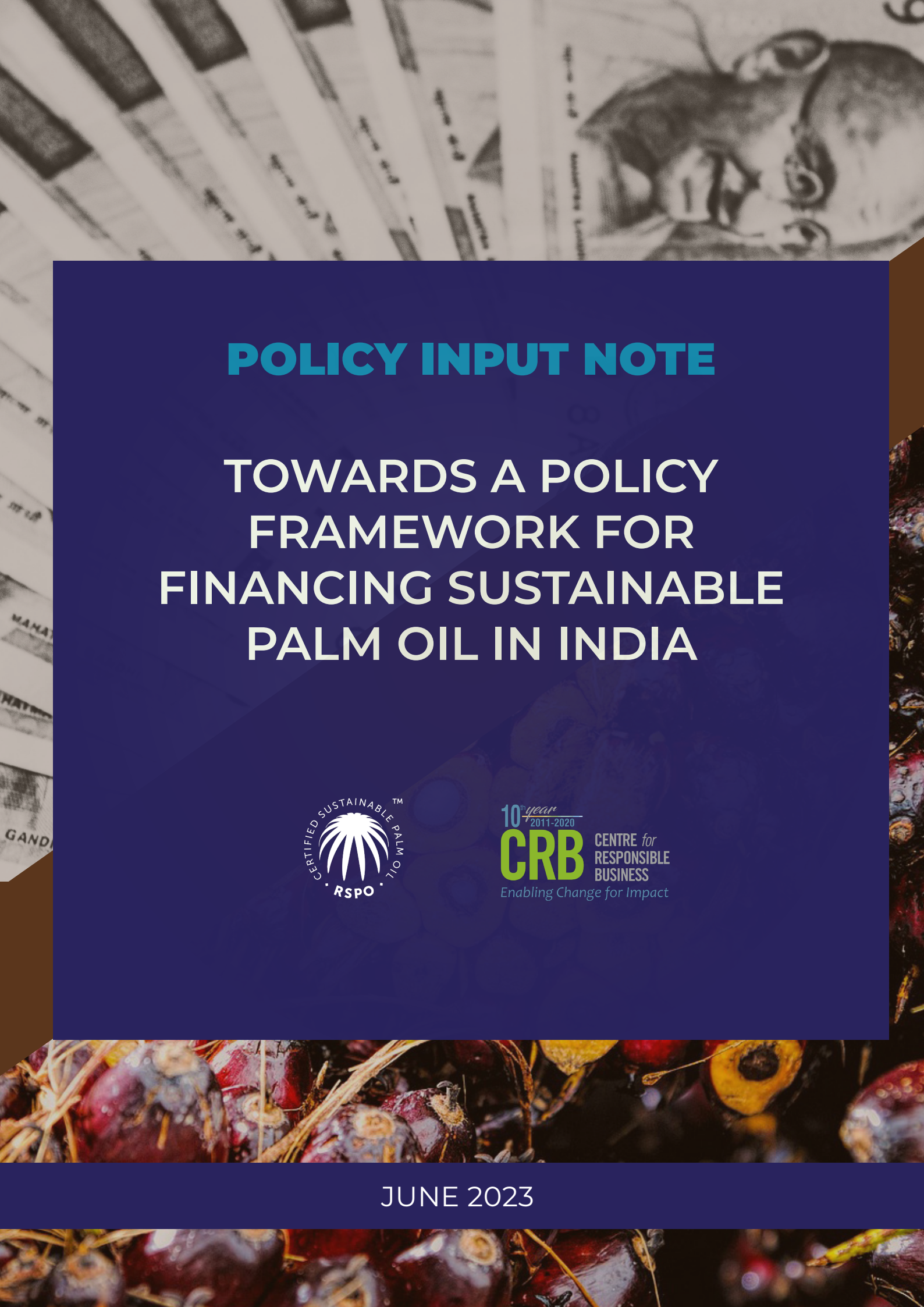

# POLICY INPUT NOTE

# TOWARDS A POLICY FRAMEWORK FOR FINANCING SUSTAINABLE PALM OIL IN INDIA

CERTIFIED SUSTAINABLE PALM OIL™ RSPO

10th year 2011-2020 CRB CENTRE for RESPONSIBLE BUSINESS Enabling Change for Impact

JUNE 2023

# ABOUT ROUNDTABLE ON SUSTAINABLE PALM OIL

The Roundtable on Sustainable Palm Oil (RSPO) was formed in 2004 with the objective of promoting the growth and use of sustainable oil palm products through credible global standards and engagement of stakeholders. RSPO is a not-for-profit, international, membership organisation that unites stakeholders from the different sectors of the palm oil industry including oil palm producers, palm oil processors or traders, consumer goods manufacturers, retailers, banks and investors, environmental or nature conservation NGOs, and social or developmental NGOs.

