit its reputation risks in these circumstances, your financial institution may wish to assess the sustainability of the palm oil activities of the wider group, rather than restrict the assessment to the activities of the single subsidiary that has applied for the finance.

Which of your financial institution's activities are bound by the policy

The policy will need to state clearly how it applies to the range of financial services that your financial institution offers to companies in the palm oil production chain, and investments in such companies. These financial services and investments may include:

- commercial banking services, such as loans, project finance, credit facilities, advisory services and trade finance;
- investment banking services, including mergers and acquisitions advisory services and the underwriting and managing of share and bond issuances;
- asset management services involving investments in the stocks of companies in the palm oil production chain, whether on your own account or on behalf of assets under management; and
- trust banking services, including the management of offshore trust activities.

The policy will also need to set out how it applies to new financing applications and investments as well as existing contracts and assets. For example, the policy could apply to new loan applications during the due diligence and approval procedures, and to existing contracts as they come up for renegotiation or a major review. If your financial institution wants to accelerate the process, it could offer incentives to clients to align voluntarily with the policy at the time of the next semi-annual and/or annual review.

Differentiating your approach to upstream and downstream companies

A comprehensive sustainable palm oil investment policy should cover both upstream and downstream elements of the palm oil production chain. However, the policy would need to include separate requirements for each.

Upstream companies are those involved in:

- growing oil palm (plantations, cooperatives, smallholders and others); and/or
- primary processing of the oil palm fruit into crude palm oil (CPO) mills.

After harvesting, oil palm fruits have to be processed within 24 hours to avoid the rapid build-up of free fatty acids. This means that CPO mills are usually located on or near plantations, are often owned by plantation companies and are generally developed in tandem with plantations. In addition, a large share of the bank loans that plantation companies attract is used for constructing CPO mills. So, for the purposes of this handbook, plantations and CPO mills are considered together as one operational group. This mirrors the RSPO criteria, which are directed at the practices of CPO mills and plantations, with the unit of certification being a mill and its plantation supply base.

Your financial institution can play an important role in ensuring a sustainable palm oil supply chain, by encouraging its downstream clients and investees to adopt a responsible purchasing policy.

Downstream companies are those involved in one or more of the following activities:

- national or international trading of palm oil products (including oleochemicals and biofuels);
- crushing palm kernels;
- refining palm oil and/or palm kernel oil;
- use of palm oil in the production of:
    - oleochemicals;
    - food, especially cooking oil, salad oil, mayonnaise, sauces, margarine, frying fat, shortenings, potato chips, crisps, instant noodles, snacks, biscuits, bread, cakes, pastry, chocolate, confectionaries, ice cream, coffee whitener;
    - soaps, detergents and cosmetics;
    - biofuel and biodiesel;
    - electricity and;
- trading or retailing products containing palm oil.

Downstream companies are exposed to market and reputation risks if they allow ‘unsustainable’ palm oil to enter their supply chains. These companies can mitigate these risks by preferential sourcing of RSPO-certified palm oil and stimulating their suppliers to operate sustainably.

The palm oil market is in many respects a ‘buyers market’ and buyers can exert considerable influence over plantations and CPO mills – especially if your financial institution encourages them to do so.

Applying a responsible palm oil policy to these downstream companies entails assessing their purchasing policies and the extent to which they encourage their suppliers to operate in an environmentally and socially responsible manner.

In general, your financial institution's ability to influence the palm oil procurement practices of a downstream company will depend on the significance of palm oil to the company's overall operations, your exposure to the company and your policy framework. Broadly speaking, it is not realistic to make the financing of retailers contingent on their having a responsible procurement policy for one commodity (in this case, palm oil). A possible exception is the financing of retailers that produce and label their own brand products and would therefore be included on the above list in their capacity as manufacturers. One of the founding members of the RSPO is Migros, a Swiss retailer that pioneered the responsible sourcing of palm oil (from Ghana) for its own brand margarine.

