



# ESG in Practice:

## A Closer Look at Sustainability in ASEAN's Palm Oil and Pulpwood Sectors



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## Executive Summary

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In recent years, there has been growing pressure on firms in ASEAN's agribusiness and forestry sectors to implement and improve Environmental, Social, and Governance (ESG) commitments. The palm oil and pulpwood industries, in particular, have faced great scrutiny for alleged linkages with issues such as transboundary haze in Southeast Asia. In response, companies have ramped up efforts to achieve sustainable production and operations as well as increase transparency in reporting, while their investors increasingly incorporate sustainability in financing criteria.

Sustainability comes with its challenges. These challenges have been further amplified by external forces such as the COVID-19 crisis and the European Union (EU)'s 2018 directive on palm oil-based biofuels, driving uncertainties in the market. While many companies are remaining committed to sustainability despite these headwinds, progress will require a multi-stakeholder effort towards a common understanding of ESG standards. This report by the Singapore Institute of International Affairs (SIIA) looks to align stakeholders – including corporates, financial institutions, and regulators – on key issues, best practices and challenges in implementing ESG in these sectors. It aims to aid the shaping of standards and expectations for ESG, while advancing the conversation on more accurately measuring sustainability going forward.

The report begins with an analysis of how ESG considerations have developed in the agribusiness and forestry sectors, reviewing the changing demands of customers and financiers, the proliferation of sustainability reporting and rating schemes, and how materiality in ESG should be defined for these sectors. The following sections assess the leading companies' implementation of environmental, social, and governance practices respectively, highlighting developments and gaps within the ESG landscape, before discussing how these ESG issues are approached by medium-sized companies in the industry. The penultimate section turns to important recent externalities that may impact ESG implementation, such as lower commodity prices and COVID-19.

Finally, the report proposes recommendations to address gaps and better align producers, consumers, financiers, and regulators, in order to collectively pursue robust and realistic standards for sustainability. Efforts are required in four main areas: (1) positive reinforcement for companies raising their ESG standards; (2) promoting sustainable finance; (3) harmonising standards and disclosures; as well as (4) "raising the floor" to help smaller players implement sustainable practices.

A total of 28 organisations were engaged for this report between July and September 2020. These included representatives from upstream and downstream palm oil and pulpwood companies, banks and investors, advisory firms, regulators, certification bodies, and non-governmental organisations (NGOs). Aside from reviewing academic literature and news on ESG in the sectors of interest, as well as companies' sustainability reports, the SIIA held consultations with stakeholders to better understand the challenges of implementing ESG standards on the ground. In addition, this report incorporates key takeaways from a virtual closed-door roundtable, *Shaping Expectations of Environment, Social, and Governance (ESG) Practices in ASEAN's Palm Oil and Pulpwood Sectors*, that the SIIA convened to allow a small group of stakeholders to freely exchange views, surfacing collective industry concerns for discussion and analysis.

# 1. ESG in the Agribusiness and Forestry Sectors: Drivers and Issues

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Southeast Asia's agribusiness and forestry sectors have been under much scrutiny for their sustainability practices. They are often linked in the media to fires and haze, deforestation or illegal land grabs in the major producer countries of Indonesia and Malaysia. Acknowledging the issue, Southeast Asian countries including Indonesia have included emissions reductions from the land use and forestry sector in their Nationally Determined Contributions under the Paris Agreement.

Criticism has been levelled at all parts of the supply chain, from plantations to traders and consumer goods companies. However, plantation companies argue that the cost of sustainability currently falls disproportionately on upstream actors.

## Drivers for ESG – customer demands

The broader issue for the industry is the impact of such negative publicity on consumption and finance. Companies have had to contend with the threat of import restrictions, facing recent queries from the EU on green and food safety criteria, as well as the United States on labour exploitation or modern slavery allegations. Another recent move that may impact demand for forest-related products is the United Kingdom's proposed non-deforestation law, which could see large companies facing major fines if they cannot prove their supply chains are free of illegal deforestation.<sup>1</sup>

In November 2018, the European Parliament agreed on a revised Renewable Energy Directive II (RED II), which mandates the phasing out of biofuels by 2030 from sources that pose high indirect land-use change risks. Palm oil was the main target of the Directive. Additionally, following increasing negative perceptions of palm oil in developed economies over the past three years, some retailers and brands have publicly made commitments to avoid its use in their products. An International Palm Oil Free Certification Trademark was launched in 2017, and as of August 2020 covered 1,450 products and was recognised in 20 countries.

The industry has argued that boycotts are unfair and unproductive. Millions of plantation workers and smallholders depend on agricultural commodities for their livelihoods, employment and income. Moreover, while the EU is an important biofuels market, it is not the only one; there would always be other “leakage markets” which have different sustainability requirements. For example, Malaysia's Plantation Industries and Commodities Minister noted in June 2020 that palm oil demand from India and the Middle East had increased despite the economic downturn caused by COVID-19.<sup>2</sup> In addition, Indonesia and Malaysia are both taking steps to increase their domestic use of palm oil based biofuels, with Indonesia moving to B30 biodiesel blending as of 2020 with a plan to eventually implement B100, and Malaysia targeting B20. It is likely that domestic consumption will increase in the long term.

Companies argue that measures such as the EU's do not recognise that some forest commodities come from producers with sound ESG practices, and are certified by credible bodies. In addition, plantation companies say that the market premium on sustainability is inadequate to serve as an incentive to go above and beyond minimum legal requirements, possibly due to a lack of consumer education about sustainable products. This means upstream companies shoulder most of the cost of improved ESG practices. In response, the Roundtable on Sustainable Palm Oil (RSPO)'s new Shared Responsibility approach includes volume targets for buyer members, to ensure that a certain percentage of a member's purchase is comprised of certified sustainable palm oil.

## Drivers for ESG – financier demands

Negative perceptions also have implications for finance and investment, with companies facing growing scrutiny from international financial institutions. Recent literature frequently mentions the financial risks that can be caused by ESG risks. The Task Force on Climate-Related Financial Disclosures (TCFD), led by 31 industry members selected by the Financial Stability Board, is a key initiative to strengthen voluntary climate-related financial disclosures. In addition, the EU leads global efforts on green finance, and the region's Green Deal emphasises the creation of green finance instruments to integrate environmental and climate risks into the financial system. Southeast Asian stock exchanges have also moved in recent years to require listed companies to provide sustainability disclosures – a positive development given that listed companies account for a large share of global commodity production.

Some industry watchers note that the limited number of international financial institutions willing to invest in “controversial” sectors has led to sky-high interest rates, especially for smaller suppliers – sometimes double that of subsidised domestic rates. Facing refinancing risks due to a shrinking pool of investors as public awareness of ESG grows, it is no surprise that many major agribusiness and forestry companies in the region have had to innovate to stay ahead of climate concerns. Leading companies have to consider how to deflect investment boycotts and be included in sustainability indices, noting that ESG-related funds remained resilient in 2020 with record fund inflows despite a global economic slowdown.<sup>3</sup> Box 1 discusses the approaches of financial institutions to ESG for forest-related sectors.

### Box 1 Greening finance

With the growth of green, sustainable or responsible finance, financial institutions are under growing pressure from their regulators, shareholders and customers to identify and address the links between financial and environmental or social risks. Regulators around the world are requiring the financial sector to improve oversight and management of ESG risk, as well as to enhance disclosure of such risks in their portfolios. Some regulators have discussed integrating climate risks into banks' capital requirements. In Southeast Asia, the Monetary Authority of Singapore (MAS) worked with banks, insurers and asset managers to create Guidelines on Environmental Risk Management which cover climate change, pollution, biodiversity and land use change risks, while Indonesia's OJK Regulation No.51 on Sustainable Finance was introduced as a binding regulation for the financial services sector.

Banks have had to strengthen their policies in response. Following the severe haze episode in 2015, the Association of Banks in Singapore issued Guidelines on Responsible Financing, which included a Haze Diagnostic Kit with guidelines on how banks should require clients to manage haze and fire risks.<sup>4</sup> A leading bank interviewed for this report described putting requirements in place for environmental and social assessments from its clients prior to project commencement, as well as assessing a client's processes to mitigate ESG risk. Another regional player described taking a collaborative approach, providing clients who do not meet requirements with time-bound roadmaps for compliance. However, the bank also highlighted that regulatory clarity on ESG is needed to get more financiers to a baseline level.

There is substantial variance in financial institutions' understanding of ESG in forest-related sectors. As recently as 2015, a Forest 500 report showed that most financial institutions surveyed did not fully understand deforestation risk, and therefore considered it non-material to investment decisions. A 2019 World Wide Fund for Nature (WWF) report found that only 9 per cent of 35 Southeast Asian

banks studied had adopted a No Deforestation, No Peat, No Exploitation (NDPE) policy.<sup>5</sup> For those that have such policies, experts observe that implementation is patchy.

