WWF

SUSTAINABLE FINANCE REPORT 2015

SUSTAINABLE FINANCE IN SINGAPORE, INDONESIA AND MALAYSIA:

A REVIEW OF FINANCIERS' ESG PRACTICES, DISCLOSURE STANDARDS AND REGULATIONS

ACKNOWLEDGEMENTS

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A newly established oil palm plantation close to a forest reserve in Sabah, Borneo.

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WWF is one of the world's largest and most experienced independent conservation organizations, with over 5 million supporters and a global network active in more than 100 countries. WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature.

WWF's International Finance Programme seeks to support this vision by engaging directly with banks, asset managers and other financial institutions. It helps strengthen lending and investment criteria for key industry sectors, provides insights and data on environmental and social risks, fulfils critical research gaps and helps unlock innovation breakthroughs in sustainable financial products.

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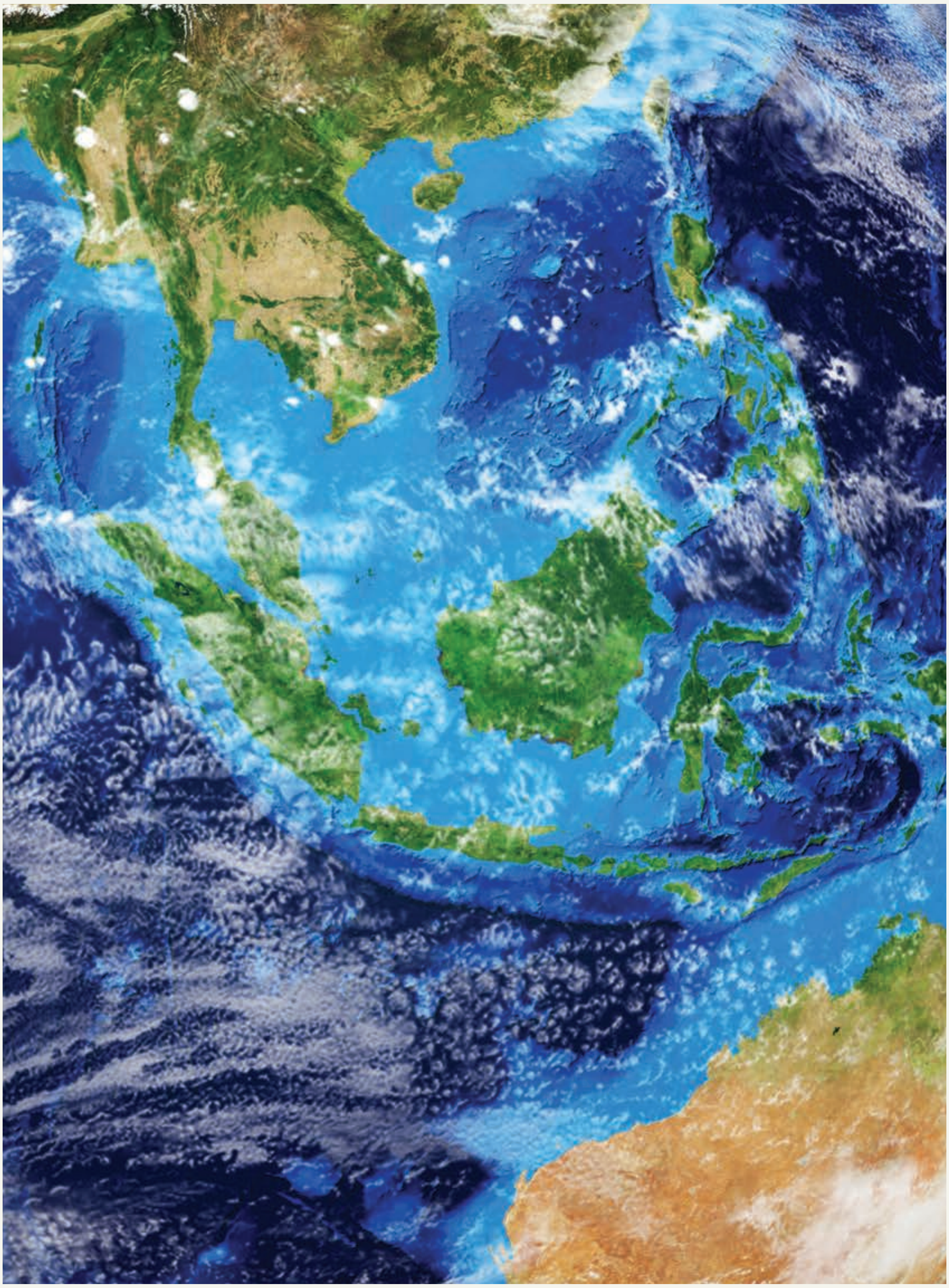

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FOREWORD

"For the health of the economy, society and the environment, policymakers should integrate sustainable development issues into capital market policymaking."

It is already clear to many global long-term investors that sustainability issues, including air pollution in China, haze in Southeast Asia, or water scarcity in India, are material to long-term investment returns. As the report suggests, some global banks and international institutional investors have begun to address the risks within their investment portfolios. It is time for the domestic financial institutions to play their part, especially due to their higher exposure to forest risk commodity sectors.

For generations policymakers have sought to align the interests of the financial markets and society. Nowhere is this tension more keenly and persistently felt than in the relentlessness of the capital markets to allocate capital to short-term, unsustainable uses and policymakers' need to plan for the long term and tackle a range of environmental and social issues, such as the nexus of issues surrounding poverty, climate change, fresh water, sustainable resource use and human rights. This outstanding report adds to the rich heritage of research in this area.

The key point for me is that it is clear that financial institutions are limited in what they can achieve by themselves. Before capital markets can be genuinely sustainable, investors need capital market policymakers to have greater regard for future generations when setting policy. For the health of the economy, society and the environment, policymakers should integrate sustainable development issues into capital market policymaking. We need policymakers to internalize corporate externalities onto company accounts via, for example, increased transparency, standards and market mechanisms. We also need to ensure that the culture within global financial services firms is not one where the many conflicts of interest are exploited. Some of this will require greater government intervention, particularly around the regulation of investor action on responsible ownership.

So, I could not agree more with the conclusion that regulators should ensure that ESG factors are taken into consideration by banks and investors; and that this would facilitate efficient capital markets and ensure that the finance sector plays its part in the development of sustainable economies. However, investors need to act now rather than wait for regulation in order to ensure that their investment portfolios have taken into account sustainability risks and opportunities and are resilient in the face of impending crises and regulatory changes.

I also absolutely agree that forest risk commodity companies stand to benefit from adopting sound management of ESG issues, and that this will help long-term profitability and improved cost of and access to capital.

As well as the proposed actions by governments, companies, banks and investors, I also hope that this innovative research inspires other civil society organisations to look more closely at this area. I think that it offers a rich research vein that should be mined for all that it is worth. I believe there are plenty more research nuggets such as those contained within the report that would similarly contribute to market sustainability.

Steve Waygood
Chief Responsible Investment Officer, Aviva Investors

KEY CONCEPTS

ESG

Environmental, social and governance (ESG) is a term and concept first proposed in June 2004 by the UN Global Compact's "Who Cares Wins" initiative to focus mainstream investors and analysts on the materiality and interplay between environmental, social and governance issues. Investors and analysts consider ESG performance in their fundamental analysis of companies on the basis that companies who proactively manage ESG issues are better placed than their competitors to generate long-term tangible and intangible results.[1] In this report the term is used interchangeably with "sustainability".

FOREST RISK COMMODITY

This refers to commodities that are associated with risks of deforestation and forest degradation. For the purposes of this report it is used to refer to palm oil, timber, and pulp & paper, which are the major soft commodities impacting forests in Malaysia and Indonesia. In other markets the term is also commonly used to refer to soy, cattle/beef and biofuels.

The word "risk" can create ambiguity. Forest risk commodity refers to the risk to forests. However, this report is also focused on risk to companies and their owners/financiers, highlighting that in many cases such risks result from mismanagement of ESG issues.

UNIVERSAL OWNERS

The concept of universal owners is helpful in analysing portfolio-level effects. The report *Universal Ownership: Why environmental externalities matter to institutional investors* from the United Nations Environment Programme Finance Initiative (UNEP FI) and the Principles for Responsible Investment (PRI) describes the concept in the following way:[2]

"Large institutional investors are, in effect, 'Universal Owners', as they often have highly-diversified and long-term portfolios that are representative of global capital markets. Their portfolios are inevitably exposed to growing and widespread costs from environmental damage caused by companies. They can positively influence the way business is conducted in order to reduce externalities and minimize their overall exposure to these costs. Long-term economic wellbeing and the interests of beneficiaries are at stake. Institutional investors can, and should, act collectively to reduce financial risk from environmental impacts."

LIST OF ACRONYMS

AGM	Annual General Meeting
AML	Anti-money laundering
BEI	Banking Environment Initiative
CDM	Clean development mechanism
CSR	Corporate social responsibility
EFB	Empty fruit bunches
FFB	Fresh fruit bunches
FPIC	Free, prior and informed consent
FSC	Forest Stewardship Council
GHG	Greenhouse gas emissions
HCV	High conservation value
HCS	High carbon stock
IFC	International Finance Corporation
ILO	International Labour Organization
OHS	Occupational health and safety
POME	Palm oil mill effluent
PRI	Principles for Responsible Investment
RSPO	Roundtable on Sustainable Palm Oil
SMEs	Small and medium-sized enterprises
UNEP FI	United Nations Environment Programme Finance Initiative

A WORD ON TERMINOLOGY USED IN THE INVESTMENT INDUSTRY

The investment industry has coined a number of terms and acronyms to describe the adoption of processes that reflect ESG concerns.

Active ownership refers mainly to voting, engagement, and advocacy activities. It is used interchangeably with "stewardship", though it incorporates a stronger element of engagement on environmental and social issues, whereas stewardship is sometimes perceived as primarily relating to corporate governance.

Dialogue is the process of influencing companies through exchanging views and opinions, rather than through voting. It is frequently used interchangeably with "engagement".

Engagement is the process of reaching out to companies to obtain information or influence policies, practices or performance. It is often used interchangeably with "dialogue", though engagement can also include voting practices.

Integration refers to the use of ESG information in the assessment and valuation of companies. The implementation will usually vary at each fund according to its management philosophy and style.

Screening refers to the exclusion of certain companies or sectors on ethical or ESG grounds, or the inclusion of companies as solutions providers or ESG leaders in their sector.

Stewardship refers mainly to voting and engagement activities. It is used interchangeably with "active ownership", though in some markets it emphasises engagement on corporate governance issues, whereas active ownership may imply a broader remit for engagement and advocacy.

Responsible investment (RI) is defined in various ways. One useful definition is "Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental and economic systems."[3]

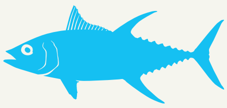
Sustainable and responsible investment (SRI) is used either to refer to funds that market themselves on the basis of ESG approaches or as a synonym for RI.

BUILDING ON PRIOR WORK

We are actively engaging with the finance sector to invest in more sustainable commodity production.
See *panda.org/finance* for the following documents.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INTEGRATION FOR BANKS: A GUIDE TO STARTING IMPLEMENTATION [4]

This 2014 WWF publication maps out in detail the “how to” steps for financial institutions in the earlier stages of their ESG journey. It provides banks with a toolkit to develop an ESG strategy and an operational framework to integrate ESG issues into their core business and operational processes. It shows them how to manage their risk exposure to unsustainable business practices and support sustainable development. The guide informs our recommendations for Singaporean, Indonesian and Malaysian banks.



THE 2050 CRITERIA – GUIDE TO RESPONSIBLE INVESTMENT IN AGRICULTURAL, FOREST, AND SEAFOOD COMMODITIES [5]

WWF’s 2050 Criteria provide a framework for investors to identify responsible practices in key soft commodities around the globe. The issues covered are widely accepted, commercially relevant, and included in major standards, such as the International Finance Corporation (IFC) performance standards and other multi-stakeholder initiatives including the Roundtable on Sustainable Palm Oil (RSPO) and Forest Stewardship Council (FSC).

By deploying credible, mainstream criteria for responsibly identifying and guiding investees, financial institutions can improve performance, manage risk, and help contribute to the economic and environmental sustainability of these crucial sectors. This report uses the 2050 Criteria for palm oil and for timber and pulp & paper as the basis for assessing corporate ESG disclosure.