Your financial institution will therefore need to determine if and how it can apply its policy to the financing of large multi-product downstream companies. One approach could be to develop a broader policy that requires clients to assess the environmental and social impacts of their products, and to put in place measures to improve sustainability where significant risks are evident. In this way, a range of broader issues (fisheries, timber products etc.) can be addressed. Some external stakeholders will expect you to apply your policy to all companies, so it may be important to develop a clear argumentation for each category of company exempted from your policy.

For its asset management operations, your financial institution may also wish to apply an engagement policy that feeds into company valuations, rather than a purely divestment or exclusion approach. See page 34-37 for details.

RSPO traceability and verification systems

The RSPO recognises four approaches to ensuring the traceability of RSPO-certified palm oil in the market. These approaches are:

Full segregation. This involves keeping material from RSPO-certified plantations separate from material from non-RSPO plantations at every stage of production, processing, refining and manufacturing along the supply chain.

Identity preserved. This involves a supply chain that assures that the RSPO-certified sustainable palm oil, and its derivatives delivered to the end user, is uniquely identifiable to a specific mill and its supply base and is kept physically isolated from all other oil palm sources throughout the supply chain (including other segregated RSPO-certified sources). The oil is then traceable from the estate/plantation where the fresh fruit bunches are harvested through to the end user.

Mass balance. This does not involve segregating RSPO and non-RSPO material but instead is based on ensuring that the total quantity of RSPO product at any stage in the supply chain is proportional to the quantity of RSPO raw material used. Thus, if half of the raw material used by a refinery is RSPO-certified, half of the refinery's production can be counted as RSPO material. In this approach, the amount of RSPO material reaching the end user reflects the amount of palm oil produced by RSPO-certified plantations. However, no direct physical link is maintained between the plantations and the final product. RSPO-certified material in end products may, in fact, have come from any source.

Book and Claim. In this approach, instead of trying to trace RSPO material through the supply chain from plantation to end-user, the 'RSPO' element of the oil is traded separately from the oil itself. This is done by issuing a tradable certificate to RSPO-certified producers, which they can then sell to downstream palm oil users wanting to claim that they support sustainable palm oil production. The actual oil enters the normal supply chain and is traded without any claim attached.

The RSPO requires that any tracing mechanism based on one of the above approaches must be supported by a rigorous verification system (including a verification standard, accreditation requirements and verification process requirements). As increasing volumes of certified palm oil enter the market, your financial institution will be able to rely on the RSPO-endorsed traceability mechanisms and verification systems to corroborate a company's claims related to its progress in sourcing RSPO-certified palm oil.

A model policy

Box 2 on page 23 sets out a model policy, based on the RSPO principles and criteria.

In developing your responsible palm oil policy, you can adapt this model to fit the characteristics of your financial institution's business and its exposure to the palm oil sector. If you already have a policy that covers palm oil, this model can serve as a reference point when the policy next comes under review.

The model is presented in relatively concise form to make it more amenable for use in external communications. It assumes that a supplementary set of procedural documents will detail how the policy applies in practice. Your financial institution will need to develop its own set of documented procedures to support implementation of its policy. For asset management, it may be necessary to define an engagement process that would precede divestment.

The model policy sets out clear and unambiguous commitments and requirements. For many financial institutions, establishing a policy along these lines would entail a major departure from their current practices and would require a rethinking of their role and the requirements they place on their palm oil clients or their engagement of companies within their investment portfolio.

Part III of this handbook provides practical guidance on integrating the policy into existing procedures. In addition, model tools for use in implementing the policy are presented in Annexes 2 to 6. The guidance and tools would need to be adapted to fit the policy adopted by your financial institution.

Financial institutions that have already adopted palm oil policies have found that these policies often result in stronger relationships with their clients and investees.

A strong policy should benefit your financial institution's clients and investees, by providing a clear set of sustainability benchmarks. Achieving these benchmarks should ultimately make their businesses more sustainable. Potential benefits to clients and investees include:

- increased or maintained access to markets;
- better supply chain fidelity and stronger relations with the value chain;
- faster and cheaper access to capital;
- reduced risk of loss of social licence to operate;
- better relations with NGOs and reduced brand and reputation damage; and
- better and more cost effective production through introduction of better practices required to achieve compliance with RSPO criteria.