One palm oil company interviewed by the SIIA mentioned encountering some banks that have poor understanding of the supply chain and are over-reliant on ESG ratings. These banks would rather blacklist palm oil alongside other controversial sectors such as coal and tobacco, than make the effort to understand what it means for palm oil to be sustainably produced. Another company noted that certain banks have a blanket requirement for product certification and do not look deeper into specific company policies such as NDPE. This reduces access to finance for smaller players that may not have the resources to become certified. That said, a number of interviewees mentioned that banks have been on a steep learning curve in the last five years, with many more now asking about specific issues such as fire prevention in their due diligence processes.

Divestments from unsustainable companies periodically make the headlines. In 2019, Norway's trillion-dollar Government Pension Fund Global was reported to have sold stakes in more than 60 companies, including 33 firms involved in palm oil, over deforestation risks. Divestment, however, is only one way for a financial institution to reduce ESG risk, and not always the most effective one. There is now also increased demand for socially and environmentally conscious investment options, which go beyond a risk management approach to reward companies for progress in their sustainability journeys. This includes green finance products such as sustainability-linked loans, where the interest rate may vary based on a company meeting certain sustainability targets.

Unilever issued its first green sustainability bond in March 2014, also the first green bond in the UK market. Olam International issued Asia's first sustainability-linked club loan facility of US\$500 million in March 2018, and Asia's first FX derivative linked to ESG criteria in June 2020. Wilmar International has also received sustainability-linked loans, including a two-year US\$200 million loan in 2020, tied to performance indicators for carbon emissions, land use, community engagement, supply chain practices, and corporate governance. However, not all major companies in this sector have embraced green financing. One leading company interviewed for this report explained that the cost associated with the added ESG monitoring required for a green loan is often not justified by the savings on interest rates. There is therefore a perception that companies taking up green financing are doing so largely for public relations purposes. To help companies defray costs attributable to obtaining external reviews for green, social and sustainability bonds, the MAS developed its Sustainable Bond Grant Scheme in 2017, and plans to release a similar incentive for green and sustainability-linked loans in Q4 2020.

Despite limited uptake to date, green finance instruments remain an avenue for financial institutions to continue financing agribusiness and forestry companies while demonstrating commitment to sustainability. It allows financiers to develop bespoke products that cater to clients at different points in their sustainability journeys, and to work with clients on action plans to build capacity in ESG. Moreover, given that many companies in this sector are private entities that heavily rely on debt, banks should take the responsibility of pushing clients to improve their ESG practices, or risk higher financing costs or a loss of access to finance.

The image problem of agribusiness and forestry companies has prompted them to further strengthen their ESG practices, as they must satisfy customers and investors that they are effectively addressing issues such as deforestation, traceability and worker rights. Producer countries also feel the pressure to double down on efforts to show that they are addressing sustainability. The literature shows that the interest of businesses in ESG goes beyond altruism and responds to economic interest in many ways – namely environmental and social risk reduction, premium enhancement, costs reduction, and gaining a competitive edge.<sup>6</sup>

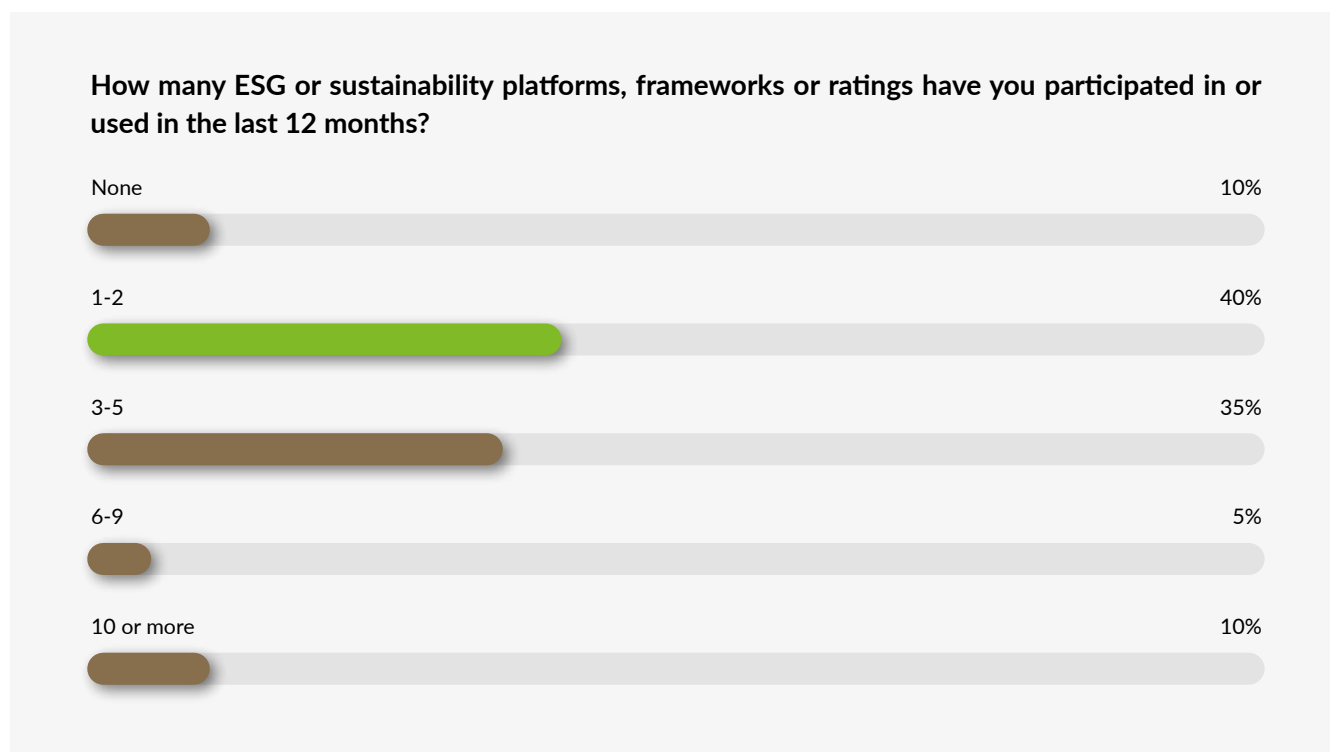
## Proliferation of ESG reporting schemes and ratings systems

ESG reporting schemes and ratings have become increasingly important to companies wishing to distinguish themselves from their peers. The push for integrated reporting by major stock exchanges, and the increasing interest of investors in sustainability and ethical issues, have added to the pressure for companies to show transparency through their reporting efforts.

However, the multiplicity of ESG frameworks has caused confusion for the companies reporting, as well as for those using the reports. The Global Reporting Initiative (GRI), a comprehensive ESG reporting framework with hundreds of indicators, is a favourite among stock exchanges and companies but does not propose standards to show how well a company is performing on ESG. MSCI looks into shareholder and board structure, considering ethics, tax, corruption, and product certification. The Carbon Disclosure Project (CDP) has more specific, ranked and quantified indicators focusing on climate change, forests, and water security, promoting reporting by states and cities as well as companies.

Specific to the palm oil and pulpwood sectors, companies have been grappling with supply chain ratings, reporting tools such as the NDPE Implementation Reporting Framework, broader ESG ratings, voluntary certification schemes from the RSPO (initiated in 2004), the Forest Stewardship Council (FSC, established 1994) and the Programme for the Endorsement of Forest Certification (PEFC, founded in 1999), as well as government-imposed sustainability standards, to satisfy stakeholders. Those wishing to utilise green financing may have the additional requirement of being monitored by ratings organisations such as Sustainalytics. Figure 1 shows results from a poll conducted by the SIIA with companies and financial institutions involved in forest-related sectors, where some 35 per cent said they had used or participated in as many as three to five ESG frameworks or ratings in the past twelve months.

**Figure 1: SIIA poll of companies, financial institutions and advisory firms involved in forest-related sectors**



Box 2 outlines some of the major rating, reporting and certification schemes that investors and other stakeholders may use to assess the sustainability of companies in agribusiness and forestry. This list is by no means exhaustive – there are many other existing organisations and initiatives aiming to assess sustainability in different parts of the value chain.

## Box 2

### Selected ESG rating, reporting and certification schemes

- **CDP.** Offers ratings on three categories: forest, climate change and water security. Includes carbon disclosure and other environmental impacts; aligned with TCFD. Based on company data.
- **EcoVadis.** Offers ratings on suppliers of key feedstocks, e.g. for consumer goods manufacturers. Covers 21 criteria across four themes. Based on company and third-party data.
- **FSC.** A certification scheme. Uses ten principles for certification, with 70 criteria. Based on third-party audits.
- **MSCI.** A rating system. Assesses resilience to broad ESG risks. Covers 37 ESG key issues across 10 themes. Based on public information.
- **PEFC.** A global alliance of national forest certifications. Includes sourcing and processing of timber. Not a standard-setting agency but a mutual recognition scheme. Based on third-party audits.
- **RSPO.** A certification scheme for upstream and downstream palm oil actors. Uses planet-people-prosperity framework, with seven principles, 40 criteria and numerous indicators. Based on third-party audits.
- **SPOTT.** Offers transparency scores to palm oil, timber-pulp and rubber companies. Covers 10 categories and 175 indicators. Based on public information.
- **Sustainalytics.** A rating system. Measures ESG risk exposure and management. Covers 20 ESG issues with 250 indicators. Based on public information for a preliminary report, then provided to corporations for discussion.