This multi-stakeholder representation is mirrored in the governance structure of RSPO such that seats in the Board of Governors, Steering Committees and Working Groups are fairly allocated to each sector. In this way, RSPO lives out the philosophy of the "roundtable" by giving equal rights to each stakeholder group, facilitating traditionally adversarial stakeholders in working together to reach decisions by consensus, and achieving RSPO's shared vision of making sustainable palm oil the norm.

The seat of the association is in Zurich, Switzerland, while the secretariat is currently based in Kuala Lumpur with satellite offices in Jakarta, London, Zoetermeer, Beijing, Bogotá and New York.

# ABOUT CENTRE FOR RESPONSIBLE BUSINESS

Since 2018, the Centre for Responsible Business (CRB) has been working in partnership with the Roundtable for Sustainable Palm Oil (RSPO) to promote the uptake of certified sustainable palm oil (CSPO). Through the partnership, CRB has been able to promote awareness amongst relevant stakeholders including businesses, downstream players, associations, international organizations, policy actors, media and youth. CRB has also worked on generating awareness and increasing capacity and knowledge on the topic, supporting multistakeholder platform and dialogues related to uptake and opportunities and facilitating increased commitment and uptake of CSPO in India.

Centre for Responsible Business (CRB) was established in 2011 as think-tank to pursue its vision,'businesses integrate sustainability into their core business practices'. Given that sustainability is a multidimensional problem especially in the context of India and other emerging economies, CRB has adopted a model of engaging multiple stakeholders to develop action plans for promoting sustainable/ responsible business, across various sectors in India.

*This Policy Input Note has been developed as part of a CRB-RSPO partnership executed over the period 2021-22 entitled, "Raising the Ambition on Sustainable Palm Oil in the Indian market post COVID19.' The Policy Input Notes will be used to recommend key policy pointers to the respective Ministries/public agencies.*

# EXECUTIVE SUMMARY

Risks from climate change, deforestation and land-use degradation are rising globally. These may transmit along the value-chain to impact business value-drivers, and pose financial risks to financial institutions. Palm oil is one such commodity, where climate-related risks in the producer markets in Southeast Asian countries could affect Indian financial institutions' lending or investment actions for Indian companies that use imported palm oil . It is imperative to encourage financing of sustainable palm oil in India, to reduce potential transmission of such risks from the use of conventional palm oil . However, this would require a concerted policy ecosystem.

Towards this objective, this brief proposes a policy framework that might be abbreviated as T-I-D-E, comprising of ***Transparency*** through alignment with credible standards, goals and awareness-building. ***Integration*** of these emerging risks into processes like governance, risk management and product strategy. ***Disclosures*** to monitor and measure progress. And ***Encouragement*** using incentive mechanisms and public money judiciously. Taken together, this framework highlights certain policies that would be required to support financing sustainable palm oil in India, thus reducing such emerging risks from impacting the domestic financial ecosystem.

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# INTRODUCTION

Indian Prime Minister Modi announced India's commitment to turn Net Zero in terms of carbon emissions by 2070, at the COP26 annual climate summit in Glasgow in November 2021. While the country had previously pledged its National Determined Contribution (NDC) to improve emissions intensity to GDP by 33-35%[1] by 2030 vs. 2005 levels; at COP26, the Prime Minister announced India's aim to further reduce emissions intensity by 45%[2]. These pledges are encouraging. It recognises that India's leadership is taking cognisance of the emerging risk from carbon emissions (carbon parts per million globally rose from ~300 to ~320 from 1900 to 1960, and exponentially to ~414[3] by 2021). Emissions are a cause of global warming (IPCC's 6th Assessment Report said the earth's land surface temperature was ~1.6°C higher in 2011-2020 vs. pre-industrial levels), ultimately leading to climate change. This number holds significant implications for business-as-usual, as studies estimate that GDP in vulnerable Asian developing countries could slip by ~17%[4] by 2050 in a ~2°C scenario. Some researchers have underlined that India[5] is already experiencing significant damages at ~1°C scenario of global warming.