As many clients in the palm oil sector will increasingly feel the need to operate more sustainably (partly because of pressure from external stakeholders), your financial institution's knowledge and advice on these issues might well be appreciated. The experiences of banks that have already adopted palm oil policies is that these policies often result in stronger relationships with their clients, for the benefit of both parties. A better understanding of how a client or investee company manages environmental and social risks will also enhance your financial institution's ability to assess accurately the risk profile of that company.

The model policy accommodates stepwise progress to sustainability across the full range of a company's activities. This flexibility will allow companies time to make the necessary changes to their production, processing and procurement practices with respect to palm oil. This aspect is important and reflects:

- the nascent market for RSPO-certified palm oil;
- the challenges some producers will face in achieving RSPO-compliant performance levels and in remedying flawed historical land clearing or land acquisition practices that would otherwise disqualify them from RSPO certification; and
- the varying levels of influence your financial institution will be able to exert depending on the nature of its relationship with the company.

The model policy recognizes the need to allow "full compliance over time", rather than strictly declining potential deals with companies on grounds that their production units are not all RSPO-certified, or because their supply chains are not yet completely free of palm oil from unsustainable sources. A company's progress towards better performance will often depend on its ability to make the investments needed to transform its operating practices. Your financial institution could support such transformation by financing a company as its mills and plantations progress towards full compliance with the RSPO criteria. However in doing so you should be mindful of the potential reputation risks that your financial institution may face, and the assurance that you can rely on (in terms of capacity and commitment) from your client.

The model policy does not expressly prioritize the most critical screening criteria. However, the policy achieves this indirectly by aligning with the RSPO's certification system. The RSPO has identified "major indicators" that cover a critical subset of the full RSPO criteria (see Annex 1). In most cases, if a production unit fails to satisfy a major indicator, it will be ineligible for RSPO certification. In developing its palm oil policy, your financial institution can choose to use the RSPO certification sytem or to develop its own screening framework with the same or different priority criteria. Either way, choosing a limited number of such 'deal-breaker' criteria makes for a pragmatic screening process. It gives an assurance that companies have achieved a minimum threshold, while allowing some flexibility to address the full RSPO criteria within an appropriate timeframe. For asset management, an extended process of engagement may be more appropriate, concluding with potential divestment for companies that present the highest risk due to their failure to address such criteria.

The model policy does not expressly refer to reduction of GHG emissions associated with palm oil plantations and mills. However, the reference to "responsible development of new plantings" mirrors RSPO principle 7, which addresses the GHG issue indirectly. RSPO criterion 7.3 bars the conversion of primary forests and high conversation value habitats for the purpose of establishing palm oil plantations. By prohibiting the clearing of such habitats, the RSPO principles seek to sever the link between palm oil production and deforestation and associated burning, the major source of GHG emission potential from the palm oil sector. The RSPO intends to develop measures to deal more directly with GHG emissions. In November 2007, the RSPO General Assembly called for a working group to be set up to review all issues relating to Greenhouse Gas emissions, and possible amendments needed to the RSPO Principles and Criteria to address this issue.

Box 2: Model sustainable palm oil investment policy

Statement of commitment
XYZ will ensure that its investments in, and financial services to, the palm oil sector are adequately screened and monitored to fund only those growers, millers and downstream palm oil users that are committed to minimizing and mitigating environmental and social risks associated with palm oil production and processing.

Scope of the policy
XYZ will apply this policy to all its services to, and investments in, the palm oil sector worldwide. For the purposes of this policy, the palm oil sector includes:

- upstream production units (crude palm oil mills and the plantations that supply them, including contract growers and other smallholders); and
- downstream users (refiners, manufacturers, traders and industrial users of products containing palm oil).

The policy applies to all financial services provided by XYZ (including commercial banking, investment banking, asset management and trust banking) and all investments made by XYZ. The policy will be applied to financing agreements and investments that predate this policy upon their renewal or as they become due for major review.