#### *Review of selected companies' publicly-available ESG ratings*

A review of ESG ratings and indicators for selected companies in agribusiness and forestry supply chains (Appendix 1) showed, unsurprisingly, substantial variance for a single company across different frameworks. The SIIA surveyed several major and medium-sized palm oil companies that control land areas ranging from 100,000 to 800,000 hectares, and giant timber-pulp-palm oil groups controlling 1 to 2 million hectares or more of land. Their aggregate scores or indicators by MSCI, Sustainalytics, CDP, EcoVadis, SPOTT, and voluntary certifications were compared.

In general, the selected companies participated in at least three of the ESG schemes selected. Considering CDP alone, most companies had better scores in the forests category than on climate change and water security. Medium-sized companies with hundred-million-dollar market capitalisations and revenue appear to be building up capacity, reporting to fewer CDP indicators and receiving lower SPOTT disclosure scores



compared to multi-billion dollar companies. However, for palm oil companies in the latter group, the larger the company, the lower the RSPO-certified ratio of process-trading volumes, indicating that traceability is an issue for larger groups.

Overall, the aggregate ratings and indicators produced mixed signals; for example, Sime Darby Plantation fared well on RSPO certification and SPOTT's disclosure rating, but lagged on CDP's. Among the commodity trading giants, Bunge and Cargill scored well; and the two major buyers, Unilever and P&G, had the best scores across upstream and downstream players. That said, Unilever recently scored in an average ESG band by MSCI, was rated medium risk by Sustainalytics while scoring highly by CDP on forests, climate change and water security, and reporting 100 per cent RSPO-certified product.

Looking at palm oil and timber-pulp conglomerates Olam and RGE, the differences in ratings and indicators across business lines and geographical segments are notable, showing no particular trend. These include varying disclosure ratings between forestry and palm businesses, and holding-level entities receiving higher CDP ratings than subsidiaries and associates.

### *Limitations of ESG ratings and certifications*

The substantial variation calls into question the usefulness of ESG schemes and ratings. A notable finding on the divergence of ESG ratings reported by MIT-Sloan researchers identifies three sources: "different scope of categories, different measurement of categories, and different weights of categories".<sup>7</sup> The same paper noted that overall perception of a firm can influence its scoring in specific categories. Another key concern is that ratings are often derived from what companies are willing to disclose, relying on scant and sometimes contradicting data.<sup>8</sup> Transparent and consistent environmental, social and governance data is therefore important to align market expectations on sustainability targets.

Each rating organisation has its own ratings scales and measures of success. Public information on methodologies is limited as many are proprietary, with only aggregate ratings made available to the public. A 2019 study found that specific ESG indicators considered on a standalone basis provided a more comprehensive view of a company's sustainability performance than ratings produced by aggregating indicators.<sup>9</sup>

As for forest and palm oil certifications, audits are typically producer-funded. Worries about the independence of certification bodies have arisen over time, resulting in calls for auditor-of-auditors, pooled funding for auditors and surprise audits. The membership structure of certification bodies has been criticised for conflicts of interest: for instance, PEFC is dominated by the forest industry and forest landowners, while industry groups possess one-third of the voting power in the FSC general assembly. In addition, critics point out weaknesses in current forest certification criteria such as the lack of mandatory climate change risk assessments.<sup>10</sup>

RSPO is a common requirement for all palm oil imports to Europe, indicating its global acceptance. According to the RSPO, a Life Cycle Assessment study found that RSPO-certified sustainable palm oil had 35 per cent lower global warming impact and 20 per cent lower biodiversity impact than conventionally produced palm oil. However, just 19 per cent of palm oil produced globally is RSPO-certified, and structural flaws have been blamed for repeated violations of ESG principles by its members. The ISPO and MSPO were created as national standards to cater to smaller producers in Indonesia and Malaysia respectively who are unable to attain RSPO certification. The adoption of ISPO and MSPO is mandatory in the respective countries, but their legitimacy and robustness are still criticised, with efforts ongoing to balance inclusivity with alignment to international standards.<sup>11</sup>

## Harmonisation efforts

Many recent studies on ESG ratings and certifications focus on their limitations, and seek improvements. Recognising the proliferation of standards, the Accountability Framework initiative (AFi) was developed by a coalition of NGOs to create a common set of norms and good practices for agriculture and forestry supply chains around the world. AFi seeks to help companies benchmark their sustainability policies – covering responsible sourcing, supplier codes of conduct, and human rights amongst others – against existing guidelines and best practices. On the finance front, Singapore recently joined the International Platform on Sustainable Finance, which seeks to enhance international coordination on taxonomies, disclosures, and green standards and labels to mobilise private capital towards environmentally sustainable investments.

The International Business Council (IBC), backed by the World Economic Forum, recently proposed a common set of metrics for corporations to measure and disclose their ESG performance, ranging from carbon emissions to gender equality and corporate governance, in a transparent and consistent way. IBC's metrics aim to address the lack of a generally accepted international framework for reporting ESG and non-financial information, as well as to cover the value chain and show value creation in a more complex way. It remains to be seen whether this framework, which IBC aims to encourage its 130-odd members to adopt by 2021, will be successful in promoting more cohesiveness in reporting.<sup>12</sup>

### Identifying material ESG issues for the palm oil and pulpwood sectors

With so many sustainability schemes and ratings, it is more difficult to assess a company's ESG stewardship. Companies may struggle to cope with reporting expectations, and few may score well across multiple systems. It is also harder for stakeholders to determine which ESG issues are most pertinent to a particular sector. Table 1 presents a mapping of the key issues across selected ESG schemes. While the broad themes are aligned, there is substantial variance in the specific indicators. The following sections of this report will explore in greater detail the material environmental, social and governance factors in the palm oil and pulpwood sectors. This is not meant to be an exhaustive list of all relevant ESG issues, but aims to help stakeholders interacting with these industries understand which factors to pay particular attention to.





**Table 1: A mapping of key ESG issues across selected reporting, rating and certification schemes**

		MSCI	Sustainalytics	CDP	EcoVadis	SPOTT	RSPO	FSC
<i>Description</i>		Assesses resilience to ESG risks. Rating vs. industry peers. Weights 52%, 29%, 19% for E, S, G.	Measures a company's unmanaged ESG risks.	Offers ratings on forest, climate change and water security.	Measures quality of sustainability management system against industry peers.	Offers transparency scores for palm oil, pulp & rubber.	A certification system for palm oil.	A certification system for forest products.
<i>Data sources</i>		Public information	Public and company data	Company data	Public and company data	Public information	Annual third-party audits	Annual third-party audits
ENVIRONMENT	Carbon/GHG emissions	Carbon emissions; Carbon footprint; Financing environmental impact; Climate change risk	Carbon emissions	Climate change	Energy consumption & GHG emissions	Soils, fire and GHG emissions	Pollution and GHG emissions; Fire	Environmental impacts
	Energy	-	Energy efficiency	-		-	Energy use	-
	Biodiversity & land use	Water stress; Biodiversity & land use; Raw material sourcing	Deforestation	Forests	Biodiversity	Deforestation; High conservation value (HCV) and high carbon stock (HCS) management	Peat, HCV and HCS management; Soil health; Soil conservation (erosion and degradation)	Management of HCV
	Water		Water pollution	Water security	Water	Water, chemicals, and waste	Water use	-
	Waste	Toxic emissions & waste; Packaging material & waste, electronic waste	Waste Management	-	Local Pollution; Materials, Chemicals & Waste		Effective integrated pest management; Pesticide use; Waste management	-
SOCIAL	Community, stakeholders	Health & safety; Human capital development; Supply chain labour standards; Responsible investment	Community relations; Indigenous peoples' rights; responsible lending	-	Social dialogue with stakeholders; Human rights	Community, land and labour; Human rights	Respect community and human rights and deliver benefits	Indigenous people; community rights
	Labour rights, diversity, health & safety		Gender and diversity; Supply chain labour standards; Health & safety	-	Child/forced labour & trafficking; Discrimination & harassment; Health & safety		Respect workers' rights and conditions	Workers' rights
	Product safety & quality	Product safety & quality; Financial product safety	Product safety; Product quality; Fair treatment of customers	-	Health & safety; Supplier environmental/social practices	Smallholder and supplier engagement	Support smallholder inclusion	-
GOVERNANCE	Corporate governance	Board policy; Ethics; Anti-competitive practices; Tax transparency	Board integrity; financial reporting; Ethics; Executive compensation; Stakeholder governance	-	Ethics; Corruption; Anti-competitive practices; Responsible information management	Policy & leadership; Grievance mechanism; Maps & traceability	Business ethics and transparency; Operating legally	Management Planning; Monitoring and Assessment; Compliance with laws

## 2. Material Environmental Issues

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Industrial plantations, which cover more than 27 per cent of peatland in Peninsular Malaysia, Borneo and Sumatra, Indonesia, face several environmental concerns. These include land management issues such as deforestation, peatland management, restoration and conservation; fire prevention and management; and greenhouse gas (GHG) emissions. In recent years, agribusiness and forestry companies have gradually strengthened their environmental policies. This is in response to pressure by governments and international agreements such as the Paris Agreement and the Amsterdam Declarations Partnership (which includes the Declaration on Deforestation and the Declaration on Sustainable Palm Oil). International buyers have also exerted pressure through their market power.