For India to achieve its climate goals, it is imperative to transform its business and financial sectors such that they incorporate climate-smart, environment and social measures, and create impact within the conventional financial risk-return paradigm. Towards this, the AFOLU sector (agriculture, forestry and landuse) in addition to energy, transport and manufacturing, holds considerable importance. The AFOLU sector was the 2nd largest source of emissions globally in 2016[6], mainly due to landuse practices and deforestation. As per IPCC, ~23%[7] of global emissions were from land-use, of which ~11% pertained to deforestation. Of the 11%, around 5% (~2.6 GT) were from agri-commodities like palm oil, of which India is one of the largest importers/consumers.

**Photo by sheikh sohel on Unsplash**

[1] https://moef.gov.in/wp-content/uploads/2018/04/revised-PPT-Press-Conference-INDC-v5.pdf
[2] https://pib.gov.in/PressReleasePage.aspx?PRID=1768712
[3] https://www.climate.gov/media/14596
[4] https://www.weforum.org/agenda/2021/06/impact-climate-change-global-gdp/
[5] https://odi.org/en/publications/the-costs-of-climate-change-in-india-a-review-of-the-climate-related-risks-facing-india-and-their-economic-and-social-costs/
[6] https://ourworldindata.org/ghg-emissions-by-sector
[7] https://www.ipcc.ch/site/assets/uploads/sites/4/2020/02/SPM_Updated-Jan20.pdf

# CONTEXT

This section tries to explain the likely implication of deforestation and land-use practices in the agri-commodities value chain for the financial sector.

This is explained by the transmission of climate-related financial risks, which impacts the financial position of businesses across the value-chain, and their lenders and investors. Two-thirds[8] of tropical deforestation-related emissions are a result of agri-commodities like palm oil. Southeast Asian nations, primary producers and exporters of crude palm oil, face direct risks related to the conversion of land and forests into plantations, causing emissions from deforestation and improper land-use and thus, climate risks.

India, a primary consumer and importer, faces climate risks which may be transmitted along the value chain from Southeast Asia, if there is little or no sustainability/climate-related information (or traceability) available for the stock(s) of palm oil being imported into the country. This transmission would impact Indian companies in the value-chain, and the conventional financial risks of their lenders and investors, like credit/investment risk, market risk, operational risk, compliance risk, reputation risk, etc. A number of countries are becoming conscious of these risks in the oil palm value chain, and enacting laws to mitigate such risks.

Unlike in Europe where palm oil is majorly blended in biofuels, in India, it is mainly used in the commercial food and personal care industries. Thus, this can hit food inflation in India, creating a severe socio-economic issue, and making it all the more imperative that the country moves to reduce climate and deforestation-related risks to its financial system from the palm oil value-chain.

The factors, highlighted above, implies India needs to prevent and mitigate potential risks related to climate change, landuse degradation and deforestation not just in Palm Oil but other commodities in the AFOLU sector, where such risks exist. This is further explained in the table below

| **Transmission of Climate-related Financial Risks to Banks and FIs** | | | |
|---|---|---|---|
| **Causes...** | **Leading to climate risks...** | **Which impacts business...** | **And finally causes financial risks** |
| • Emissions<br>• Deforestation<br>• Land-use degradation<br>*(Latter two causing emissions & effluents, and have social implications as well)* | • Physical risks (acute & chronic events like extreme weather events, & rise in temperature, precipitation)<br>• Transition risks (policy, technology & market risks as a result of low-carbon transition)<br>• Liability risks (loss compensation from climate risk events) | • Damages infrastructure<br>• Damages business assets<br>• Hits supply chains<br>• Hits business continuity<br>• Leads to stranded assets<br>• Penalties & fines<br>• Hits client demand pull<br>• Higher cost of inputs<br>• Reduces human/labour productivity<br>• May not remain an employer of choice | • Impacts ability to repay & earn cash flows, hence credit risk & investment risk<br>• Impacts valuation of assets & collateral, hence credit risk<br>• Shift in consumer demand leads to market risk<br>• Hits credit rating (& cost of capital), due to reputation risk<br>• Fines imply compliance risk<br>• Disruption to business leads to operational risk<br>• Disruption to energy-guzzling data servers means IT risk |