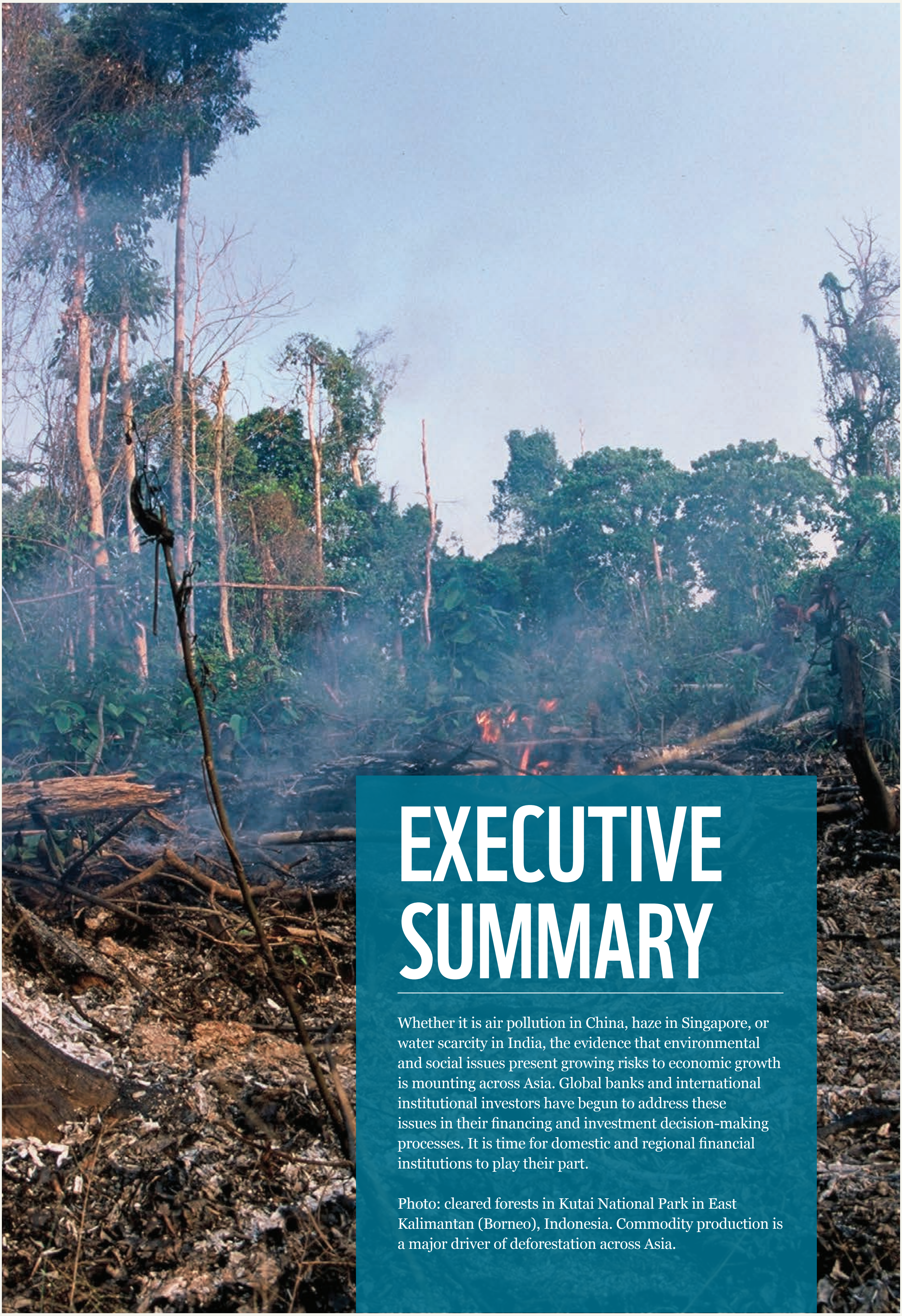
PALM OIL INVESTOR REVIEW 2012 [6]

This 2012 report outlines how investors can more effectively play their part in supporting the sustainable development of the palm oil industry – and how the RSPO and WWF should support them. It also summarizes findings from a first-of-its-kind survey of 35 key palm oil investors, examining their understanding of – and progress in dealing with – the challenges related to palm oil and sustainability.

CERTIFIED SUSTAINABLE PALM OIL ™
RSPO

PROFITABILITY AND SUSTAINABILITY IN PALM OIL PRODUCTION [7]

This is the first study to comprehensively examine the financial costs and benefits of producing sustainable palm oil under the guidelines set out by the RSPO. The joint producers of the report were WWF, CDC (the UK’s development finance institution) and FMO (the Dutch development bank). The report finds that the economic benefits outweigh the financial costs of pursuing sustainable palm oil operations.



EXECUTIVE SUMMARY

Whether it is air pollution in China, haze in Singapore, or water scarcity in India, the evidence that environmental and social issues present growing risks to economic growth is mounting across Asia. Global banks and international institutional investors have begun to address these issues in their financing and investment decision-making processes. It is time for domestic and regional financial institutions to play their part.

Photo: cleared forests in Kutai National Park in East Kalimantan (Borneo), Indonesia. Commodity production is a major driver of deforestation across Asia.

EXECUTIVE SUMMARY

This report is intended to support change.

This report's primary audiences are the domestic providers of capital – banks and investors – and financial regulators of Singapore, Indonesia and Malaysia. It focuses on the extent to which these capital providers are considering sustainability in their financing and investment activities, and the adequacy of sustainability reporting requirements in light of existing disclosure levels on material environmental and social issues.

The report uses the palm oil, timber and pulp & paper sectors as central case studies as these sectors are important for both the domestic economies and as key players in managing risks to the region's globally important tropical forests. The report bases its assessments on public disclosure.

KEY FINDINGS

There is a strong case for banks and investors to address environmental, social and governance (ESG) issues in assessing companies for loans and investment. International financial institutions have begun to do so. Domestic banks and investors are lagging far behind.

This is clear for palm oil, timber and pulp & paper companies, where there is an increasingly accepted commercial rationale for improved management of ESG issues such as those laid out in WWF's 2050 Criteria. Yet as a group the leading companies from these sectors listed in Singapore, Indonesia and Malaysia provide insufficient relevant disclosure for investors to assess their management of material ESG issues.

International investors have sought to address these disclosure gaps through engagement and collaborative initiatives. There is no evidence that domestic investors have taken such steps.

Similarly the global banks reviewed all have policies on financing forest-related commodity companies. Yet only one of the domestic banks appears to have this type of policy.

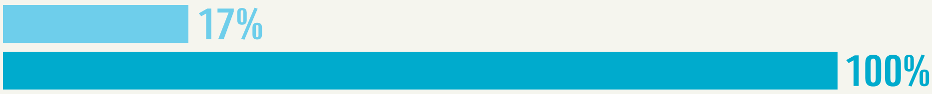
BANKS

There is a strong case for banks to consider ESG issues in their risk management, reputation management, client/transaction approval and credit processes. However, on the basis of their public disclosure, the majority of the domestic banks reviewed do not consider broad ESG factors in assessing clients. Where client behaviour is considered, it is mainly in relation to Islamic subsidiaries avoiding "sin" industries or as part of anti-money laundering (AML) practices. This forms a strong contrast with the four global banks reviewed that provide detailed sector level policies for high ESG risk industries such as forest risk commodity sectors.

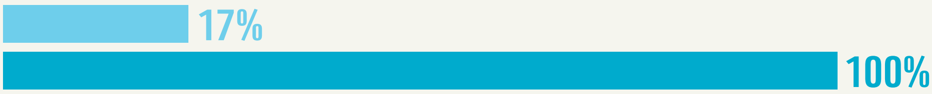
There is some national variation. Indonesian banks are typically further ahead. All three of the domestic banks that provide a statement on sustainable lending are Indonesian. Overall, the Singaporean banks provided the least relevant disclosure on ESG integration.

DOMESTIC BANKS – DISCLOSURE AND ESG INTEGRATION

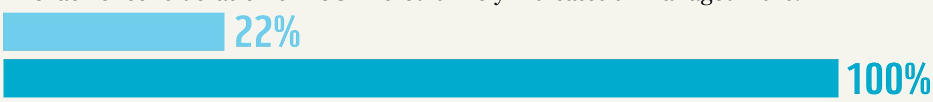
Is there a high level statement on sustainable lending?
There were very few statements of intent from domestic banks. All three were from Indonesian banks.



Does client approval include an ESG screen for factors other than Sharia?
Almost all the domestic banks have Islamic subsidiaries that operate ethical screens, however, broader ESG factors were rarely considered.

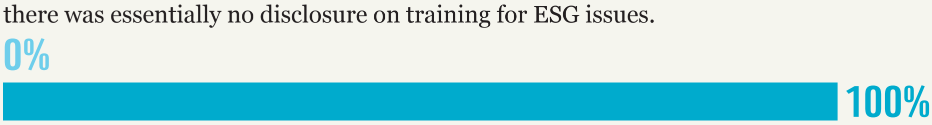


Is ESG used as a tool in credit processes?
The lack of consideration of ESG in credit likely indicates unmanaged risks.

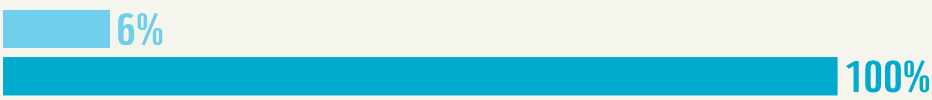


Is there disclosure of an ESG policy relating to forest risk commodities?
All of the global banks have forest risk commodity related policies. Only one domestic bank had a policy specific to palm oil.

Is there disclosure of training on ESG?
Although most of the domestic banks provide disclosure on human capital management, there was essentially no disclosure on training for ESG issues.



Is the bank a member of relevant multi-stakeholder initiatives?
The global banks are all members of at least three of the four multi-stakeholder initiatives reviewed.



BANK REGULATORS

Low levels of ESG integration at domestic banks show there is a role for regulators to stimulate further progress. Singapore and Malaysia do not have banking regulations relating to ESG standards. Indonesia launched a Sustainable Finance Roadmap in December 2014 and is due to announce additional regulations in 2016.

International regulators, such as those in China and Brazil, have brought in "green" credit or sustainable banking guidelines and/or require mandatory environmental and social impact assessments (ESIA) prior to loan disbursements. These create a level playing field for banks.

KEY RECOMMENDATIONS

BANKS

- Develop an ESG strategy and implementation framework including sector policies. Refer to WWF *ESG Integration for Banks: A Guide to Starting Implementation*[8].
- Implement, monitor and report on the ESG strategy.
- Join multi-stakeholder initiatives and other banking initiatives such as the Banking Environment Initiative (BEI)[9] or Equator Principles[10].
- Encourage and support national banking associations to create voluntary sustainable finance guidelines.
- Islamic finance councils may wish to consider whether there is scope to include environmental factors.

BANKING REGULATORS

- Produce national guidelines for banks to support integration of environmental and social risks into credit evaluation processes.
- Support banks through training and capacity-building programmes.
- Introduce reporting standards to increase bank transparency on management of environmental and social risks in portfolios.

INVESTORS

There is a robust case for investors to consider ESG issues across their portfolios including – and especially – for forest risk commodity companies. None of the domestic investors disclose a structured approach to their thinking on ESG or RI, although the majority have adopted at least one form of ESG practice for some of their assets. The domestic investors lag far behind international institutions on RI.

INVESTORS – DISCLOSURE AND ESG INTEGRATION

Does the investor provide disclosure of its holdings?
In many markets transparency has increased accountability to beneficiaries.

0%
100%

Does the investor disclose its corporate governance policy?
A corporate governance policy allows a consistent, evidence-based approach to discharging ownership responsibilities.

17%
100%

If the corporate governance policy is published, does it include specific reference to ESG?
The absence of disclosure on ESG-related engagement suggests domestic funds are not considering material ESG risks.

8%
100%

Does the investor specifically allocate funds to sustainability solutions providers?
Sustainability problems offer many potential equity opportunities and a fast-growing requirement for debt funding. Yet the domestic funds show very little interest in these areas.

17%
100%

Is the investor a member of any relevant international collaborative initiative?
The domestic funds have not even become signatories to CDP, the major climate initiative, which is free of charge to investors .