It is worth noting that few of the major ESG reporting schemes make explicit reference to peat and fire management policies, likely due to the irrelevance of these issues to other sectors such as manufacturing. However, the fact that they are major environmental concerns for forest-related sectors, and the multitude of downstream companies that purchase these commodities, should merit their inclusion across all ESG frameworks in the form of sector-specific guidance.

### Peatland management and conservation

Peatland is found across Southeast Asia and is highly concentrated in carbon. Development for agriculture often causes drainage and degradation, and requires robust management to prevent fires. One study found that by 2010, only 36 per cent of historical peat swamp forests remained,<sup>13</sup> and another noted that the majority of the remaining peat forests were degraded.<sup>14</sup> Degraded peat is more susceptible to fire events, which in turn are a massive contributor to air pollution and GHG emissions.

Peatland management is a complex issue requiring action by both the public and private sectors. Indonesia has a permanent ban in place on granting new commercial licenses on primary forests and peatland. The government in 2016 established the Peatland Restoration Agency, with the task of restoring 2.5 million hectares of degraded peatland within a five-year period. However, with more than half of this area lying within concessions, restoration requires cooperation from companies.

Many leading companies have forest-related sustainability policies and now prohibit development on peatland regardless of depth. However, there is room for improvement: a recent study found that only half of the top 100 major timber and pulp suppliers committed to zero deforestation, and those that did lagged in reporting on implementation.<sup>6</sup> Many companies are now focused on increasing yields rather than opening new agricultural land, but this is a challenge: in the palm oil sector for example, smallholders account for 40 per cent of global supply but have on average 20 per cent lower yields than private companies.<sup>15</sup> Major companies that purchase products from smallholders have made efforts to provide them with technical support and agricultural inputs such as fertiliser to improve their yields.

Companies have also initiated forest conservation or restoration projects. Some have collaborated with local governments and international agencies to establish wildlife corridors or conservation areas. Others are investing in research on peatland agriculture, identifying crops that can thrive natively in peat ecosystems.



## Fire and haze prevention

It is widely acknowledged that forest and peat fires that plague Indonesia during dry seasons are largely human induced, albeit with variations in human behaviour and differences in burn patterns between geographical areas.<sup>16</sup> In many parts of Sumatra and Kalimantan, fire is still perceived as a cheap and effective method of land clearing for agriculture. While Indonesia has severe legal penalties for companies found responsible for fires, even government officials have acknowledged that enforcement is lacking.<sup>17</sup>

Most major companies have NDPE policies that include a zero-forest-burning policy, and monitor fires within a certain radius (typically 5 kilometres) beyond their concession areas. In some companies, these policies extend to suppliers. Fire prevention projects are a popular initiative among plantation groups, who often collaborate with local communities, providing them with the necessary training and equipment. The Fire Free Alliance is an industry-led group that enables companies to share best practices regarding community engagement on fire prevention. In Indonesia, companies also collaborate with the Manggala Agni, a task force established under the Ministry of Environment and Forestry to control forest fires.

## GHG emissions reporting

Research has consistently shown that GHG emissions from plantations result primarily from land use change as well as plantation and mill activities. Emissions are classified into three scopes under the GHG Protocol:

1. Scope 1 refers to all direct emissions due to the activities carried out by or under the control of a company;
2. Scope 2 refers to indirect emissions resulting from sources owned or controlled by the company, e.g. the generation of electricity used by a company;
3. Scope 3 refers to all other indirect emissions from sources not under a company's control, e.g. products procured in a company's supply chain.

CDP notes that nearly all Scope 3 emissions arise either from a company's purchased goods and services, or from the use of its sold products, and 40 per cent of global GHG emissions are driven by companies' purchases and sales.<sup>18</sup> For the agribusiness and forestry sectors, increased scrutiny on third-party sourcing by mills and refiners, as well as growing emphasis on traceability, have prompted calls for more companies to report Scope 3 emissions.

GHG emissions reporting matters particularly for palm oil companies that supply feedstock into the EU's biofuels program as well as other markets such as California. Such companies often aim for GHG-saving processes to benefit from subsidies and other support. As for pulp and paper companies, a review of selected company sustainability reports found substantial variation in the quality of reporting, with some reporting details on Scope 1 GHG emissions from their mill complex, and others not at all.

There is growing interest in generating carbon offsets through nature-based solutions such as the conservation of peatland. Indonesia has been looking into establishing a carbon trading system. If a robust carbon market can be established, it will provide companies an opportunity to monetise conservation projects and an impetus to improve GHG emissions reporting.



Table 2 highlights selected initiatives of agribusiness and forestry companies that address material environmental issues.

**Table 2: Selected companies' environmental initiatives**

Company	Environmental Initiative
<b>PT Austindo Nusantara Jaya (ANJ)</b>	ANJ has identified its higher fire risk estates and coordinates with local authorities, fire brigades, and communities to manage fires. The company established a community-based fire-fighting group among smallholder farmers called <i>Kelompok Tani Peduli</i> (KTPA). ANJ initiated KTPA groups in seven villages around its estates in Bangka Belitung, North Sumatra, and West Kalimantan as of December 2019.
<b>APRIL</b>	APRIL initiated its <i>Restorasi Ekosistem Riau</i> (RER) programme in 2013, involving the restoration of 150,693 hectares of peat swamp forest on the Kampar Peninsula and Padang Island in Eastern Sumatra. APRIL pumped a US\$100 million investment into the programme in 2015, collaborating with NGOs on implementation. The company supports nature-based solutions and adopts a production-protection approach in its operations.
<b>Golden Agri-Resources (GAR)</b>	GAR's Peat Ecosystem Rehabilitation (PER) project in West Kalimantan aims to rehabilitate 2,600 hectares of degraded peatland. GAR reported that it had successfully re-vegetated 350 hectares of land as a buffer zone by 2019. The PER project runs in tandem with GAR's alternative livelihood projects with local communities, which involves collaborations with the University of Tanjungpura, L'Oréal, and the South Pole Group.
<b>IOI</b>	In 2020, IOI introduced its Climate Change Action Initiative as a long-term action plan to mitigate and reduce GHG emissions from its operations, and ultimately to achieve carbon neutrality. This would be achieved by enhancing existing carbon reduction initiatives, while exploring new opportunities in minimising carbon emissions through operational efficiency and utilising renewable energy. The Initiative is aligned with IOI's overall company strategic priorities.





### 3. Material Social Issues

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The ongoing COVID-19 pandemic has drawn attention to the social factor in ESG, with companies across sectors being exposed for poor or hazardous working environments. COVID-19 infections among migrant workers in meat processing, fisheries and farming have been in the headlines in many countries. The vegetable oils and forestry sectors were spared most of the spotlight, even though they were deemed “essential” sectors that continued to operate while countries were in lockdown. However, several social issues have long been associated with these sectors, despite efforts by the industry to find equitable solutions. These include land rights, gender equality, worker rights and smallholder engagement.<sup>19</sup>

In addition, the industry has called for improved methods to measure social sustainability. Several companies argue that the livelihood and poverty reduction benefits brought to smallholder farmers and local communities through their operations are often overlooked due to a lack of metrics. Social factors, which require on-the-ground assessment, are also difficult to monitor on large plantations – unlike environmental factors that can be monitored using satellite data and other technology. Companies say that this leads to unbalanced ESG evaluations that place a disproportionate weight on easily-measured environmental factors. Another effect is the erroneous perception of a tension between meeting ESG standards and the socio-economic development needs of local communities.

#### Worker rights and gender equality

Worker rights in the palm oil sector come under heavier scrutiny than in the pulpwood sector, as palm oil tends to employ more workers in the value chain. However, both sectors share common long-standing issues such as poorly enforced occupational safety and health standards, low wages and long working hours, as well as forced and unpaid labour.<sup>20</sup> In addition, workers sometimes receive unpaid assistance from family members, often women and children.<sup>21</sup> In October 2020, it was reported that the United States had banned imports from a major Malaysian crude palm oil producer following an investigation into forced labour allegations.<sup>22</sup>

Forced labour has also been cited as an issue in the pulp and paper sector, particularly in countries with lax government oversight. It is estimated that in producer countries including in Southeast Asia, 50 to 90 per cent of forestry activity is carried out illegally.<sup>23</sup> According to the Earthworm Foundation, some pulp and paper producers remain unaware that practices such as withholding workers' passports and recruitment fees can be forms of forced labour.<sup>24</sup>

Gender equality is also an issue. One company interviewed by the SIIA noted that due to the physically demanding nature of work in oil palm estates, most job applicants are male and the company has a 70 per cent male workforce. That said, the company is working to attract more female employees in tandem with the adoption of mechanisation to alleviate laborious field work.