Transmission of climate risks into conventional financial risks of financial institutions could impact the country's financial landscape, a cause of concern for policymakers and regulators. The Basel Committee on Banking Supervision, which sets standards for prudential regulations of banks, said risks[9] from climate change are expected to cause future losses for financial institutions, and has subsequently released principles for effective climate risk management for financial institutions and regulators.

The Indian financial sector is yet to see meaningful interest from domestic financial firms to fund certified and sustainable palm oil (CSPO) owing to a lack of regulatory and market drivers. But there is a need to drive awareness and integration of climate risks as part of credit and investment process. For this to occur, an enabling policy ecosystem is needed.

[8] https://engagethechain.org/investor-guide-deforestation-and-climate-change
[9] https://www.fsb.org/work-of-the-fsb/financial-innovation-and-structural-change/climate-related-risks/

# POLICY RECOMMENDATIONS

This Policy Brief provides recommendations for a policy ecosystem comprising of four components: Transparency (T); Integration (I); Disclosures (D); and Encouragement (E).

- **T**ransparency (of adherence to standards, goals and awareness-building),
- **I**ntegration (of these risks into governance, risk management and product strategy),
- **D**isclosures (to help monitor and measure progress), and
- **E**ncouragement (use of incentive mechanisms and public money to nudge financing towards CSPO and deforestation-free supply chains)

Specific recommendation under each of these components are provided below.

## 3.1 T - TRANSPARENCY AND AWARENESS

*This section focuses on the need for companies to align with credible sustainability and certification standards, and their reporting requirements. It stresses the need for companies to be transparent about how they plan to achieve their net zero goals, not just what they aim to achieve. Lastly, awareness programs and clear guidance in the form of a taxonomy criteria would further aid transparency in this space*

- Adherence of financial institutions and companies in the value-chain with established voluntary standards for sustainable palm oil, including transparency in related reporting, for example, the Roundtable on Sustainable Palm Oil (RSPO). Malaysia and Indonesia (leading palm oil producers globally) have also developed national standards like the ISPO (Indonesia) and MSPO (Malaysia), that are being promoted by their governments. RSPO has been widely accepted globally to mitigate climate, nature and social-related risks in the palm oil supply chain. Currently ~20% of the total volume of palm oil traded globally is certified as per RSPO standards. As this grows further, transparent alignment to its reporting requirements is to be expected.

- A litany of international legislations has been adopted in recent times that requires companies from advanced economies to drive traceability in global commodities supply chain, including palm oil. This has been done to regulate the entry of palm oil with likely deforestation and forest degradation related risks from entering advanced economy markets. Lack of traceable supply chain of palm oil (and other forest-risk agri-commodities) therefore poses considerable risk to both exporting and importing businesses.

- A major challenge emerging from the perspective of sustainable consumption globally, is 'greenwashing'. Companies sometimes use their own criteria to communicate 'sustainability performance,' which isn't verified by a third party certifying agency, and can wrongly influence market outcomes and consumer decisions. Policies that encourage adherence to credible certification standards would help reduce greenwashing.

- Awareness-building and training is crucial in infusing transparency in the system. Climate risk awareness is still nascent amongst leading Indian financial institutions, as per studies conducted by ODI, Climate Bonds Initiative and auctusESG[10], and Climate Risk Horizons[11]. Policies can play active role in supporting awareness-building by companies and financial institutions.

- Being transparent about operational plans, strategies and targets to achieve Net Zero or carbon neutral goals can help companies get better credibility with investors and regulators. Policy incentives for companies that disclose their plans, strategies and targets towards these goals are imperative, and will enable more companies in the Indian industry to move from commitment to actual action.