0%
100%

SECURITIES MARKET REGULATORS

Low levels of ESG practice at domestic investors suggest a significant opportunity for investors to engage with companies to reduce risks and capitalize on opportunities, including at forest risk commodity company holdings; and a role for regulators to encourage and support active ownership, for example via stewardship codes.

KEY RECOMMENDATIONS

INVESTORS

- Use ESG analysis to identify systemic risks such as climate change and enhance valuation/forecasting.
- Step up active ownership to manage systemic and company risks.
- Engage with portfolio companies, especially forest risk commodity companies, to improve ESG standards.
- Access knowledge and best practices by joining international collaborative initiatives such as PRI, CDP, and ACGA.
- Engage with locally-listed banks within investment portfolios to support their development of ESG practices.

SECURITIES MARKET REGULATORS

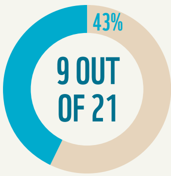
- Support increased levels of active ownership, including through promotion of stewardship codes for institutional investors.

COMPANIES

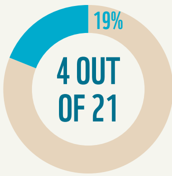
Some companies are making efforts to capture the benefits and mitigate related risks through enhanced ESG management practices. However, there is limited or no company disclosure on many of these issues. Opportunities remain to optimize shareholder value if the lack of disclosure reflects a lack of implementation of best management practices. The disclosure gaps and inconsistencies between companies also present a significant barrier for financial institutions that seek to evaluate the longer-term prospects of forest risk commodity companies.

COMPANIES – DISCLOSURE AND ESG INTEGRATION

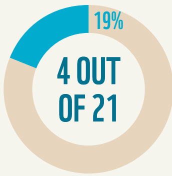
PALM OIL



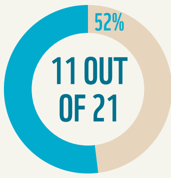
Does the company disclose policy or equivalent practices relating to priority areas or areas on which it will not plant?
This relates to limiting deforestation risk, which is increasingly a customer requirement.



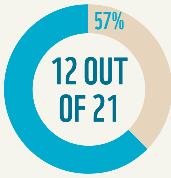
Does the company disclose time-bound targets to reduce greenhouse gas (GHG) emissions from current operations?
Climate change is a risk to the industry, yet very few companies disclose steps to mitigate it.



Does the company disclose that its product, including externally sourced materials, is produced/ harvested in compliance with all applicable local, national and ratified international laws and regulations?
Legal production is increasingly a requirement of producer and consumer governments and of buyers and traders.

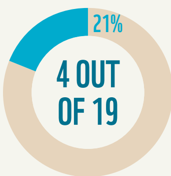


Does the company disclose a policy on local and indigenous communities?
Many traders and buyers have policies banning exploitation.

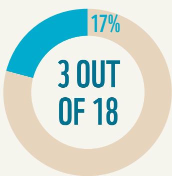


Does the company disclose that it uses International Labour Organization (ILO) standards or provide relevant protections?
Securing an adequate labour force is increasingly a challenge – high standards can create a better reputation.

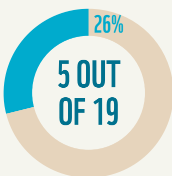
TIMBER, PULP AND PAPER



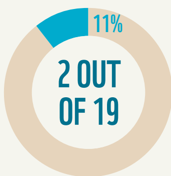
Does the company disclose policy or equivalent practices relating to preservation of priority areas in line with its activities?
This relates to limiting deforestation risk, which is increasingly a customer requirement.



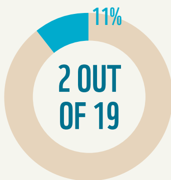
Does the company disclose a policy or take equivalent actions relating to local and indigenous communities in areas from which it sources?
Many buyers have policies banning exploitation.



Does the company disclose a due diligence system to manage the risk that its product is not produced/ harvested and traded in compliance with all applicable local, national and ratified international laws and regulations?
Illegal production is increasingly penalized through legislation by producer and consumer governments.



Does the company disclose a policy on GHG emissions or equivalent practices?
Climate change is a risk to the industry, yet very few disclose steps to mitigate it.



Does the company disclose that it uses ILO standards or provide relevant protections?
Securing an adequate labour force is increasingly a challenge – high standards can create a better reputation.

KEY RECOMMENDATIONS

FOREST RISK COMMODITY COMPANIES

- Create value through improved management practices. Focus on yield improvements that contribute to secure reliable long term supply chains, responsible land-use planning, and optimized use of natural resources; rather than land acquisition or a mining approach (i.e. harvest and go).
- Highlight core sustainability strategy and implementation to banks and investors.
- Enhance disclosure including of material ESG issues as outlined in the 2050 Criteria.
- Become members and undergo certification by multi-stakeholder initiatives such as the RSPO and FSC.

SECURITIES MARKET REGULATORS

- Enhance ESG disclosure through mandatory requirements for listed companies, specifying minimum levels of statistical information, with sector-specific guidelines for high impact sectors.

LIST OF ORGANIZATIONS ASSESSED FOR THIS REPORT

	SINGAPORE	INDONESIA	MALAYSIA	INTERNATIONAL
BANKS	• DBS • OCBC • UOB	• Bank Central Asia • Bank Mandiri • Bank Negara Indonesia • Bank Pan Indonesia • Bank Permata • Bank Rakyat Indonesia • Victoria Investama	• AMMB Holdings • Bank Muamulat • BIMB Holdings • CIMB • Hong Leong Bank • Maybank • Public Bank • RHB Capital Berhad	• ANZ • HSBC • Standard Chartered • Westpac
INVESTORS	• GIC • Temasek	• Bahana • Danareksa	• ECM Libra • EPF • K&N Kenanga • KAF • KWAP • PNB • SOCSO • Tabung Haji	• BlackRock • CalPERS • NBIM • USS
PALM OIL COMPANIES	• Bumitama Agri • First Resources • Golden Agri-Resources • Indofood Agri Resources • Olam International • Wilmar International	• Astra Agro Lestari • Austindo Nusantara Jaya • BW Plantation • Sampoerna Agro	• Felda Global Ventures • Genting Plantations • Hap Seng Plantations • IJM Plantations • IOI Corporation • Kuala Lumpur Kepong • Kulim (Malaysia) • Sarawak Oil Palms • Sime Darby • TSH Resources • United Plantations	
TIMBER COMPANIES	• Samko Timber	• Barito Pacific • Dharma Satya Nusantara	• Evergreen Fibreboard • Java Berhad • Jaya Tiasa Holdings • Subur Tiasa Holdings • Ta Ann Holdings • Tadmax Resources • WTK Holdings	
PULP & PAPER COMPANIES	• United Fiber System	• Fajar Surya Wisesa • Indah Kiat Pulp and Paper • Kertas Basuki Rachmat Indonesia • Pabrik Kertas Tjiwi Kimla • Suparma • Toba Pulp Lestari	• NTPM Holdings • Wang Zheng	

INTRODUCTION

Financial institutions and regulators have a crucial role to play in the transition to a sustainable economy and the mitigation of systemic risks that major environmental and social issues can present. International financial institutions increasingly understand the links between ecosystems, climate change and the economy. As a result they are embedding ESG into their processes to reduce systemic risks and support long-term performance. From a review of public disclosure, the domestic financial players of Singapore, Malaysia and Indonesia have yet to adopt ESG practices in the same way as international institutions.

Photo: A worker in East Kalimantan, Borneo removes bark to prepare logs for rafting to the plywood factory downstream. The company, PT Ratah. Timber, practises reduced impact logging to minimize damage to the forest.

INTRODUCTION

Financial institutions and regulators have a crucial role to play in the transition to a sustainable economy and the mitigation of systemic risks that major environmental and social issues can present.

International financial institutions increasingly understand the links between ecosystems, climate change and the economy. As a result they are embedding ESG into their processes to reduce systemic risks and support long-term performance. From a review of public disclosure, the domestic financial players of Singapore, Malaysia and Indonesia have yet to adopt ESG practices in the same way as international institutions.

Forest risk commodity sectors provide a useful case study of the need for and benefits of adopting ESG practices, and the gap between international and domestic financial institutions' approaches.

The capital and lending markets of Southeast Asia finance many leading companies involved in the production of palm oil, timber, and pulp & paper. These sectors underpinned early economic development in Malaysia and Indonesia, as well as Singapore through its trading and financing relationships. These commodity sectors continue to support their national economies and national development goals, and are important generators of foreign exchange. Well-managed responsible operators contribute to poverty alleviation through providing incomes to smallholders and employing large labour forces.

ZERO NET DEFORESTATION AND FOREST DEGRADATION BY 2020

However, development has often come at the expense of the region's primary and other high conservation value (HCV) forests [11]. This has created a number of problems. The forests are critical due to their biodiversity, other conservation values and provision of ecosystem services; as well as providing local communities with food, fuel, fibre and medicine.

The forests' ecosystem service of storing carbon is of particular importance. It is not possible to avert dangerous climate change [12] without reducing levels of GHG emissions from agriculture, forestry, and other land-use changes [13]. Yet without addressing climate change, systemic risks to the economy, to banks and investors, and even to the palm oil, timber, and pulp & paper companies, will continue to build.

To tackle these issues, WWF advocates a global shift to zero net deforestation and forest degradation by 2020 [14]. The aim is for no overall loss of forest area or forest quality at the global level, while allowing for some flexibility at the regional level to meet local needs.

International financial institutions also recognize the importance that forests play. As a result many have extended their ESG practices to forest risk commodity production. Steps include drafting sector-specific policies, refusing to invest in or finance companies that are consistently failing to respond to ESG challenges, and engaging with forest risk commodity supply chains including retailers, manufacturers, traders, growers and harvesters.

Given that domestic financial institutions are also a critical source of funding for palm oil, timber, and pulp & paper production in the region and should have relevant industry expertise on ESG issues, it would be natural to expect that they would be engaging with local industry in this way. However, the review of 30 domestic institutions found almost no evidence of assessment of or engagement on these issues. Only one institution, Bank Negara Indonesia, provided specific statements to the effect that clients in forest risk commodity sectors must adopt minimum ESG standards.

This report was written as a first step in assessing and addressing these gaps between domestic financial practices and the processes needed to contribute to a sustainable economy. The report aims to support leading financial institutions and regulators from Singapore, Indonesia and Malaysia in understanding the rationale for taking part in the transition and the steps necessary to do so. It uses forest risk commodity production as a central case study in setting out the more general argument for financial institutions to adopt ESG practices. It also presents recommendations for companies, investors, banks and financial regulators.

CALL TO ACTION

The report serves a number of objectives:

- Educate banks and investors on the business case for ESG in general and in respect of forest risk commodity production.
- Raise awareness that current levels of locally listed forest risk commodity company disclosure do not cover the most material ESG issues.
- Call for domestic investors to raise ESG issues with portfolio companies, including forest risk commodity companies.
- Call for international investors to engage with locally listed banks on adopting ESG practices.
- Spur banks to raise ESG issues with clients and support clients on their sustainability journey.
- Spur regulators to support adoption of ESG practices across financial services and in high impact industries.
- Educate forest risk commodity companies on the importance of implementing best management practices for ESG issues and providing disclosure to stakeholders.

TARGET AUDIENCE

This report is intended for senior decision-makers and implementing teams in a variety of industries and contexts.

- **Banks:** board members, senior executives, chief risk officers, credit officers, investment/research analysts
- **Investors:** board members, chief investment officers, risk officers, portfolio managers, analysts covering the banking sector, analysts covering the forest risk commodity sectors, ESG analysts
- **Regulators:** securities, banking and stock exchange regulators, other relevant government agencies
- **Forest risk commodity companies:** board members, senior executives e.g. finance directors and risk officers, investor relations officers, sustainability officers

REPORT STRUCTURE

Chapter 1 considers **banks**. It reviews the disclosure on ESG-relevant practices of 18 major locally headquartered banks with significant identified links to the sample forest risk commodity companies. It compares the domestic banks' practices with 4 global banks. The review assesses the banks for features that create a higher propensity to adopt ESG practices and the extent to which they already do so. It then presents the rationale for banks to integrate ESG.

Chapter 2 considers the same points relating to **investors** with significant links to forest risk commodity companies, reviewing 12 major domestic institutional investors and 4 international investors. It also provides the rationale for investors to adopt ESG practices.