The Indonesian palm oil sector also employs many women as temporary workers, as indicated by a review of sustainability reports. Several companies explained that their female workforce preferred flexible schedules to accommodate family commitments. Due to their temporary status, however, women have been denied access to medical insurance schemes, pensions, and other benefits, including maternity leave.<sup>25</sup> They are also more vulnerable to abuse such as arbitrary pay cuts for failing to reach targets.

To address these issues, major companies including APRIL, Asia Pulp and Paper and Wilmar have adopted various International Labour Organisation conventions throughout their operations. Companies have also hired more women as permanent workers and set up occupational health and safety committees. In addition, the RSPO established a Human Rights Defenders Hotline, allowing for confidential complaints to be lodged against an RSPO member in case of any observed human rights violations in its operations.

## Engagement with local communities and land rights

Community land rights are sometimes unclear and not well-enforced, with the authority to grant land use rights often diffused across bodies and levels of government. This has sometimes resulted in the granting of concessions on lands that overlap with local communities or indigenous territories. Plantation expansions have therefore led to accusations of dispossessing local communities of their land rights and traditional livelihoods. In West Kalimantan, a study of a recent palm oil expansion hotspot found some 119 conflicts recorded among 377 concessions.<sup>26</sup>

Unequal power dynamics and structural disadvantages often reduce the negotiation capability of local communities.<sup>27</sup> Poor economic conditions push them to accept land transfers to companies in exchange for compensations that are often unfair. Instead of development and income generation, this results in communities losing their lands, which further entrenches them in poverty and food insecurity.<sup>28</sup> Some communities also allege having been misled about the impact that agricultural conversion would have on water quality and forest degradation on their land. In addition, corporations receiving the concessions sometimes make reimbursements at an individual level, creating conflict within communities as most traditional land tenure systems rely on communal rather than individual property rights.<sup>29</sup>

To reduce the potential for conflict, some companies engage in participatory mapping initiatives with communities, a consultative process that takes into account communities' livelihood and food security needs. Many companies have now adopted Free, Prior and Informed Consent (FPIC), a specific right recognised in the United Nations Declaration on the Rights of Indigenous Peoples, allowing local communities to give or withhold consent to a project that may affect them or their territories. A large palm oil company explained to the SIIA that various processes are in place to build relationships with local communities prior to the FPIC process. Thereafter, social impact assessments are conducted at various stages of operations in addition to regular consultative meetings with the community.

## Smallholder and supplier support

The pulp and paper industry is concentrated and dominated by huge concessions with fewer community or smallholder suppliers. This is due in part to long harvesting cycles in wood plantations, and the need for extensive assessments to fulfil HCS, HCV and NDPE requirements prior to development. For instance, APRIL reports only two per cent of its fibre supply coming from community plantations. Nearly all leading pulpwood companies now include their suppliers in their sustainability reports and dashboards.

Transparency and traceability is harder to achieve for palm oil companies, who may have a significant amount of third-party fresh fruit bunches coming into their mills and third-party palm oil in their supply chains. Many palm oil groups have smallholder schemes under their concession agreements, with Indonesian regulations requiring about 20 per cent of land area set aside for smallholders. Smallholders are defined by the RSPO as family-based businesses with no more than 50 hectares for production. Scheme smallholders represent roughly 40 per cent of smallholders, working on a company's plantations and selling production to a partner mill. Schemes usually lead to debt for smallholders for agricultural input costs, although their productivity rates are close to corporation yields.<sup>30</sup> Companies that do not have these smallholder schemes often purchase from independent smallholders.

Smallholders' involvement with ESG is crucial for ensuring a sustainable supply of forest commodities. However, it is often difficult for them to access certifications, due to the high cost of audits and a lack of technical expertise. This in turn restricts access to finance, perpetuating their marginalisation. The RSPO has a Smallholder Support Fund, which has benefited 26,000 individual smallholders in 15 countries, and a Smallholder Standard which aims to provide equitable access to certifications.<sup>31</sup> In addition, several leading companies interviewed by the SIIA have capacity-building initiatives to help smallholders increase their yields, understand land and waste management, prevent child labour, and access local and international certifications.

Table 3 highlights selected initiatives of agribusiness and forestry companies that address material social issues.



**Table 3: Selected companies' social initiatives**

Company	Social Initiative
<b>PT Austindo Nusantara Jaya (ANJ)</b>	Under its Responsible Development Strategic Project, ANJ began a third-party plantation traceability pilot in 2018 in North Sumatra which helps independent smallholders transit to more sustainable practices. ANJ reported having successfully registered more than 850 independent smallholders across a total plantation area of 8,100 hectares by 2019.
<b>APRIL</b>	APRIL's Sustainable Forest Management Policy (SFMP) 2.0, launched in 2015, pledges zero tolerance for child labour, forced labour, or bonded labour under Section VII: Responsible Practices in Our Work Places of the SFMP. The policy also covers APRIL's current and future wood suppliers.
<b>Golden Agri-Resources (GAR)</b>	GAR's Independent Farmers Replanting Programme encourages independent smallholders to replant using better quality seeds to boost income and productivity, and reduce the need for new land. The smallholders are provided financial support throughout the four years required for new seeds to mature. Since 2014, GAR has helped independent farmers secure nearly IDR400 billion in loans from state-owned banks.
<b>Musim Mas</b>	Musim Mas and the International Finance Corporation established the Indonesian Palm Oil Development for Smallholders (IPODS) programme in 2015. IPODS helps independent smallholders meet industrial farming and sustainability standards. By 2019, 27,927 smallholders had been engaged and 705 had become RSPO-certified through the programme. Musim Mas aims to help 2,000 smallholders in Sumatra and Riau achieve RSPO certification by 2020.





## 4. Material Governance Issues

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Companies are required by governments, business partners and financial markets to provide corporate governance disclosures. While this need is not unique to forest-related sectors, some experts highlight sustainability governance weaknesses in these sectors that remain to be addressed. This section explores major governance issues of accountability and oversight, leadership, and traceability.

### Structure and leadership

The Global Reporting Initiative points to the importance of structure and leadership in corporate governance.<sup>32</sup> Research has indicated that the quality and independence of board members affects a company's sustainability performance. Companies that record better attendance to board and committee meetings, and have more independent directors, are more likely to implement environmentally-friendly policies and international sustainability standards. Firms with more diverse boards and clearer separation between the chairperson and CEO also record better sustainability performance.<sup>33</sup>

### Independent oversight of sustainability targets

The Board of Directors in a company is tasked to protect the interests of stakeholders and is responsible for risk governance.<sup>32</sup> Studies have shown that theme-specific committees increase sustainability performance and effective oversight of ESG risks. Such committees might report to the board of directors on environmental and social issues impacting the company.<sup>34</sup>

However, this is not a common practice among companies. A 2015 research paper noted that only 10 per cent of U.S. public companies had standalone sustainability committees at the board level.<sup>35</sup> In addition, just 55 per cent of the S&P 500 firms had oversight of sustainability issues at the board-level.

Several companies involved in forest commodity supply chains have grievance and traceability processes which are evaluated by specialised teams and are disclosed publicly. In the pulp and paper sector, APRIL established a Stakeholder Advisory Committee to oversee the implementation of its forest management policy. In the palm oil sector, a leading company told the SIIA that the evolving ESG landscape has prompted it to look into broadening its Sustainability Advisory Panel into a consultative forum including external experts and civil society groups.

### Traceability

Traceability is a long-standing governance issue in agribusinesses. The supply chain of a palm oil-buying company may include traders, producers, as well as thousands of mills, large and medium-sized plantations, and smallholders. It is important for downstream players in particular to present traceability as an assurance to end-consumers that ESG policies are executed all the way through the supply chain. This also drives ESG price premiums.

Most major companies have put policies in place to monitor suppliers and help them adopt time-bound commitments to adhere to responsible sourcing guidelines. For example, IOI utilises an online digital platform, Tools for Transformation, that allows suppliers to benchmark their operational systems against NDPE best practices and identify areas for improvement with customised action plans. Many market leaders have also developed traceability platforms to their mills and plantations. An example is Unilever's pilot with Orbital Insight, a US technology company, using geolocation data and traffic patterns to provide visibility on the farms and plantations supplying to the mills in the company's supply chain. This allows for better prediction and monitoring of deforestation and other issues.<sup>36</sup>

However, not all major companies apply sustainability policies to all their suppliers. From 2019, the RSPO has pushed for improved disclosures on certified product volume ratios by its members. There are separate disclosures for the production and process-trading parts of the supply chain, with the latter currently showing lower volumes of certified product. This suggests that companies still struggle to achieve full traceability. A recent WWF survey found that only 18 out of 173 companies reported full traceability to the mill and plantation level.<sup>37</sup>

## 5. ESG in Small and Medium-sized Companies

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It is evident that most of the largest companies in Southeast Asia do have ESG practices in place, complying with reporting standards and participating in disclosure or rating exercises. Questions do remain about the implementation of their commitments, or whether corporate policies translate fully down to the local level and all the way through the supply chain. However, such firms largely are speaking the language of ESG, not least because of growing pressure from international stakeholders.