XYZ shall exercise discretion in deciding whether to apply this policy to: (a) transactions that only have an indirect connection to palm oil production and trade; or (b) the provision of financial services to, or investment in, a company that has only marginal involvement in the palm oil sector. XYZ will make such decisions on a case-by-case basis after assessing the materiality of risk to XYZ.

When financing or investing in a legal entity that is part of a larger corporate group, XYZ may elect to make such investment conditional upon related legal entities agreeing to comply with this policy.

Conditions on investment in the palm oil sector
Companies with upstream palm oil production units must commit to achieving compliance with the criteria of the Roundtable on Sustainable Palm Oil (RSPO), which address the following 8 principles:

1. Commitment to transparency
2. Compliance with applicable laws and regulations
3. Commitment to long-term economic and financial viability
4. Use of appropriate best practices by growers and millers
5. Environmental responsibility and conservation of natural resources
6. Responsible consideration of employees and of individuals and communities affected by growers and mills
7. Responsible development of new plantings
8. Commitment to continuous improvement in key areas of activity

A company will be required to demonstrate this commitment for each of its upstream production units by attaining RSPO certification of the unit or by committing to a time-bound, stepwise plan to achieve RSPO certification of the unit.

A company will be required to plan and develop any new production unit, or any significant expansion of the plantation area or mill capacity of an existing production unit, in a manner consistent with RSPO criteria and achieve RSPO certification within an agreed time period soon after the new or expanded production unit becomes operational.

A company with downstream operations will be required to commit to progressively increasing the volume of palm oil entering its supply chains that is sourced from RSPO-certified production units as a proportion of the total volume of palm oil entering its supply chains.

Transparency
XYZ will ensure transparency in the application of this policy and will provide its clients and prospects with clear information about its requirements and procedures. It will also publicly report on its performance in implementing this policy.

Through joining the RSPO, XYZ will stay abreast of developments in the sector and report annually on its progress in implementing this policy.

Key points from Part II

- Sustainable palm oil production entails legal, economically viable, environmentally appropriate and socially beneficial management and operations.

- In developing your financial institution's responsible palm oil policy, it may be useful to set up a working group to consult widely on the appropriate parameters of the policy and to develop a draft policy for consideration by the board of directors. The working group might include representatives from senior management, business units associated with palm oil sector transactions, those units responsible for developing operational procedures, asset managers, and any units dealing with environmental or social issues. External advice and input (from clients, NGOs and others) may also be useful in framing the policy.

- The steps involved in establishing a responsible palm oil policy should include: (1) drawing up the policy; (2) developing a set of procedures for implementing the policy; (3) managing the internal roll-out of the policy and procedures; (4) managing communication with external stakeholders; and (5) setting up a monitoring and reporting system.

- The scope of the policy will need to be defined, including which of your financial institution's activities are bound by the policy.

- Your financial institution will need to consider how its policy will apply to transactions with a limited connection to palm oil production, or to companies with marginal involvement in the palm oil sector. One approach is to decide this case-by-case, based on a preliminary assessment of the materiality of risk.

- Downstream companies are exposed to market and reputation risks if they allow 'unsustainable' palm oil to enter their supply chains. These companies can mitigate these risks by preferential sourcing of RSPO-certified palm oil and stimulating their suppliers to operate sustainably. Your financial institution can play an important role in encouraging its downstream clients and investees to adopt responsible purchasing policies. However, your financial institution's ability to influence the palm oil procurement practices of a downstream company will depend on the significance of palm oil to the company's overall operations, your financial institution's exposure to the company and the strength of your financial institution's policy on palm oil and screening procedures.

- A strong policy should benefit your financial institution's clients and investee companies, by providing a clear set of sustainability benchmarks. If achieved, these will bring benefits such as market access, supply chain fidelity, access to capital, a social licence to operate, reduced risk of brand and reputation damage, and greater efficiency due to introduction of better management practices required to achieve compliance with RSPO criteria.

- Financial institutions that have adopted palm oil policies have found that these policies often result in stronger relationships with their clients or investees, for the benefit of both parties.

- The model policy recognizes the need to allow "full compliance over time" with RSPO criteria and responsible procurement, and the role a financial institution can play in providing funding for a company need to transform its operating practices.