Chapter 3 covers **company disclosure** on the most material ESG issues based on WWF's 2050 Criteria. It reviews a sample of 40 companies – 21 involved in palm oil, 10 in timber, and 9 in pulp & paper – listed on the Singapore Stock Exchange, Bursa Malaysia and Bursa Efek Indonesia (IDX). The chapter also sets out relevant ESG disclosure regulation for the Singaporean, Indonesian and Malaysian equity capital markets.

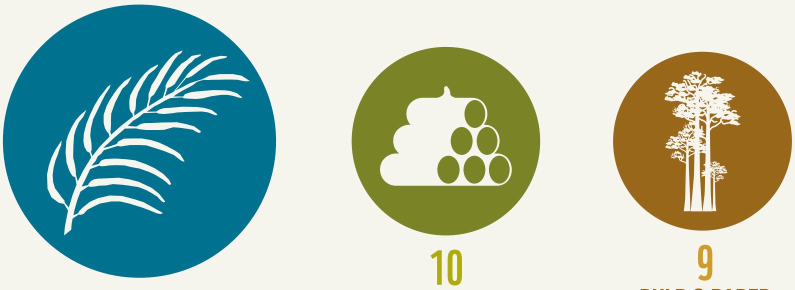
Chapter 4 discusses the **commercial case** for management of ESG issues. It presents the material ESG issues from the prior chapter and sets out the commercial implications of adopting best management practices for each issue. The chapter also covers major developments in the sourcing policies of key international buyers and traders as well as relevant legislation in key markets.

METHODOLOGY

This paper undertakes a formal review of ESG-related practices of 78 organizations. In each case the review is based on assessing public disclosure that the company has made available through annual or sustainability/corporate social responsibility (CSR) reports, through its corporate website, through disclosure of policy documents, or through press releases. The reviews used information published prior to 6 April 2015, particularly from the most recent annual reports. In some cases policy statements from prior reports were also considered. The companies and the financial institutions were not interviewed and have not verified the information contained in this report.

The number of organizations by type and the basis for assessing them is as follows:

FOREST RISK COMMODITY COMPANIES



21 PALM OIL

10 TIMBER

9 PULP & PAPER

WWF's 2050 Key Performance Criteria for palm oil, timber and pulp & paper were used to identify the relevant issues and mitigating actions. The list of questions was then designed in light of the way that companies typically present their practices. This allowed the review to positively record disclosure as equivalent to a policy even where relevant statements were not designated as official policy. Timber companies and pulp & paper companies were assessed with the same set of questions.

FINANCIAL INSTITUTIONS

12 DOMESTIC INVESTORS

4 INTERNATIONAL INVESTORS

18 DOMESTIC BANKS

4 GLOBAL BANKS

The reviews were based on public disclosure provided by the institutions themselves through annual reports, CSR/sustainability reports, corporate websites, official policy statements, and corporate press releases. Membership of multi-stakeholder initiatives was assessed through the members' pages of the initiatives.

The reviews were designed to assess relevant disclosure of ESG practices of local financial institutions even where these statements were not provided as part of an official policy. The disclosure questions tend to be black and white – there is, or is not, disclosure. The discussion of the propensity of financial institutions to adopt ESG practices is by nature more interpretive, and was limited to the local institutions.

CHAPTER 1

Chapter 1 considers banks. It reviews the disclosure on ESG-relevant practices of 18 major locally headquartered banks with significant identified links to the sample forest risk commodity companies. It compares the domestic banks' practices with 4 global banks. The review assesses the banks for features that create a higher propensity to adopt ESG practices and the extent to which they already do so. It then presents the rationale for banks to integrate ESG.

CHAPTER 1 BANKS AND ESG INTEGRATION

KEY FINDINGS

- There is a robust case for banks to integrate ESG into their risk management, reputation management, client/transaction approval, and credit processes.
- Leading global banks disclose an ESG framework covering their client and credit assessment processes and including sector policies for forest risk commodity sectors.
- Domestic banks in general do not have a structured approach and are only at the beginning of the ESG journey.
- Domestic banks can build upon existing client ESG reviews such as those used in Islamic banking subsidiaries and AML assessments.
- Domestic banks have inconsistent sector definitions when disclosing loan portfolio by sector, making it challenging to compare their levels of portfolio ESG risk.

This chapter presents the findings of a public disclosure review of the level of ESG integration by selected domestic banking groups, comparing them to global banks. (It does not examine the actual implementation of the ESG policies, and there may exist gaps between policy and implementation standards on the ground.) It starts with specific drivers for the banks to adopt ESG-related practices, before presenting the results of the review. The second section presents the broader rationale for sustainable banking, including reviewing a number of multi-stakeholder initiatives that international financial institutions use to support their ESG strategies.

On the basis of public disclosure, with few exceptions the domestic banks reviewed have taken very few steps on the journey to adopting sustainable finance. Where the banks have started to assess ESG factors in their choice of client, this is primarily in the context of Islamic subsidiaries, which apply ethical screens to customers, or as part of AML requirements.

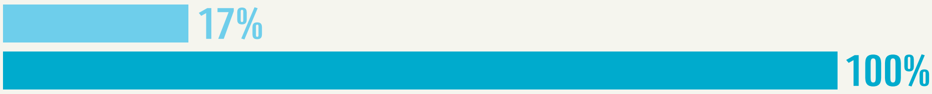
The domestic banks typically do not show a structured approach to broader ESG concerns, i.e. systematic ESG integration is lacking. As shown in the summary table below, only three out of eighteen refer to ESG in their client approval beyond AML and Sharia screens, and only four out of eighteen incorporate ESG into credit assessment processes. Only one of them has a policy related to forest risk commodities and none of them disclose any training on ESG issues.

A more detailed table with additional criteria and assessment of individual institutions is provided further on in this chapter. This table shows that eight of the eighteen domestic banks have designed products for micro-finance or low income market segments. Four gave details of financing of companies providing environmental solutions. One, Bank Negara Indonesia, is a member of a major relevant international multi-stakeholder initiative.

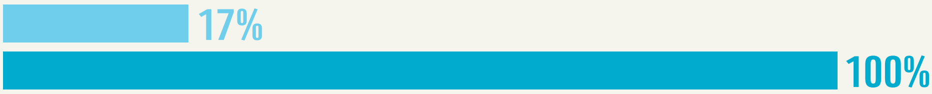
This is a significant contrast with the four global banks covered. All four state that ESG is a risk factor, either under sustainability, credit, or reputation risk, and they all provide sector-specific ESG policy statements. All four also provide details of financing for companies that provide environmental solutions.

DOMESTIC BANKS – DISCLOSURE AND ESG INTEGRATION

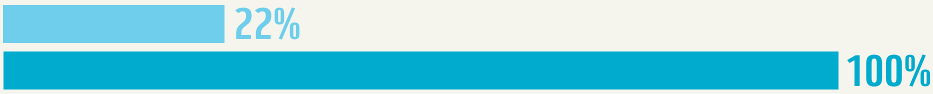
Is there a high level statement on sustainable lending?
There were very few statements of intent from domestic banks. All three were from Indonesian banks.



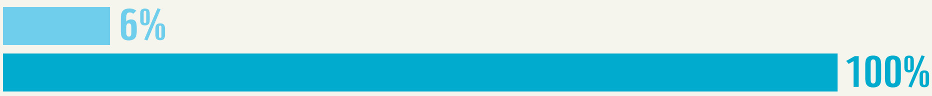
Does client approval include an ESG screen for factors other than Sharia?
Almost all the domestic banks have Islamic subsidiaries that operate ethical screens, however, broader ESG factors were rarely considered.



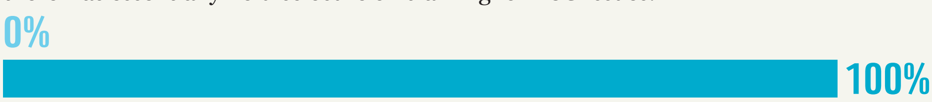
Is ESG used as a tool in credit processes?
The lack of consideration of ESG in credit likely indicates unmanaged risks.



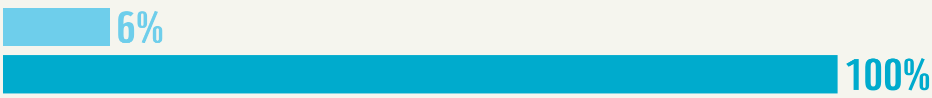
Is there disclosure of an ESG policy relating to forest risk commodities?
All of the global banks have forest risk commodity related policies. Only one domestic bank had a policy specific to palm oil.



Is there disclosure of training on ESG?
Although most of the domestic banks provide disclosure on human capital management, there was essentially no disclosure on training for ESG issues.



Is the bank a member of relevant multi-stakeholder initiatives?
The global banks are all members of at least three of the four multi-stakeholder initiatives reviewed.



Notwithstanding the difference in disclosure levels, the domestic banks have several drivers to improve their ESG practices. Some drivers are equally relevant to the global banks:

- A failure to address systemic ESG challenges will affect economic growth and returns in the longer-term, so financing must play a role in addressing ESG issues.
- Regulatory standards on ESG are tightening in many markets affecting banks and their clients, creating opportunities for banks that are proactive.
- ESG can enhance credit risk and reputation risk management.

Other drivers that are relevant to the domestic banks reviewed include:

- Where banks are significant national champions, ensuring they have strong ESG standards is consistent with such leadership, especially where they are seeking to become regional champions.
- Banks that have substantial shareholders with a focus on ESG should adopt these shareholders' standards.
- Islamic banks are by nature concerned about social and community factors. Environmental factors may be a natural extension of these concerns.
- Banks with significant environment or forest initiatives as part of their CSR programmes should ensure that client activities do not worsen environmental problems.
- The domestic banks have exposure to certain high risk industries, particularly forest risk commodity sectors.

KEY RECOMMENDATIONS

BANKS

- Assemble cross-functional teams (risk, reputation, credit, human resources etc.) with executive-level involvement to address ESG opportunities and risks.
- Develop an ESG strategy and implementation framework including sector policies.
- Implement, monitor and report on the ESG strategy.
- Join multi-stakeholder initiatives and other banking initiatives such as the Banking Environment Initiative (BEI) [15] or Equator Principles. [16]
- Encourage and support national banking associations to create voluntary sustainable finance guidelines.
- Islamic finance councils may wish to consider whether there is scope to include environmental factors.

The 2014 WWF publication *Environmental, Social, and Governance Integration for Banks: A Guide to Starting Implementation* sets out many of these steps in more detail. [17]

BANKING REGULATORS

- Produce national guidelines for banks to support integration of environmental and social risks into credit evaluation processes.
- Support banks through training and capacity-building programmes.
- Introduce reporting standards to increase bank transparency on management of environmental and social risks in portfolios.