There are greater challenges in engaging with medium-sized or national-level plantation companies. These companies operate on a commercial scale and are organised like industrial plantations, but may not be publicly listed nor deal directly with international financial institutions. There is a tendency in the academic literature to polarise producers, characterising them as large or small without differentiating smallholders and medium-sized companies. This suggests that policies and initiatives are not being formulated with the latter group in mind. More attention must be paid to their specific characteristics to build a truly sustainable supply chain.

In some cases, the lack of ESG commitments from medium-sized firms may simply reflect a lack of capacity. The number of different sustainability frameworks and guidelines for companies to adhere to is overwhelming, particularly for smaller businesses without a dedicated sustainability or compliance team. The lack of a cohesive set of auditable standards and milestones adds to the administrative burden. Rather than implementing more stringent ESG standards, or “raising the bar”, there have been calls to instead “raise the floor”, to reach producers who are not currently placing a strong emphasis on ESG. The ISPO and MSPO certifications are motivated by such inclusive thinking.

In recent years, large international companies have stepped up efforts to engage with their suppliers. They recognise that NGOs, and therefore investors and customers, will hold major firms accountable for any perceived wrongdoing within their supply chain. However, top-down governance is challenging, particularly in the palm oil sector where there are a multitude of producers. The largest players own refineries with dominant market shares; and thus, many buy large volumes of crude palm oil from mills owned by other (including mid-sized) plantations.

In an interview with the SIIA, a leading palm oil company highlighted its efforts to fully investigate its suppliers, looking beyond the local level to see if the supplier is linked to a holding company or business group. The company noted that even if a plantation's operations in the palm oil sector are sustainable, it could belong to a business group that has ESG issues with a mining subsidiary, or problematic pulp and paper operations. A business group could also be connected to environmental or labour abuses in a different geographical market entirely. Due diligence is therefore necessary, and major companies will be increasingly obliged to be accountable for all their supplier relationships.

In addition, while it has been noted that the financial sector has a role in encouraging stronger ESG practices, agribusiness companies themselves also play financing roles. Very often, small and medium-sized growers financed by a large company will also be their suppliers, with supply agreements used to help pay back loans. One company told the SIIA that when a supplier is found to be errant, the company might remove the supplier from its supply chain, but keep a financing relationship as a last resort effort to rehabilitate the supplier

rather than cutting them off (hence losing leverage entirely over the supplier's ESG practices). The company acknowledged that these financing relationships may not be reflected in traceability disclosures.

Companies have noted that the sector needs time to adapt. In some cases, a smaller company lacking RSPO or FSC certification and formal NDPE commitments might not necessarily mean that the firm is ignoring sustainability concerns. It may have valid reasons, such as that the company sells purely to the domestic rather than export market, and does not enjoy a sustainability price premium that enables it to invest in ESG. A company may also have some sustainability and community development activities in place, even if it has not codified this into a policy framework. Efforts may be made to bring these "leakage market suppliers" into the sustainability landscape, by offering support in exchange for specific steps to improve their sustainability practices and governance. Simultaneously, national certifications should continue to be strengthened to increase their acceptance by international stakeholders.

## 6. Externalities in 2020 and Effects on ESG

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Even as companies respond to growing calls from investors, regulators and other stakeholders to become more sustainable, market conditions have brought headwinds. This year, the COVID-19 pandemic has threatened companies' profitability and called into question their ability to fulfil sustainability commitments. The SIIA interviewed private sector representatives to understand COVID-19's impact on ESG in their businesses, more than half a year since the pandemic began.

### COVID-19 and economic downturn

Before the COVID-19 pandemic, palm oil companies were already facing decreasing market demand and price volatility. Palm oil prices have been trending downward since the peak of over US\$1,000 per tonne seen in 2011 and 2012. Several factors are driving this, one of which is the negative international perception of the commodity, as shown by the EU's decision to phase out palm oil from biofuels. Somewhat ironically, some within the palm oil sector argue that tight margins due to low palm oil prices make it more difficult to promote stronger ESG practices and persuade growers to join certification efforts such as the RSPO.

Agricultural commodity prices have not been hit as strongly by COVID-19 compared to other commodity sectors such as metals and energy. Some oleochemicals have remained in demand amidst the pandemic, such as ones used in hand sanitisers. However, there has been an overall fall in global consumption as first China, then other economies, implemented lockdowns. The price of crude palm oil slid from US\$834 per tonne in January to US\$531 per tonne in May, according to the Malaysian Palm Oil Board. Prices rallied from May to August, supported by the recovery in crude oil prices which boosts biofuel appeal, but not to the level seen at the start of the year. In addition, some companies now face cash-flow issues due to loan extension requests from suppliers.

While reduced profitability has affected budgets, a number of companies interviewed stressed that the effect has been felt across the entire business; ESG budgets have not been singled out for trimming. That said, one company explained that they have had to review resource allocations within their sustainability programme by deprioritising external assurance, in favour of continued funding for implementation of their sustainability efforts. In July 2020, it was also reported that Sime Darby Plantation withdrew from the High Carbon Stock Approach, with a company spokesperson explaining the need to focus resources on on-the-ground implementation of their commitments to deforestation.<sup>38</sup>



## Labour issues

Some companies note that profitability has also been affected by a labour shortage. About 84 per cent of Malaysia's plantation workforce is comprised of migrants from countries including Indonesia, India and Bangladesh,<sup>18</sup> whereas the Indonesian plantation workforce is largely comprised of migrants from other Indonesian provinces. Due to movement restrictions enforced to curb the transmission of COVID-19, it was reported in September 2020 that Malaysia's plantation industry was struggling with a shortage of 500,000 workers, with the palm oil sector facing a shortfall of 37,000 workers or approximately 10 per cent of the workforce.<sup>39</sup>

Amid concerns that the labour shortfall would stall the harvest of perishable yield and decrease output, Malaysian palm oil companies turned to prison labour, but this in turn raised concerns about modern slavery.<sup>40</sup> In addition, some industry watchers note that there has been no labour-driven shortfall in yield during the pandemic; rather, the shortage is a chronic one, and companies may be using the pandemic as an excuse to lobby for hiring more migrant workers.

## Monitoring & verification of ESG compliance in supply chains

Monitoring of ESG compliance in the supply chain was also disrupted due to movement restrictions imposed in Malaysia and Indonesia in the first half of 2020. Auditors were unable to visit plantations to conduct field assessments, and consequently had to move towards greater remote auditing through the use of technology. One company interviewed mentioned using an application allowing suppliers to conduct self-assessments, by uploading photo documentation of their ESG compliance. While these technological adaptations have allowed monitoring to continue, verification work faces a bigger challenge. In particular, while the monitoring of deforestation can be done remotely through radar technology, it is not a proper substitute for field audits.

## Pandemic response: corporate social responsibility initiatives

Several agribusiness and forestry companies have responded to COVID-19 with initiatives to support local communities and national governments in combating the pandemic. This contributes towards demonstrating a company's commitment to upholding "social" responsibilities.<sup>41</sup> For instance, Musim Mas embarked on a US\$2 million pandemic-related effort and distributed care packages of staple foods such as rice, noodles and cooking oil to vulnerable groups, easing living expenses and reducing the need for grocery trips while movement restrictions were in place.<sup>42</sup> Some companies have donated medicines, personal protection equipment, test kits, face masks and hand sanitisers to medical workers and the local community. Others such as Wilmar have helped to educate communities where they operate about handwashing and social distancing.<sup>43</sup>

## Looking ahead

The pandemic has not affected all players equally. Some of the larger companies interviewed for this report agreed that they are equipped to maintain their sustainability programmes and weather the economic downturn, as budgets for the year were planned prior to the onset of the pandemic. Smaller players with lower profit margins may face greater pressure to be both sustainable and profitable. Indonesia has struggled to control the pandemic; if economic recovery is slow, sustainability initiatives may yet be deprioritised.

While COVID-19 may have impacted companies' ability to implement ESG initiatives, there is good reason for companies to remain committed to sustainability. Industry watchers note that COVID-19 has accelerated calls for ESG investments, and multiple studies show that companies with strong ESG frameworks have been more financially resilient in the face of the pandemic.<sup>44</sup> Staying on top of sustainability issues is likely to serve companies' long-term business interests.

## 7. Recommendations: Bridging the Gaps in ESG

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To facilitate productive engagement among producers, consumers, financiers and regulators on ESG, key efforts are required in four main areas. These are: (1) positive reinforcement for companies improving their ESG practices; (2) promoting sustainable finance; (3) harmonising standards and disclosures; as well as (4) “raising the floor” to help smaller players implement sustainable practices.

These steps aim to help the sector and its stakeholders come to a common understanding over time of the material ESG factors, current gaps in aligning implementation with reporting, and actions to be taken so that robust sustainability standards and expectations are diffused across the supply chain. These recommendations also aim to align incentives among various stakeholders for improving ESG practices.