- Taxonomy, i.e., the classification of allowable sustainable activities has been effective globally for mobilizing sustainable finance into sectors with positive ESG impacts. India's Finance Ministry has been working towards creating a taxonomy for sustainable finance in the country, a timely step. A set of social and environmental criteria (based on the 'taxonomy') will help ascertain climate and nature related checks and balances for mobilizing financing towards deforestation and climate risk-free AFOLU value chains in India.

[10] https://odi.org/en/publications/esg-and-climate-risk-management-in-the-indian-financial-sector-a-landscape-analysis-of-10-leading-financial-institutions/
[11] https://climateriskhorizons.com/research/Unprepared.pdf

## 3.2 I – INTEGRATION OF THESE RISKS INTO GOVERNANCE, RISK MANAGEMENT AND PRODUCT STRATEGY

*This section focuses on the need to integrate climate and deforestation risks into the conventional risk management processes, including the creation of a consistent ESG criteria that would facilitate peer comparison. It stresses the need to develop Board-level policies and structures to oversee such risks. Further, product development that incorporates such risks would help facilitate increased flow of capital towards sustainable objectives*

- Governance through Board oversight structures, inclusion of technical experts at the Board-level, and improving the organization's overall climate competency would help create a top-down push to integrate climate and sustainability considerations into credit and investment decisions. Such a strategy has seen to be working globally. For example, ING has a climate change committee[12] at the Board-level comprising of internal and external experts.

- Policies need to encourage Indian financial institutions to establish Board-level responsibility and oversight on climate risk and monitor how these affect conventional financial risks. Such policies must cover: (i) processes to assign responsibility and accountability; (ii) inclusion of technical members who do not hold executive positions (akin to previous policies that encouraged inclusion on non-executive directors in Indian Boards); (ii) response mechanisms to be used; (iii) KPIs to monitor and report the progress; and (iv) improving the Board's understanding and awareness of these risks.

- Risk management processes that reduce incidences of transmission of these risks into conventional financial risks would require improved data, traceability and monitoring of investments. Thus, policies that enable data sourcing and measurement, traceability of palm oil products to their source and help financiers monitor the value-chains and information better, would be useful.

- Policies must mandate every financial institution to institutionalize a comprehensive Environment and Social Management Plan that assess ESG risks in a consistent methodology across the value-chain and goes beyond the current ESG checks to include possible implications on conventional financial risks.

- Climate risks needs to be part of the three lines of defense of financial risk management, i.e., frontline managers, risk managers and internal audit managers. For example, frontline managers may require checks to ensure palm oil is sourced from certified producers, as part of client onboarding and due diligence. Similarly, internal audit may require documentary evidence of such certification information, from the frontline managers.

- Risk management policies need to be categorized into: (i) pre-investment; (ii) during-investment and (iii) post-investment. Aligning risk management to climate risk principles would reduce compliance, reputation and credit risks. Materiality analysis, establishing a baseline for climate risks and quantifying the risks, perhaps through climate risk scoring or extended carbon footprint will ease decision-making. Policies need to look at the inclusion of these considerations in the investment process.

  The financial institution's strategy should combine climate and deforestation risks into product development, say use-of-proceeds based green/sustainability bonds or performance-based sustainability-linked products. Thus, policies must nudge such finance towards companies that reduce emissions and deforestation, by encouraging the use of standardized principles and guidelines. Adherence would imply products are achieving what they claim to achieve and avoid greenwashing. Other examples of product development include (i) sustainable letters of credit (to encourage procurement of certified sustainable palm oil); (ii) value-chain based financing (that covers the buyer and seller ecosystems); and (iii) blended finance structures (that use public funds to de-risk the project and raise multiples of private capital).

- Policy interventions may also look at driving longer tenor loans, because sustainability-oriented projects in the AFOLU sector may often involve long gestation periods, and the use of carbon credits to raise climate finance to conserve forest areas.