1. DOMESTIC BANKS' LEVEL OF ESG INTEGRATION

1.1 SELECTION OF BANKS

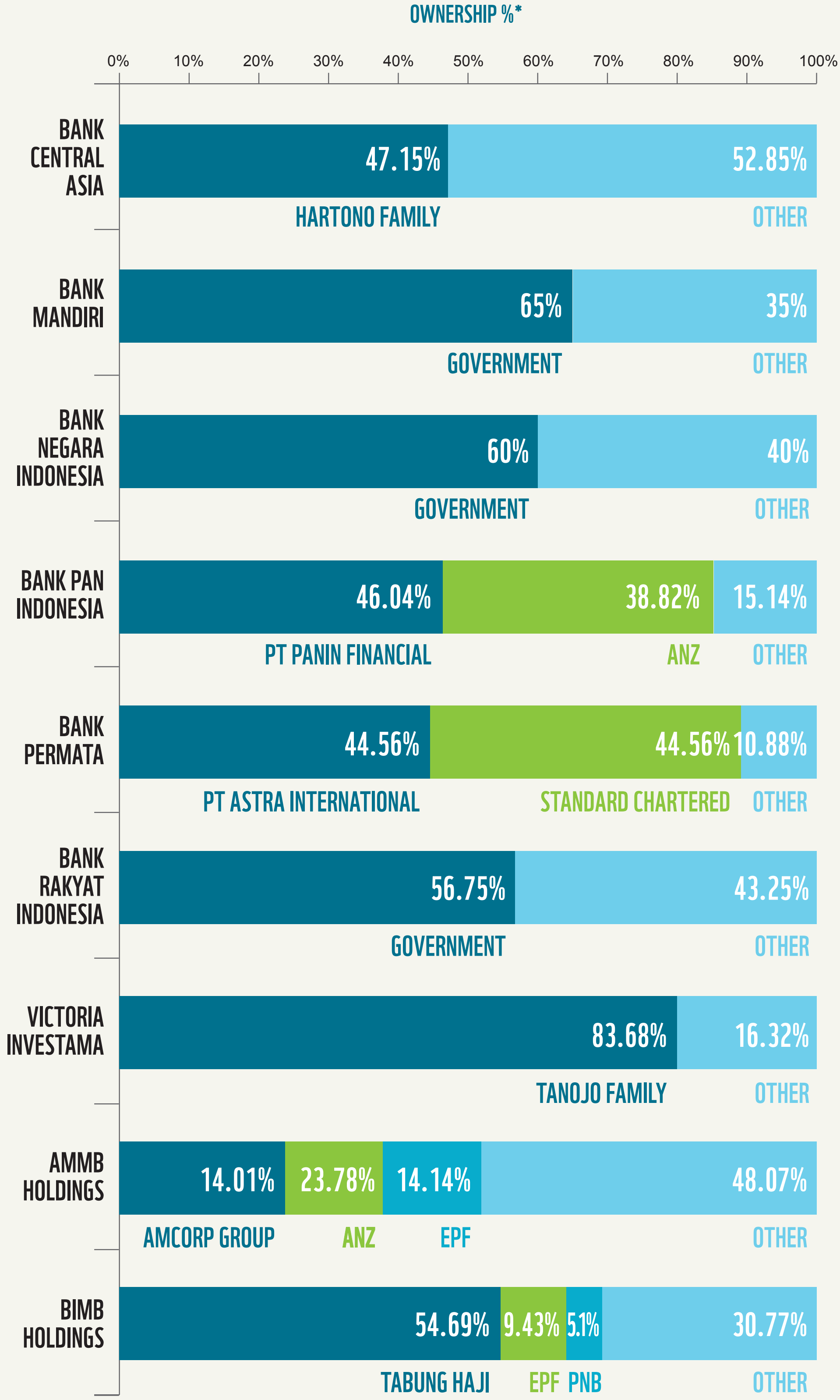
Banking groups were selected on the basis of relationships with the sample forest risk commodity companies, as established from publicly available sources and financial databases. Banks domiciled in Singapore, Indonesia, or Malaysia that had the most significant relationships by number or size on a variety of measures – loans, working capital, underwriting assistance, etc. – were included. Asian subsidiaries of global banks were not selected. [18]

1.2 FACTORS RELEVANT TO THE ADOPTION OF ESG AT BANKS

There are a number of factors that can prompt banks to act on ESG aside from purely commercial factors. These include:

- Where banks are significant national champions, ensuring they have strong ESG standards is consistent with such leadership, especially where they are seeking to become regional champions.
- Banks that have substantial shareholders with a focus on ESG may have an additional reason to improve ESG integration.
- Islamic banks are by nature concerned about social and community factors. Environmental factors may be a natural extension of these concerns.
- Banks with significant environment or forest initiatives as part of their CSR programmes should ensure that client activities do not worsen environmental problems.
- Domestic banks have exposure to certain high risk industries, particularly forest risk commodity sectors.

DOMESTIC BANKS – OWNERSHIP STRUCTURE AND VISION



VISION**
To be the bank of choice and a major pillar of the Indonesian economy

VISION**
To be Indonesia's most admired and progressive financial institution

VISION**
To be a bank that excels, is prominent and advanced, in delivering services and performance

VISION**
To transform Panin Bank into one of Indonesia's leading consumer and business banks

VISION**
To be the pioneer in delivering innovative financial solutions

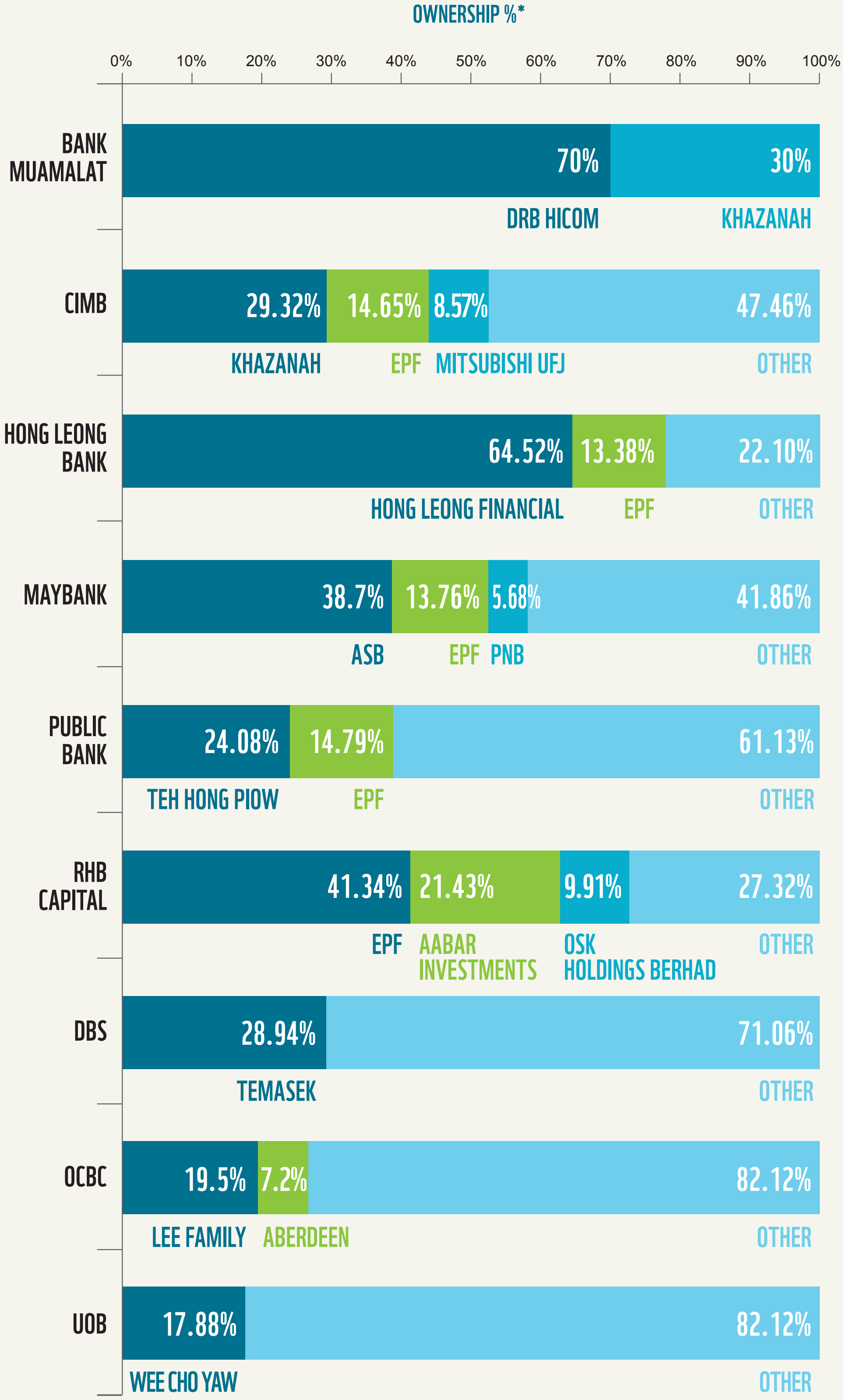
VISION**
To be the leading commercial bank that always prioritizes customer satisfaction

VISION**
To be an international scale top-tier investment company and provide one-stop financial service solutions that are trustworthy through its subsidiaries

VISION**
To be Malaysia's preferred diversified, internationally connected financial solutions group, and take pride in growing your future with us

VISION**
To be an investment holding company for Malaysia's pioneer Sharia-compliant business entities, involved mainly in Islamic banking, takaful and stockbroking

*Sourced from annual reports, websites and stock exchange filings. **In most cases the banks present an explicit vision statement, in some cases the vision statement used is extracted from relevant sections of the banks'descriptions.



VISION**
To deliver best value to the stakeholders

VISION**
To be the leading ASEAN company

VISION**
To be an outstanding financial services organization, highly competitive and profitable, where people make the difference

VISION**
To Be A Regional Financial Services Leader

VISION**
To sustain the position of being the most efficient, profitable and respected premier financial institution in Malaysia

VISION**
To be a Leading Multinational Financial Services Group

VISION**
To be the Asian Bank of Choice for a New Asia

VISION**
To help individuals and businesses across communities achieve their aspirations by providing innovative financial services that meet their needs

VISION**
To be a Premier Bank in the Asia-Pacific region, committed to providing Quality Products and Excellent Customer Service

1.2.1 OWNERSHIP

Substantial shareholders often have an influence on operating procedures at the companies they hold. Where such shareholders have a strong approach to ESG, this can increase the propensity of a company to strengthen its ESG practices.

In the case of the domestic banks there are a number of examples of shareholders with an enhanced interest in ESG, including state actors, global banks and other institutional investors.

Where a bank is state-owned or state-linked this may create extra consideration of environmental and social factors in its choice of business relationships. In Indonesia, the government is expected to bring in regulation to enhance consideration of environmental factors in credit assessment, and it is natural that state banks lead the implementation. Bank Mandiri, Bank Negara Indonesia and Bank Rakyat Indonesia are all state-owned Indonesian banks, and notably all disclose steps taken to assess ESG in credit processes.

CIMB and Bank Muamalat both have Khazanah Nasional Berhad, the government of Malaysia's strategic investment fund, as a controlling shareholder. Khazanah is increasing its consideration of ESG. It states in its 2013 corporate responsibility report: "Our project to develop a sustainability-adjusted valuation model that incorporates the impact of ESG (Environmental, Social and Governance) factors when valuing companies, continued in 2013." Further, its mandate extends to "Active development of Human Capital for the nation", which is an ESG concern. It was beyond the scope of the review to assess the level of these two banks' human capital management disclosure compared to other banks, though it is notable both have an educational programme as part of their CSR initiatives. It would be a natural extension of Khanazah's remit to encourage CIMB and Bank Muamalat to use ESG assessments to support their banking clients.

A number of the major shareholders of Malaysian banks are institutional investors. EPF, PNB and Tabung Haji sit on the steering committee for the Malaysian Code for Institutional Investors, which includes as a principle incorporation of ESG in investment processes. It is natural to extend this thinking to the banks in which they have large holdings.

A further consideration is the presence of global banks as important shareholders. Bank Pan Indonesia and AMMB Holdings both have ANZ as a significant shareholder, while Standard Chartered is a major investor in Bank Permata. Both of these global banks have significant disclosure relating to their ESG integration and this represents an opportunity for knowledge-sharing between the organizations. It is consistent for global banks to ensure that banks in which they hold significant stakes implement group ESG policies and sustainability measures.

There is also a role for international institutional investors even if they only have minority stakes. Such investors have engaged with banks on ESG issues in the past. [19]

1.2.2 OTHER FEATURES

Certain banking business models are more naturally associated with considering the social implications of their choice of clients. BIMB and Bank Muamalat are both fully Islamic banks that will not provide financing for certain "sin" industries. Since environmental stewardship is also a tenet of Islam, Islamic banks are well positioned to incorporate wider ESG issues into their client approval processes.

Bank Rakyat Indonesia's business model lends itself to greater consideration of ESG concerns. It is focussed on the micro finance/small and medium-sized enterprises (SME) sector. As such it is more closely involved in financing activities at the community level, which supports poverty alleviation.

DBS is also an interesting case. It was previously the Development Bank of Singapore and has a heritage of supporting the Singaporean economy. This comes through today in DBS championing social entrepreneurs through its CSR and community programmes. Integrating ESG into its client approval processes would be consistent with the Bank's historical roots.

1.2.3 VISION

Banks' vision statements provide a guiding principle for their strategy, operations and culture. The review gathered together the vision statements for each bank to identify the synergies between the vision and the principle of embedding ESG in client approval and credit assessment.

A number of common patterns emerged from the vision statements, with some banks focussing on regionalization, some on innovation, and some on growth of clients' businesses or the national economy.

ESG integration is highly relevant for banks seeking to expand operations beyond national borders. A regional ESG strategy or framework can help banks make fewer mistakes in less familiar geographies and sectors. This is particularly important for new frontiers such as Myanmar, where ESG-related regulations, guidance and practices are not all in place and there can be more unknowns. In addition, for markets that have green credit guidelines in place, such as China or Vietnam, new entrants face a greater concentration of ESG risks if they take on business that incumbents are refusing on ESG grounds. DBS, UOB, Maybank, CIMB and RHB Capital all refer to regional or multinational ambitions.