### Positive reinforcement for ESG

1. **Positive reinforcement through grants and incentives to align market signals.** Some companies highlight that the inadequate price premium on sustainability leads to non-compliance. Their certified products do not derive enough value-added to pass on to suppliers, leading to ESG policies not being implemented all the way through the supply chain. Governments should provide grants and incentives to encourage sustainable practices and the creation of sustainability-related jobs, beginning with processes they control, such as government procurement rules. Such measures will compensate for the premium that the market is not yet paying.
2. **Educating midstream buyers and end-consumers about sustainably-produced commodities.** Negative perceptions of forest-related sectors are impacting consumption and investment in companies. Companies and major producer countries should make efforts to improve education on sustainable commodities. This includes educating midstream buyers as well as domestic buyers and those in potential “leakage markets”, such as India and China which are major consumers. A critical mass of demand-side actors understanding ESG issues will ensure that upstream companies are rewarded for sustainability through a market premium or off-taking guarantees. This may also in turn drive government policy.
3. **Allowing midstream and downstream actors to “fund” sustainability in different ways.** Plantation companies have commented that the cost of sustainability is often distributed unevenly, with downstream actors less willing to provide an adequate sustainability premium. In addition to price premiums, actors further downstream in the supply chain can contribute to the cost of sustainability in other ways. These may include participating in funds that finance conservation or community projects, or purchasing carbon credits from conservation projects.
4. **Defining social sustainability to be better accounted for in ESG evaluation.** There is a need for the industry and financial sector to better define ways to measure social sustainability. Methodologies such as calculating the “social return on investment” (SROI), frequently used in impact investing, will help ensure that ESG assessments used by financial institutions and buyers do not emphasise environmental factors at the expense of social ones. It will also correct the perceived tension between ESG commitments and socio-economic development needs. Governments, for instance, would be less likely to perceive sustainability requirements as conflicting with other social policy goals such as smallholder livelihood support.

## Promoting sustainable finance

1. **Strengthen ESG regulatory standards for financial institutions, with sector-specific guidance.** A lack of industry alignment on ESG regulatory obligations leaves banks disinclined to have more stringent requirements than their peers. Regulators should provide more clarity on ESG standards for financiers, as well as specific guidance on sectors with higher ESG risks, aligned with financial institutions' existing Know Your Customer (KYC) requirements. The standards should account for transition financing, given varying ESG competencies of companies in this region. Regulatory clarity will improve the quality of disclosures. Finally, regulators should look into making it costlier for banks to finance unsustainable companies, for instance through capital requirements.
2. **Provide grants or incentives for green and sustainable finance.** Unclear ESG standards have caused some banks to avoid or divest from palm oil and pulpwood completely. However, divestment means a loss of leverage over an unsustainable client, and a reduction in financing sources for an industry that supports millions of livelihoods in Southeast Asia. Financial institutions should instead be provided grants or incentives to develop green finance products that are attractive to clients, and that enable the financial institution to view ESG as an opportunity in addition to a risk. Green finance products such as sustainability-linked loans allow financiers to not only retain or grow their clients in these sectors, but also play stewardship roles in working with clients to improve their ESG practices.
3. **Singapore to lead in growing green and sustainable finance.** Companies note that the cost-benefit analysis for sustainable finance does not always favour its uptake, and additional incentives are required. As an established financial centre and now ASEAN's largest green finance market, Singapore is well placed to take a leadership role in incentivising regional green finance development. In addition, as regional stock exchanges have been pushing for improved ESG disclosures, the Singapore Exchange (on which several palm oil majors are listed) should also look to strengthen and harmonise its standards with industry expectations of ESG.

## Harmonising ESG standards and disclosures

1. **Conduct industry-led gap analysis and establish reporting standards.** Agribusiness and forestry companies should lead an effort to harmonise sector-specific standards, working together with existing initiatives such as the AFi. These standards should include measurable targets, and be reviewed periodically so that they stay relevant. The analysis should also identify existing weaknesses in reporting – such as Scope 3 GHG emissions and traceability – and propose actions to address them.
2. **All ESG standards should consider sector-specific material factors such as fire prevention, traceability and Scope 3 GHG emissions.** Financiers and other stakeholders that have limited understanding of forest-related sectors often over-rely on sustainability ratings or certification. These in turn vary too much in their standards and methodologies. They may also omit factors that are unique to this sector, such as fire prevention, therefore providing an incomplete view of a company's ESG risk. The industry should work with existing ESG reporting frameworks to create guidance for reporting sector-specific material factors. For instance, GRI commenced development of an Agriculture and Fishing Sector Standard in April 2020 with a global working group.
3. **Set up information-sharing platforms to improve ESG data transparency.** Existing ESG reporting frameworks and industry certifications have faced criticism about data transparency and integrity. A common platform for the industry to share best practices and sustainability data would raise standards as well as disclosures, particularly in areas such as social indicators and traceability where metrics are less defined. Such a platform could be coordinated by industry certification bodies such as the RSPO or FSC. Improved availability of quality data could in turn help policymakers craft robust regulations.



## “Raising the floor” for smaller industry players

1. **Strengthen national certification schemes to cater to players of different sizes.** The difficulty in accessing international certifications and high compliance cost continue to pose challenges for smallholders and medium-sized companies, impeding their access to finance and international markets. While national certifications cater to these players, they must be strengthened. Leading global companies should continue working with national certification schemes so that they become better aligned with international requirements. They should simultaneously work to bring all suppliers into the sustainability landscape – taking customised approaches to account for differences in capabilities and resources between smallholders and medium-sized companies.
2. **Bespoke financing solutions for smaller companies.** All companies need financing to operate, and there is a gap in access to finance for smaller producers. Therefore, even if a company does not sell to export markets, the need to access finance should be a sufficient driver and lever for it to improve its ESG practices. Financial institutions should take a collaborative and bespoke approach to help smaller players become more sustainable – including standardised criteria, tiered incentives and time-bound sustainability targets, for instance. For smallholder producers, impact investment and blended finance should be promoted in collaboration with local partners.



## Conclusion

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There is increasing understanding among corporations that sustainability is a crucial part of business strategy, and impacts growth and profit in the long term. Robust ESG practices not only reduce reputational, legal and operational risks in the eyes of the market, but also make a company attractive to a wider range of investors. However, what companies do is only one part of the equation.

Financial institutions, demand-side actors and NGOs also have important roles to play in ensuring that companies uphold good standards of environmental protection, engagement with workers and suppliers, and supply chain traceability. Rather than divest to avoid risk, financial institutions must uphold higher standards and demand them from their clients, rewarding sustainable practices with easier access to financing on favourable terms. End-consumers and midstream buyers must also be educated, so that the market premium for sustainability provides sufficient value to upstream producers. Singapore, as a global hub for finance and trade, has an important role in facilitating this effort to improve industry practices on sustainability.

Regulators and governments must strengthen their suite of both “carrots and sticks”. A common refrain in the SIIA’s stakeholder interviews was that the industry has been fixated on “no” policies, or what companies should be prohibited from doing. These “no’s” are helpful in setting a baseline and ensuring a minimum level of compliance. However, complementing them with positive reinforcement can accelerate progress. Incentives will push companies as well as financial institutions to innovate in ESG to maintain a competitive advantage over their peers. The pathway towards sustainability is therefore two-fold: regulations to “raise the floor” and incentives to “raise the bar”.

Finally, all actors in the supply chain would benefit from greater consistency in the criteria and terminology used to evaluate environmental, social and governance issues. Better harmonisation and availability of ESG data in the public domain will facilitate goal-setting, implementation and monitoring of sustainable practices over time.