[12] https://www.ing.com/Sustainability/Sustainability-direction/Sustainability-governance.htm

## 3.3 D – DISCLOSURES TO MONITOR AND MEASURE PROGRESS

*This section focuses on the increased impetus towards sustainability disclosures. It adds disclosure is not just about showing data but applying that data strategically towards business improvement. That is what investors are looking for. Mainstreaming of advanced technologies would help capture data more accurately, enabling better disclosure*

- Long-term institutional investors have driven companies to adhere to credible, long-term sustainability goals. One way this has manifested is through the demand for sustainability disclosures. Globally, climate disclosure frameworks, like TCFD, are being mandated and the developments around the consolidated ISSB standards are awaited. India has mandated the Business Responsibility and Sustainability Reporting (BRSR) requirement based on the nine principles of responsible business conduct, starting with the top-1000 listed companies from the financial year 2022-23. This should augur well to create a data repository of corporate sustainability information. Recent efforts to create a list of BRSR-Core KPIs, which would require assurance, is also a step in the right direction to generate verifiable data. At the same time, investors are demanding to know how companies are using the reported data to make strategic improvements in their business models, operations and targets, which in turn, is facilitating improved investing decisions by them.

- Policies may even look at how financial institutions can integrate ESG information within their financial analysis, as part of investment decision process. This is called ESG Integration, and it has become the fastest growing ESG investing strategy in recent years. It refers to how sustainability considerations are connected with business value-drivers. It captures the transmission of ESG/climate risks into conventional financial risks..

- A critical part of verifiable disclosures are policies that encourage the affordability and accessibility of digital technologies towards data measurement and tracking. IOT, remote satellite imagery, robotics, automation, machine learning, AI and precision technologies would help measure data more accurately, leading to more relevant disclosures .

## 3.4 E – ENCOURAGEMENT THROUGH INCENTIVE MECHANISMS AND PUBLIC MONEY

*This section focuses on the need to create incentives mechanisms in sectors where sustainable finance is yet to pick up in India, in order to nudge financing. Towards this, judicious use of public money to reduce perceived risks and crowd-in private sector capital to scale up financing would hold key*

- Unlike energy, mobility and green buildings, the AFOLU sector is yet to become mainstream within the Indian sustainable finance space. Such sectors may require unconventional approaches to encourage or incentivize financing flows. Incentives may look to reduce perceived risks, especially for private sector commercial capital. For example, incentives like interest rate discounts or interest payouts through outcome-based structures. If the cost of capital with minimal impact on returns, it creates a natural incentive towards unconventional sectors, like sustainable palm oil.

- Using of public sector money judiciously to provide such incentives, such that it encourages buyer demand and mobilization of private sector capital, can be instrumental to create that initial push. In the low-income housing market, this policy has been used to encourage affordable housing finance loans by low-income buyers, through a public sector scheme (PM Awaas Yojana[13]). In the same manner, policies that channelize public sector money judiciously to incentivize sustainable palm oil, may help reduce the risks from climate change, deforestation and land-use. Such incentives may also be used in India's domestic palm oil cultivation plans under Aatmanirbhar Bharat scheme.

- While carbon credits have been mentioned in previous sections, policies may also look at developing the payment for ecosystem services' market in India, such that incentives are created to conserve natural ecosystems, thus disincentivizing deforestation.

- At the same time, incentives must look at sustainable procurement, to identify and reduce negative socio-environment impact . This requires looking at whether policies can drive financing to those procuring sustainable commodities, or enable the procurement of sustainable inputs by those keen to produce sustainable end-products?

- For financial firms engaging with companies that want to source sustainably, they might add such requirements in the investment criteria, provide incentives like an interest rate deduction, longer tenure, extended moratorium, etc. The intent is to drive financing behavior towards sustainable alternatives.

[13] https://homeloans.sbi/pmay

# CONCLUSION

The proposed **T-I-D-E** ***Policy Framework*** puts forward an approach, that may help encourage more financing towards sustainable AFOLU-commodities supply chain, for example, palm oil in India. Apart from certain recommendations, it helps create an understanding of how the transmission of climate and deforestation risks may occur in the palm oil value chain, and ultimately hit the conventional financial risks of Indian financial institutions lending or investing in such companies.

While institutional investors are driving corporate sustainability alignment, regulations and policies are critical to give a clear guidance and direction to companies on what is allowed, or not allowed. While foreign financial institutions operating in India may use criteria or guidelines developed in their parent entities, the major chunk of credit assets in India lies with domestic financial institutions, most of whom are yet to develop comprehensive guidelines on managing climate risks. Policies and regulatory movement can nudge them to do this. This Policy Brief aims to contribute towards this!

Image by NDTV India

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