A second relevant area is innovation, where ESG provides fertile opportunities. Banks could introduce products focussed on inclusion or access to finance, such as micro-insurance or service platforms for the rural poor, perhaps with features specifically developed for agricultural smallholders. On the environmental side, banks may consider financing for renewables, clean technology, and other environmental solutions – for example methane capture from palm oil mill effluent (POME) and other sustainability improvement projects related to certification. There may also be options in other forms of ethical finance in addition to the demand for Sharia products.

OCBC and Bank Permata both explicitly mention innovation, while Bank Mandiri and Bank Negara invoke the notion of innovation in their vision statement.

A third theme is growth, which is clearly a focus for all the banks. AMMB Holdings refers to growing with its clients. As set out in the commercial case (chapter 4), many components of ESG underpin growth in the longer term. Banks are well positioned to support companies in developing the relevant expertise and to facilitate their clients' access to new markets or international customers that require higher sustainability standards. This is especially true in the forest risk commodity sector, where market access conditions are tightening.

Bank Central Asia's vision expresses a similar theme, though at the national rather than company level, in its ambition to be a major pillar of the Indonesian economy. The Indonesian economy includes a high level of natural resource companies that face high ESG risks. It fits with the vision for Bank Central Asia to help address these through its banking relationships, particularly in resource sectors.

1.2.4 CSR ACTIVITIES

Corporate social responsibility (CSR) is a wide-ranging concept. In Asia it is typically used to refer to philanthropy or community investment. In other markets it has a broader use, more like the way that ESG is used in this report or the concept of shared value. [20] The broad use of CSR includes core business areas such as human capital management or research and development expenditure in light of emerging social and environmental trends. As the domestic banks usually distinguish between CSR and human capital management, the latter is considered in a separate point.

The review covered CSR activities primarily to highlight that where banks are making efforts to reduce their direct environmental footprint, or where they have significant initiatives in forest conservation, it is inconsistent to finance companies or activities that are damaging forests and other ecosystems.

The domestic banks show a significant variation in their interpretations of CSR, and this is reflected in a wide variation in the quality and content of their CSR disclosure. The range encompasses website pages with a few community initiatives to standalone sustainability reporting typically addressing the direct ESG footprint of the banks' own operations.

Within the CSR sections, the most frequent disclosure from the domestic banks is on philanthropic initiatives. Some banks link these initiatives to the communities in which they operate.

The environmental reporting is typically weaker than other areas. Some banks mention a few initiatives to manage their own footprints, such as reducing energy, water and paper use.

A number of the banks mention conservation initiatives. These include large tree-planting programmes by Bank Negara Indonesia and Bank Pan Indonesia. Bank Mandiri, Bank Permata, Public Bank and Bank Muamalat all have small tree-planting initiatives. Bank Rakyat Indonesia has a mangrove conservation programme, while Maybank has contributed to organizations working on conservation initiatives for tigers.

It is logical for banks with conservation programmes to ensure that they are not financing client activities that irreparably damage ecosystems and natural heritage. This can be motivating for the many employees who care about nature and conservation, and can assist in talent recruitment and retention.

1.2.5 HUMAN CAPITAL MANAGEMENT

Human capital management is a critical issue for banks, particularly in higher growth markets where talent is considered a constraint. The banks generally provide disclosure on this topic in a dedicated section of the annual report, frequently with statistics about the staff and their training.

The banks understand the necessity of and returns from investing in labour force development. A natural extension of this expertise is to consider how their clients are managing human capital and share knowledge with them, especially for labour-intensive sectors.

Forest risk commodity companies' disclosure on labour rights and occupational health and safety is very limited, so there is a significant opportunity for banks to engage with their clients on these key issues. (For labour rights 57 per cent of the palm oil companies and 11 per cent of the timber and pulp & paper companies provide mininum standard disclosure; while for occupational health and safety (OHS), 48 per cent of palm oil companies and none of the timber and pulp & paper companies provide statistics.)

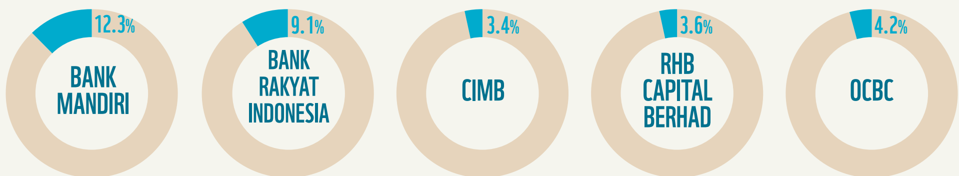
1.2.6 HIGH-RISK INDUSTRIES

Consideration of ESG is most relevant where there is exposure to high-risk industries, such as forest commodity production. The argument is strongest for banks with a concentration of exposure, however, any relationship with a company from high ESG risk industries can trigger issues such as reputational risk. Banks can find value in joining relevant multi-stakeholder initiatives, such as the RSPO, to benefit from their expertise and use this to develop sector-level policies to help mitigate and manage the impacts of high ESG risk.

The following table sets out proportions of lending to agriculture/forestry-related sectors and some notable relationships for a selection of the banks reviewed.

PROPORTION OF LENDING IN AGRICULTURE/FORESTRY SECTORS[21]

Agriculture, wood and wood products as a proportion of bank credit (2014)	Agriculture as a proportion of loans (2013)	Primary agriculture as a proportion of total loans and advances portfolio (2014)	Agriculture, hunting, forestry & fishery as a proportion of total loans and advances (2013)	Agriculture, quarrying, mining as a proportion of loans and advances (2014)



Notable relationships [22]	Notable relationships [22]	Notable relationships [22]	Notable relationships [22]	Notable relationships [22]
•Golden Agri-Resources •Bumitama Agri •Indah Kiat Pulp and Paper •Pabrik Kertas Tijwi Kimla	•BW Plantation •Indofood Agri Resources •Indah Kiat Pulp and Paper •Pabrik Kertas Tijwi Kimla	•Genting Plantation •Wilmar International •Bumitama Agri	•Wilmar International	•Astra Agro Lestari •Bumitama Agri •Wilmar International •Fajar Surya Wisesa

1.3.1 SPECIFIC DISCLOSURE

The following table presents a disclosure review of the 18 domestic banks and 4 global banks to identify where banks have processes, policies or products that embed ESG considerations in the provision of finance. For each issue covered, the table indicates where each bank makes a clear statement relating to the issue. The guidelines used to assess each issue are provided in the commentary.

		INDONESIA							MALAYSIA									SINGAPORE			GLOBAL			
REVIEW AREA	DISCLOSURE FACTORS	Bank Central Asia	Bank Mandiri	Bank Negara Indonesia	Bank Pan Indonesia	Bank Permata	Bank Rakyat Indonesia	Victoria Investama	AMMB Holdings	BIMB Holdings	Bank Muamalat	CIMB	Hong Leong Bank	Maybank	Public Bank	RHB Capital Berhad	DBS	OCBC	UOB	ANZ	HSBC	Standard Chartered	Westpac
COMMITMENT	Sustainable lending statement		●	●			●													●	●	●	●
RISK MANAGEMENT	Lists major risk categories	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
	ESG a separate category on list																				●		●
REPUTATION AND RELATIONSHIPS	Reputation risk process	●	●	●	●	●	●		●		●	●		●	●	●	●			●	●	●	●
	AML processes	●	●	●	●	●	●				●	●		●	●	●	●			●	●	●	●
	Sharia exclusions*	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●			●	●	
	Other ESG client approval restriction			●		●	●													●	●	●	●
CREDIT AND ESG	Credit process covers ESG		●	●			●							●						●	●	●	●
	Forest ESG policy disclosure			●																●	●	●	●
	Training on ESG																			●	●	●	●
ESG IN PRODUCTS **	Islamic finance	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●			●	●	
	Financial inclusion		●	●	●		●			●	●			●	●					●		●	●
	Green finance			●			●					●				●				●	●	●	●
MULTI-STAKEHOLDER INITIATIVES	UNEP FI			●																●	●	●	●
	Equator Principles																			●	●	●	●
	BEI																					●	●
	RSPO																			●	●	●	

*This records the presence of Sharia departments/subsidiaries.
In the case of BIMB Holdings and Bank Muamalat, Sharia screens apply to the entire entity.
**This records the disclosure of any relevant product or service in the relevant category, hence the different treatment of Islamic finance from Sharia exclusions.

1.3.2 COMPARISON TO GLOBAL BANKS

The four global banks selected are mainstream banks with a significant presence in Asia-Pacific markets. They all disclose commitments and a framework to consider sustainability in their lending practices (e.g. sector policies and client and transaction approval procedures).

HSBC and Westpac set out sustainability risk as a risk category in its own right. Standard Chartered and ANZ handle ESG risks primarily under reputational risk or credit risk.

All four of the banks state that they consider ESG in client approval and in credit processes. They also provide sector-specific policies including for forest and palm oil (sometimes covered under agribusiness/agriculture policy). They all provide some disclosure on staff training for ESG.

All four offer products based on sustainability or ESG considerations. In addition they are each members of three or more relevant international multi-stakeholder initiatives.

In summary, the global banks appear to recognize and take steps to manage reputational and credit-related risks from ESG as well as identifying opportunities. This contrasts strongly with the domestic banks reviewed, which as a group are only just starting to consider the issues.

1.3.3 DETAILED REVIEW

1.3.3.1 COMMITMENT

"As intermediaries in the financing system, banks have a critical role to play in advancing sustainability. Sustainability is a part of our top management's commitment and it brings value to our stakeholders. We apply the sustainability principle with an environmental and social risk analysis in the credit decision process."

Peter Stock
President Commissioner
Bank Negara Indonesia

A high-level statement signals that a bank recognizes that the ESG characteristics of its clients present risks and opportunities for itself and the economy. It can be an effective tool to have senior executives make such statements, which gives a signal of importance and intent to relevant functions. Usually they are presented in credit policies that focus on ESG or sustainability.

Only three domestic banks make a clear statement on assessing ESG risks and opportunities at their clients. As an example, in Bank Negara Indonesia's sustainability report, President Commissioner Peter Stock says in the opening statement: "As intermediaries in the financing system, banks have a critical role to play in advancing sustainability. Sustainability is a part of our top management's commitment and it brings value to our stakeholders. We apply the sustainability principle with an environmental and social risk analysis in the credit decision process."

In reviewing this section, statements on community development funds, environmental initiatives and responsible lending policies that consider only the clients' ability to repay were not considered sufficient.

1.3.3.2 RISK MANAGEMENT

ESG risks and associated management processes apply across more than one category – credit, reputation and potentially systemic risk management. Consequently it can be helpful to oversee the implementation of ESG risk management from one central area. The review first considered disclosure of general risk management processes, finding that all of the banks provided detailed disclosure. It then assessed the list to see whether ESG was set out in its own high-level category. None of the domestic banks set out sustainability or ESG risk in this way. For the global banks, HSBC and Westpac set out sustainability risk in its own category, while Standard Chartered and ANZ considered this risk area under reputational risk or credit risk.

1.3.3.3 REPUTATION AND RELATIONSHIPS

One key question for banks is whether there are potential clients that they do not wish to do business with. Aside from narrow financial reasons – the client might not repay – banks may turn away business for regulatory reasons (such as AML), ethical or faith-based reasons, and reputational reasons. This section reviews the domestic banks that are considering broader ESG issues, before looking at relevant reputational, ethical and regulatory disclosure.

The global banks all state that ESG is a factor in their choice of clients. HSBC, Standard Chartered and Westpac all disclose specific minimum ESG standards that forest risk commodity companies must meet as a condition of providing banking services.

There were only three domestic banks that explicitly referenced ESG in client approval. Bank Negara Indonesia was clearest, basing certain decisions on a poor performance on the Indonesian government's environmental standard, PROPER. The bank states: "BNI no longer provides loans for corporations that have red or black PROPER rating." It also provides disclosure of total corporate loans by PROPER rating over the last three years, demonstrating the implementation of this policy.

Bank Rakyat Indonesia states that it has a "policy to offer investment or working capital loans only to industries that apply environmentally friendly practices". However it does not provide details.