## Appendix 1: Publicly-available ESG Ratings and Indicators for Selected Companies

	ESG perspectives on selected corporate groups	MSCI ESG	Sustainalytics	CDP	SPOTT (disclosure rating, practice focus)	Voluntary certification percentage (process-trading focus)	Market capitalisation; revenue (USD)
PALM OIL GROUPS	PT Austindo Nusantara Jaya Agri	..	..	Forests 2019: B- (palm)	69%, 80%, 51% (Organisation, Policy, Practice)	RSPO: 51% of production	USD 135 million; USD 130 million
	IOI Corporation Berhad	BB	30	Forests 2019: B- (palm); Climate Chg 2019: D ; Water Security 2019: C	73%, 79%, 65% (Organisation, Policy, Practice)	RSPO: 97% of production, 21% of process-trading volume	USD 6.8 billion; USD 1.8 billion
	Musim Mas Holdings Pte Ltd	..	..	[PT Musim Mas] Forests 2019: B (palm) ; Climate Chg 2019: C ; Water Security 2019: B-	72%, 74%, 65% (Organisation, Policy, Practice)	RSPO: 84% of production, 7% of process-trading volume, 1% of volume used in manufacture	Private company; USD 7 billion revenue
	PT Sampoerna Agro Tbk	..	..	Forests: Mostly "No response", 2012-2020	53%, 41%, 44% (Organisation, Policy, Practice)	RSPO: 19% of production	USD 228 million; USD 221 million
	Sime Darby Plantation Berhad	A	31	Forests 2019: C (palm) ; Climate Chg 2019: C ; Water Security 2019: "no response"	66%, 85%, 62% (Organisation, Policy, Practice)	RSPO: 100% of production, 62% of process-trading volume	USD 8.5 billion; USD 2.9 billion
	Wilmar International Ltd	BBB	40	Forests 2019: B- (palm) ; Climate Chg 2019: C ; Water Security 2019: C	89%, 90%, 68% (Organisation, Policy, Practice)	RSPO: 100% of production, 5% of process-trading volume	USD 21.4 billion; USD 30.9 billion
	Golden Agri-Resources Ltd	..	32	Forests 2019: A- (palm) ; Climate Chg 2019: D ; Water Security 2019: C	85%, 87%, 65% (Organisation, Policy, Practice)	RSPO: 56% of production, 4% of process-trading volume	USD 1.4 billion; USD 6.4 billion
PALM OIL CUM TIMBER-PULP GROUPS	Olam International Ltd - palm oil	..	33	Forests 2019: B, B (palm, timber) ; Climate Chg 2019: C ; Water Security 2019: "Not scored"	74%, 88%, 58% (Organisation, Policy, Practice)	RSPO: 100% of production, 2% of process-trading volume	USD 3.2 billion; USD 23.9 billion
	Olam International Ltd (Congolaise Industrielle de Bois or CIB in the Republic of Congo and Concorde Industries Limited or CIL in Myanmar) - wood/wood fibre	..	..	(as above)	55%, 75%, 75% (Organisation, Policy, Practice)	PEFC: No results; FSC: no results for CIL-Olam while CIB-Olam's 2.1 million hectares of commercial operations 100% FSC-certified (under ADR (Investigation))	(as above)
	Asian Agri (part of RGE) - palm oil	..	..	Forests 2019: B- (palm)	67%, 65%, 77% (Organisation, Policy, Practice)	RSPO: For PT Inti Indosawit Subur 87% of production, for AAA Oils and Fats Pte Ltd 3% of process-trading volume	Private company^
	Apical (part of RGE) - palm oil	..	..	..	87%, 82%, 54% (Organisation, Policy, Practice)	For AAA Oils & Fats Pte Ltd 3% of process-trading volume	Private company^
	APRIL Group (part of RGE) - pulp & paper	..	..	Forests 2019: B (timber); Climate Chg: "Not available" and "Not scored" 2016-2019, "No response" for 2010-2015	78%, 64%, 53% (Organisation, Policy, Practice)	PEFC: 88% concession areas; FSC: no result since Aug 2013 (baseline assessment initiated by FSC in 2020)	Private company^



	ESG perspectives on selected corporate groups	MSCI ESG	Sustainalytics	CDP	SPOTT (disclosure rating, practice focus)	Voluntary certification percentage (process-trading focus)	Market capitalisation; revenue (USD)
PULP AND PAPER GROUPS	Sinar Mas (PT Asia Pulp & Paper, APP) - pulp & paper	..	..	Forests 2019: B (timber); Climate Chg 2019: B ; Water Security 2019: N/A	APP: 76%, 72%, 64% (and APP China: 30%, 37%, 25%) (Organisation, Policy, Practice)	PEFC: 4 units of APP Timber; FSC: no result since Oct 2007	APP units are Indah Kiat, Tjiwi Kimia, Lontar Papyrus (see below)
	Sinar Mas (PT Indah Kiat) - pulp & paper	BB	27	Climate Chg 2019: "no response"	..	PEFC: 3 units; FSC: no results	USD 3.3 billion; USD3.2 billion
	Sinar Mas (PT Tjiwi Kimia) - pulp & paper	..	35	Climate Chg 2020: "no response"	..	PEFC: chain of custody; FSC: no results	USD 1.4 billion; USD 1.0 billion
	Sinar Mas (PT Lontar Papyrus) - pulp & paper	..	..	Water 2014: "no response"	..	PEFC: chain of custody; FSC: no results	.. ; USD 0.5 billion
AGRI-COMMODITY TRADER-PROCESSORS	Wilmar International Ltd	BBB	40	Forests 2019: B- (palm); Climate Chg 2019: C; Water Security 2019: C	89%, 90%, 68% (Organisation, Policy, Practice)	RSPO: 100% of production, 5% of process-trading volume	USD 21.4 billion; USD 30.9 billion
	Bunge Ltd	AAA	35	Forests 2019: B-, B- (palm, soy); Climate Chg 2019: B; Water Security 2019: B	65%, 78%, 62% (Organisation, Policy, Practice)	RSPO: 28% of process-trading volume	USD 6.1 billion; USD 41.1 billion
	Cargill Inc	..	34	Forests 2019: D, C, (palm, soy); Climate Chg 2019: C; Water Security 2019: D-	46%, 69%, 61% (Organisation, Policy, Practice)	RSPO: 100% of production, 29% of process-trading volume	n/a; USD 113.5 billion
	Louis Dreyfus Company BV	..	..	Mostly "No response," 2012-2020	52%, 46%, 38% (Organisation, Policy, Practice)	RSPO: 4% of process-trading volume	n/a; USD 33.5 billion
MAJOR BUYERS OF PALM OIL	Unilever plc	A	23 (18, PT Unilever Indonesia Tbk)	Forests 2019: A, A, A- (palm, soy, timber) ; Climate Chg 2019: A ; Water Security 2019: A (same for Unilever Indonesia)	..	RSPO: 100% of volume used	USD 156 billion; USD 60.8 billion
	Procter & Gamble Co	AA	26	Forests: Mostly "No response," 2012-2020; Climate Chg 2019: A- ; Water Security 2019: B	..	RSPO: 52% of volume used	USD 324,6 billion; USD 67.7 billion

Notes: This table aggregates data from publicly-available sources on the performance of agribusiness and forestry companies based on selected sustainability indicators. Information and data for 2019 except market capitalisation which is from Aug/Sep 2020. Voluntary certification percentage summaries are readily available at the RSPO (by grower production, processor-trader volumes, and consumer goods manufacturer volumes) and forestry certification information from company reports. ^Corporate website lacks Annual Report.

## Appendix 2: Literature Review

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The SIIA searched recent academic literature for papers on ESG and certification in the palm oil and pulp and paper sectors. Only articles in English were reviewed—there were papers published in other languages, some of which used the translation of key terms such as ESG. A significant number of the articles made reference to other related concepts including corporate social responsibility and socially-responsible investing. One group of papers was on financial aspects including ESG risk assessments at the investment level, and focused on more general ESG considerations. Other major papers were on industry-specific issues.

Palm oil-ESG issues gained interest in recent years, with the literature showing a strong emphasis on Indonesia and Malaysia. A variety of topics are addressed, including sustainable finance, production, company performance, etc. (Thuard et al., 2019; Sagar, 2019; Shahida, 2019). Financial themes such as green investment, banking performance, material issues in the financial sector, etc., gained visibility from 2015 (Clark et al., 2015; UNEP, 2015) and now are dominant alongside ESG risk topics (Thuard et al, 2020), indicating growing understanding from the financial sector about the materiality of ESG risks in palm oil (Palsson, 2015). Additionally, among the companies mentioned in the literature, Unilever was repeatedly referred to as a responsible corporation for including ESG requirements along its supply chain, reporting sustainability performance, and supporting smallholders for accessing certifications (Van Way, 2017).

The pulp and paper sector caught less attention, but this is increasing. Academic papers that make reference to ESG in this industry are concerned with the effectiveness of certification: Cheng and Le Clue (2010) as well as Taylor and Streck (2018) stated that certification has yet to be widely implemented; Brotto, Pettenella, Cerutti, and Pirard (2016) and Nikolakis, Nelson, and Cohen (2012) found that certification has low relevance in general and amongst fund managers specifically. Cheng and Le Clue (2010) highlighted additional sustainability weaknesses in the pulp and paper sector, including land and social disputes, corruption, and weak enforcement of government regulations.

A consolidated view of certification and ESG impacts seems pending academic review; perhaps no surprise since the industry is grappling with the proliferation of reporting schemes. Cheng and Le Clue (2010) identified key shortcomings of forest certification schemes in terms of membership structure, performance- and system-based models, and lack of auditor independence. Different studies explore the structural flaws of the RSPO certification system, with problematic areas identified including: inadequate guidelines, weak enforcement and control, conflicts of interest, and monitoring capacity. There is common agreement in the literature regarding the difficulty of smallholders to access certifications due to the costs, lack of expertise, and low productivity. This is not only detrimental in environmental and social terms, but also perpetuates the marginalisation of local producers in the form of market barriers (Sagar et al. 2019).

Turning more broadly to ESG, academic papers in the mid-2000s focused on environmental and social aspects of the ESG framework; governance became more prominent in the literature later. The latest papers shift attention to the perceived shortcomings of ESG. Hedstrom (2019) noted that ever since “governance” replaced the “economic leg” of the previously adopted people-planet-profit framework, the ESG framework has been “inherently silent on corporate strategy”, thereby “[missing] the vitally important dimension of weaving ESG issues into corporate strategy”. Notably, there are studies on the growing inclination of investors to incorporate social and environmental dimensions into their decision-making processes (Morin and Orsini, 2020; Byrd and DeMates, 2017; Sutherland et al., 2016). Some publications mention financial risks that can be caused by the lack of ESG risk assessment during investment decision-making (Gadinis and Miazad, 2020; Hawkes, 2019; Volz, 2018).

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