Both Bank Mandiri and Maybank apply ESG standards in credit assessments. In Bank Mandiri's case it was not possible to confirm from the disclosure whether ESG assessment also applies to client approval.

Generally the banks provided disclosure of the steps they take to manage reputational risk. The review of reputational risk management looked for disclosure beyond providing a definition to include specific action taken to address reputational risks.

From the domestic banks, thirteen disclosed reputational risk management in its own section or paragraph and set out steps to address it. These steps generally included customer complaint handling, putting crisis management plans in place, and carefully reviewing new products. Generally reputational risks due to the nature of the client's activities were not mentioned.

AML refers to the set of processes banks use to vet new and existing clients to ensure that they are not inadvertently helping to legitimize the proceeds of illegal activity. The processes are based on legislation. This is an example of the principle even in mainstream finance that there are certain activities that banks should not facilitate. AML provides a good starting point for ESG client approval and a set of processes and procedures that banks can build on as ESG policies are developed.

Twelve of the domestic banks provide statements on AML that include specific steps they are taking. For example, Bank Muamalat sets out the building blocks of its approach

ISLAMIC FINANCE

ISLAMIC BANKS REFUSE CLIENTS FROM CERTAIN INDUSTRIES OR WITH CERTAIN FINANCIAL CHARACTERISTICS ON ETHICAL GROUNDS IN ACCORDANCE WITH SHARIA RULES, LEADING TO SHARIA EXCLUSIONS

in its Annual Report, including setting of roles and responsibilities, training, client and transaction due diligence (including research needs), reporting to and assisting enforcement agencies, maintaining appropriate records, processes to escalate concerns internally, independent review of internal controls, and disciplinary actions for breaches.

In Islamic finance, banks refuse clients from certain industries or with certain financial characteristics on ethical grounds in accordance with Sharia rules, leading to Sharia exclusions. Two of the domestic banks reviewed were exclusively Islamic and fifteen had Islamic subsidiaries. Three of the global banks had Islamic subsidiaries/departments. There is a tremendous opportunity for "mainstream" finance to adopt the principle, embedded in Islamic finance, that banks should consider the effects of the activity they finance on society. At the same time, Islamic Councils may wish to extend exclusions to those companies over-using, destroying or polluting environmental resources such as water, forests, land or clean air.

The global banks typically provide specific policy statements setting minimum ESG requirements that clients must satisfy. Standard Chartered provides an example in its Palm Oil Position Statement: [23]

"Standard Chartered is aware that in some circumstances environmental and/or social risks and impacts cannot be successfully mitigated. In the palm oil sector we will therefore restrict the provision of financial services to Corporate and Institutional, Commercial, and Retail Business Clients who:

- Do not convert or adversely impact High Conservation Value Forests (HCVF) or primary tropical moist forest for palm oil plantations
- Do not use fire in their plantation operations, including in the clearance and preparation of land for planting
- Do not significantly impact upon, or have operations located within, UNESCO World Heritage Sites and RAMSAR Wetlands
- Follow IFC Performance Standard 6 where operations impact upon Protected Areas or Critical Habitats."

1.3.3.4 CREDIT AND ESG

While some elements overlap, credit assessment and client approval are somewhat different processes. Four of the domestic banks state that ESG is a component of credit analysis. However, only one of them (Bank Negara Indonesia) provides sector-level policy or refers to forest commodities, while none disclose training on ESG in credit assessments. All of the global banks provide disclosure on each of these elements.

In its 2013 sustainability report, Maybank monitors "ESG risk to ensure that appropriate due diligence around environmental and social risks is carried out". Bank Mandiri has taken similar steps: "To improve the Bank's social role and concern to the environmental risk and as an implementation of Good Corporate Governance (GCG), the Bank has set up a Guideline for Technical Analysis of Environmental and Social in Lending which is used as a reference in analysing environmental risk in a credit analysis."

Bank Negara Indonesia provides enhanced disclosure with sector examples that include forest commodities: "In the palm oil industry, we encourage the large palm oil producers to have a research unit that measures the environmental impact of the plantation." The results are also disclosed in the sustainability report: "BNI continues recommending palm oil companies that apply for or have secured loans to implement sustainability principles or obtain ISPO/RSPO certification. Up to 2013, nine companies have obtained ISPO/RSPO certification. Eight companies were in the process of obtaining the certification."

Bank Rakyat Indonesia states the following: "for other service products, we always conduct investment assessment based on Bank Indonesia provisions, to determine the feasibility of loan disbursement. In this context, we put our concern on the fulfillment of environmental responsibility (RKL & RPL, AMDAL), fulfillment of responsibility for employee, OHS implementation, and governance compliance."

4 BANKS

ONLY 4 OUT OF 18 DOMESTIC BANKS STATE THAT ESG IS A COMPONENT OF CREDIT ANALYSIS

The global banks have more specific statements. HSBC sets out policy relevant to forest risk commodity companies in its March 2014 document, *HSBC Statement on Forestry and Palm Oil.* [24] This states the bank's expectations for companies operating in these sectors and the support it is willing to provide. HSBC will end banking relationships with companies unwilling or unable to meet the required standards. These standards are provided, with the policy based on certification. The bank states:

"Forest certification is now mature and HSBC therefore expects all its forestry customers in high risk countries to achieve FSC/PEFC certification by December 2014. Palm oil certification is less well developed and HSBC therefore expects all its customers who grow oil palm all to have all of their plantations certified to RSPO standards by December 2018, proving they are on a path to achieve that in 2014."

HSBC also provides an incentive for palm oil companies through discounted finance. It states: "As certification is not yet mainstream, we will help our customers to understand what is needed to achieve certification, by providing them with information and other support. HSBC has developed a specific product – discounted finance for RSPO-certified palm oil that will be offered to our customers from 1 July 2014 – to incentivize trade in sustainable palm oil, to encourage them to achieve RSPO certification more rapidly."

The global banks also provide some details on building staff capacity to conduct ESG assessments and incorporate ESG issues into credit processes.

ANZ reported against prior commitments on ESG training in its 2014 shareholder review. [25] The bank states that it incorporated the corporate sustainability framework into essential induction training, had 1,333 completions of its online course, and had 263 employees that completed its Sustainability Leadership Program. The new commitments include training on ESG both internally and for clients:

- "Deliver sustainability workshops for mid-size corporate customers in two Asian markets.
- Continue to implement mandatory online Social and Environmental risk training for IIB and Commercial employees with the authority to make credit decisions and train a further 500 employees in these Divisions in lending, risk and support roles.
- Update our Sustainability Leadership Program and pilot it with 100 employees in emerging markets in Asia and the Pacific."

1.3.3.5 ESG IN PRODUCTS

Banks can achieve a number of goals through providing products and services that contain ESG as a core component of the offer. In the longer term a transition to a sustainable economy will only be possible with significant financial support. For example, sustainable energy and transport systems have significant financing requirements. Banks can also differentiate themselves, find niche markets, and enhance their reputation through offering products with enhanced ESG characteristics.

0 BANKS

NONE OF THE DOMESTIC BANKS DISCLOSED TRAINING ON ESG

The review differentiated three sorts of offerings: Islamic finance; financial inclusion, which refers to products that aim to enhance access to finance such as microfinance; and green finance, which was defined broadly for this study and refers to funds provided for renewable energy projects, clean technology, or environmental service providers. Participating in government subsidized initiatives such as the Malaysian Green Technology Financing Scheme is not considered within this section.

Seventeen of the domestic banks offer some kind of Islamic product in part or all of their business, and three of the global banks have Islamic subsidiaries/departments. Islamic finance is based on screening out certain "sin" sectors and supporting community development. While screening and excluding clients may be considered to represent an opportunity cost, there is a strong countervailing argument. In an interview set out in the annual report, Bank Muamalat's CEO states: "The element of ethics is not regarded as a limitation but rather a value added factor in Islamic Banking, which should be considered in every decision making process to strike a balance between profit and social objectives."

Financial inclusion is the least well defined of the three types of offering, partly as it is not clear where the cut-off should be – how poor should a client be for a product to count as inclusion? For example, should Bank Central Asia's niche in two-wheeler vehicle financing be considered an example of supporting access to finance? The review only considered cases where the intention to provide financial inclusion or access to finance, or to target micro-sectors, is directly stated or can be inferred. It found that eight of the domestic banks and three of the global banks have relevant products. However, in many cases these are small initiatives, rather than representing a broader focus on supporting poorer demographics.

Four of the banks were assessed as providing green finance due to mentioning support for businesses that provide environmental solutions. For example, RHB Capital collaborates with the Japan Bank for International Cooperation to provide finance to SMEs engaged in greenfield clean development mechanism (CDM) projects. CIMB's infrastructure fund manager, Capital Advisors Partners Asia, is focusing on renewable energy investments and looking at the ESG aspects of its investments."

The global banks are typically further advanced. For example Westpac makes the following statements on its financing for environmental solutions: "$8.0 billion lent to the CleanTech and environmental services sector significantly exceeding our commitment to make available up to $6 billion by 2017. 59% of total energy financing is directed to renewable energy generation (including hydro, wind and solar)."

1 BANK

ONLY 1 OUT OF 18 DOMESTIC BANKS HAS JOINED A MULTI -STAKEHOLDER INITIATIVE COMPARED TO THE GLOBAL BANKS EACH SIGNING UP TO AT LEAST 3 INITIATIVES

1.3.3.6 MULTI-STAKEHOLDER INITIATIVES

The multi-stakeholder initiatives are described further below and are a significant source of expertise. All of the global banks participate in the initiatives. However, from the domestic banks reviewed the only bank that has joined one is Bank Negara Indonesia, which is a signatory to UNEP FI.

This represents a significant opportunity for the domestic banks to develop their practices. For example, the global banks use RSPO certification as a due diligence tool to help in the client approval processes. Three of the four banks reviewed (ANZ, HSBC and Standard Chartered) are members of RSPO, while three of them (HSBC, Standard Chartered and Westpac) refer to RSPO in their approval policies.

2. DRIVERS FOR ESG INTEGRATION BY BANKS

There are multiple reasons for banks to consider ESG in their choice of client and financing activities. This section considers the business case. The major commercial reasons for banks to integrate ESG include:

- Bank performance is linked to the economy, creating an interest in addressing systemic ESG risks such as climate change.[26]
- ESG practices can enhance credit risk management.[27]
- Supporting clients' ESG development enhances client relationships.[28]
- ESG can reduce reputational risks.[29]
- Green finance offers new product opportunities.[30]
- Regulatory standards are tightening in many markets affecting banks and their clients.[31]

2.1.1 ADDRESSING SYSTEMIC RISKS

A bank's financial performance is tied to the performance of the broader economies in which it operates. This gives banks an incentive to act where ESG issues present systemic risks to national economies or the global system as a whole. This is particularly the case where banks are funding activities that exacerbate the risks.

The World Economic Forum's Global Risk Report provides an analysis of perceptions of major risks by likelihood and impact, together with the links between them. Water crisis and failure of climate change adaptation rank among the highest risks.

Standard & Poor's (S&P) echoes these views in its report *Climate Change is a Global Mega-Trend for Sovereign Risk*. Key findings include that "Climate change is likely to be one of the global mega-trends impacting sovereign creditworthiness, in most cases negatively." S&P finds these impacts will be felt through effects on economic growth.

The Bank of England has also recognized that fundamental environmental changes could "affect economic and financial stability and the safety and soundness of financial firms, with clear potential implications for central banks". [32] Mitigation of climate change through necessary regulation may pose a risk to financial systems, and the Bank is undertaking a review of these risks. [33]

Banks can reduce ESG-related systemic risks such as climate change through limiting their financing of companies or activities that contribute to the risks, and supporting clients in taking steps to improve sustainability. Forest risk commodity companies are an important part of this process as it is not possible to mitigate climate change without addressing deforestation, forest degradation and other agriculture-related emissions.

2.1.2 ESG IN CREDIT MANAGEMENT

Company mismanagement of ESG issues can create risks to assets in various ways. Community unrest or significant safety incidents can result in disruption of operations or even destruction of assets, while licences can be revoked following a poor track record of pollution, labour unrest, or illegal activities such as illegal deforestation.

Global banks typically address these issues through embedding ESG assessment into client approvals and credit processes. [34] Leading banks use sector-level policies for high-risk sectors, such as forest risk commodities, to highlight specific standards that their clients should meet. WWF's *Environmental, Social and Governance (ESG) Integration for Banks: A Guide to Starting Implementation* provides examples of sectors and issues for which banks typically have policies in place to support their internal client and transaction approval processes.

2.1.3 IMPROVED CUSTOMER RELATIONSHIPS

Monitoring and supporting clients on ESG performance can enhance client relationships. Working with the Consumer Goods Forum (CGF), the Banking Environment Initiative (BEI) has devised the BEI Soft Commodities Compact to help clients improve their standards in relation to soft commodity sourcing. [35]

The commitments include working with consumer goods companies and their supply chains to develop appropriate financial solutions to support the growth of markets producing palm oil, timber products, soy or beef without contributing to deforestation. Banks also commit to engage clients in high risk geographies to improve their sustainability performance in line with responsible industry practice and CGF requirements.

Undertaking these activities can deepen bank relationships with clients, provide fertile ground for product innovation, and reduce ESG-related credit risk.

2.1.4 REPUTATIONAL RISKS

Global banks have faced a wide range of reputational issues since the financial crisis. In a number of cases this is due to their choice of clients. Notable examples include breaches of AML, counter-terrorism and international sanctions-related norms.

In some markets climate change-related issues have also led to protests and customer boycotts. [36] While the numbers may be small, boycotts are a risk for banks as retail deposits are a long-term source of low-cost, patient capital. In other markets, activist NGOs have launched petitions against banks financing companies linked to deforestation. [37]

In addition to customer boycotts, shareholders are increasingly engaging banks on integrating ESG into lending portfolios. Ceres is a US-based non-profit that advocates for sustainability leadership. It regularly prepares shareholder resolutions on ESG at US companies. [38] It prepared four shareholder resolutions for 2015 requesting greater transparency from banks over ESG issues such as climate change. This is an increase from three in 2014.

2.1.5 GREEN FINANCE AND INNOVATION

ESG can present new business upsides for banks. These include new product development through ESG-themed or green products, or additional financing opportunities aimed at addressing ESG challenges such as climate adaptation or mitigation-related expenditures.

One specific example is the Banking Environment Initiative Sustainable Letter of Credit. [39] This creates opportunities for banks to participate and incentivize growth in the trade of sustainably-produced commodities.

The huge potential for green finance is highlighted in the market for “green bonds”, i.e. bonds issued to finance a low carbon, green economy (sustainable transport and clean energy have been predominant themes thus far). The Climate Bonds Initiative together with HSBC estimated the total size of the market at US$503 billion in their *State of the Market 2014* report. [40] The total market for labelled green bonds was estimated at US$36 billion as at 10 June 2014, triple its size in 2011.

Yet this is still vastly below the scale of the financing challenges. The IEA’s 2014 World Energy Investment Outlook estimates that to avoid catastrophic global warming and get the world onto a two-degree emissions path, US$53 trillion of cumulative investment in energy and energy efficiency is required over the period up to 2035. Of this US$14 trillion is required in energy efficiency. [41] On top of this are investments in adaptation-related infrastructure.

The Climate Bonds Initiative found agriculture and forestry accounted for only US$4.2 billion, or less than one per cent of the total US$503 billion universe of climate-themed bonds outstanding as of June 2014. This highlights significant market potential for additional climate-themed bonds as agriculture and forestry companies seek to create more sustainable supply chains and operations. Opportunities may arise for banks to finance projects such as waste to energy production/biogas digesters, certification projects, traceability-related management information systems and efficiency/yield investments in suppliers.

2.1.6 STAYING AHEAD OF REGULATION

Regulatory standards relating to ESG are tightening in many industries, including banking. For client industries, tighter regulation can create risks and opportunities that are relevant to credit risk assessment as discussed above.

Banks can choose to support their own regulators through being proactive in implementing ESG assessments. This can create a better relationship with regulators and allow banks to help shape future regulations, especially if they group together today to first create voluntary industry guidelines. Examples of markets that are bringing in regulation are considered in the following section.

2.2 REGULATORY DRIVERS FOR ESG INTEGRATION IN BANKS

Regulation is a factor for banks aside from commercial drivers. The University of Cambridge, BEI and UNEP FI reviewed the Basel Accords, which provide the basis for banking regulation. The review found that Basel III, the most recent version of the Accords, does not address the financial stability risks associated with systemic environmental risks. However, the review also found that an increasing number of national economies are implementing regulations to address such risks.

Based on public disclosure by their central banks, Singapore and Malaysia do not have banking regulations relating to ESG standards. The Indonesian central bank currently requires banks to consider certain ESG-related factors in their credit quality assessments, including the debtor's actions to manage environmental issues, their Amdal (Environmental Impact Assessment) results and PROPER ratings. In December 2014 Indonesia's Financial Services Authority (OJK) and the Environment and Forestry Ministry launched the Roadmap to Sustainable Finance.[42] In line with this, Indonesia is due to introduce additional sustainable finance regulations in 2016. There are currently no voluntary sustainable finance initiatives led by national banking associations in the three countries covered in the review.

Other Asian examples of banking regulation on ESG include: [43]
- Bangladesh – issued environmental risk management guidelines in 2011
- China – issued Green Credit Guidelines in 2012
- Vietnam – issued an Environmental and Social Risk Management Circular in 2014

Brazil, which was one of the countries facing rampant deforestation in the past due to unsustainable logging and commodity production, provides an interesting voluntary example. In 2009 the Brazilian Federation of Banks, FEBRABAN, signed the Green Protocol with the Brazilian Ministry of Environment. This created a voluntary commitment to provide credit to higher sustainability activities, consider environmental impacts and customer ESG risks, and promote greater awareness of natural resource consumption.[44]

A Central Bank of Brazil Regulation of May 2014 took a further step. Central Bank-authorized financial institutions must now execute a socio-environmental liability policy (SELP) by 2015. The main aim of the SELP is to prevent losses stemming from environmental damage caused by the activities of the financial institutions as well as their clients.

2.3 OTHER FACTORS DRIVING ADOPTION

There are various other factors driving adoption. In some cases banks are specifically established to address ESG issues, such as the UK's Green Investment Bank. Development banks such as the World Bank and JBIC have a greater focus on these issues.

State-owned banks may in principle have a stronger reason to act on ESG issues where this is in line with government policy, for example to help develop the smallholder agriculture sector through micro-finance linked to sustainability measures.

2.4 SUSTAINABLE LENDING INITIATIVES

Banks seeking to integrate ESG or sustainability into their lending face several challenges. A number of initiatives aim to address these challenges through acting as a knowledge portal, bringing standards into line, and as platforms for collaboration on new products. The following section outlines the major relevant initiatives with significant banking membership.

2.4.1 UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE (UNEP FI) [45]

Founded in 1992, UNEP FI's mission is "to bring about systemic change in finance to support a sustainable world". Its members commit to the principles of sustainable finance through signing the UNEP Statement of Commitment by Financial Institutions (FI) on Sustainable Development.

UNEP FI members comprise banks, insurers and investment institutions. There are 225 members in total, of which 141 are banks. Asia Pacific accounts for 24 per cent of total members, with Australia and Japan providing the largest number of representatives. Within Southeast Asia, there are two members from Indonesia (Bank bjb and Bank Negara Indonesia) and one from Malaysia (Amgeneral Insurance Berhad), as well as two institutions each from Thailand and the Philippines.

The initiative has a banking workstream with the following agenda:
- Defining sustainable banking
- Understanding the intersection between banking, society and the environment
- Capacity-building
- Promoting "green finance"
- Policy engagement

2.4.2 EQUATOR PRINCIPLES (EP) [46]

The Equator Principles are the main standard for environmental and social risk management in project finance. These have been adopted by 80 members, known as Equator Principle Financial Institutions (EPFI). Of these, five are headquartered in Asia[47] and five in Oceania (Australia).

Members must categorize projects proposed for financing according to potential environmental and social impacts. Where these are not minimal, financial institutions should require their clients to provide assessments to minimize, mitigate and offset adverse impacts. Clients should maintain ongoing engagement with stakeholders, particularly affected communities, establish a grievance mechanism and ensure independent review of the projects. The EPFI should build environmental and social requirements into financial covenants.

Each EPFI must also report publicly each year on relevant transactions.

Benefits of implementing the EP include enhanced identification and mitigation of environmental and social risks in financing projects. This reduces financial and reputational risks for financial institutions that adopt the policies. The EP also enhance knowledge transfer and provide a standardized approach to environmental and social risk management.

2.4.3 BANKING ENVIRONMENT INITIATIVE (BEI) [48]

The BEI's mission is "to lead the banking industry in collectively directing capital towards environmentally and socially sustainable economic development."

There are 11 members. Asia-Pacific is well represented, with three Asian banks (China Construction Bank, Nomura and Sumitomo Mitsui Banking Corporation), one

Australian bank (Westpac), and Standard Chartered, which is UK-headquartered and has a strong Asian focus.

The BEI focuses on topics where industry-wide action is needed and works in partnership with customers. Member bank CEOs actively lead the initiatives. Major work streams include:

- The BEI-CGF Soft Commodity Compact, which is an alliance with consumer goods companies to finance sustainable commodity supply chains
- The Sustainable Shipment Letter of Credit
- The annual BEI Forum
- Financial sector regulatory research, including into potential gaps in financial stability regulation due to systemic risks from sustainability issues
- A partnership with electric utilities to unlock investment in clean energy

2.4.4 ROUNDTABLE ON SUSTAINABLE PALM OIL (RSPO) [49]

The RSPO's primary mission is to advance the production, procurement, finance and use of sustainable palm oil products. The RSPO has 1,700 members representing palm producers, processors or traders, consumer goods manufacturers, retailers, banks/investors, and environmental and social non-governmental organizations (NGOs).

There are 13 financial institutions that are members of the RSPO. Of these 12 are banks/credit institutions and one is an investor. The only Asian financial institution represented is the Indonesian Koperasi Kredit Keling Kumang, which is a small credit union focusing on poverty alleviation. HSBC, ANZ and Standard Chartered are members.

For financial members, benefits of joining include building a thorough understanding of the relevant issues; having access to the latest developments and to key industry players; having a stake in the development of sustainable palm oil; highlighting their commitment to financing sustainable business; reducing reputational risk; and minimising related environmental and social risks.

Financial members' commitments include abiding by the RSPO Code of Conduct; establishing relevant internal policy; specifying a time-bound plan for providing financial services/products to clients that are RSPO members who provide CSPO or derivative products; reporting progress on an annual basis; and requiring or encouraging clients to be members of RSPO and to promote RSPO as the preferred certification standard for their clients.

CHAPTER 2

Chapter 2 considers the same points relating to investors with significant links to forest risk commodity companies, reviewing 12 major domestic institutional investors and 4 international investors. It also provides the rationale for investors to adopt ESG practices.

CHAPTER 2 INVESTORS AND RESPONSIBLE INVESTMENT

KEY FINDINGS

- There is a robust case for investors to implement responsible investment (RI) practices across their portfolios. [50]
- International investors are increasingly embedding ESG practices across their portfolios, [51] including addressing forest risk commodity production issues in Southeast Asia.
- None of the domestic funds reviewed has a structured approach to ESG.

This chapter presents the findings of a public disclosure review of selected domestic institutional investors from Singapore, Indonesia and Malaysia regarding their ESG-related practices in general and in respect of forest risk commodity companies. The review first considers the potential drivers of adoption of ESG practices for this specific group of investors. It then turns to the ESG practices that the domestic investors use, comparing their approach to that of four international investors. The second section of the chapter presents the broader rationale for RI, including a number of relevant initiatives in which international investors participate.

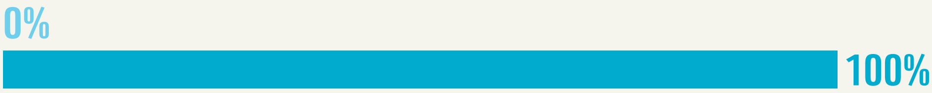
On the basis of public disclosure, none of the investors discloses a structured approach to ESG management. However, all but one of the twelve domestic institutional investors reviewed have implemented some form of ESG practice in their portfolios. Only one of the investors discloses any details relating to ESG management of forest risk commodity companies. The table below provides a snapshot of the findings. The detailed table showing additional criteria and assessment of individual institutions is provided further on in this chapter.

This contrasts with leading international investors that are seeking to embed ESG considerations into their investment processes and ownership practices. International investors have also taken specific steps to address ESG and sustainability within agricultural and forest risk commodity supply chains.

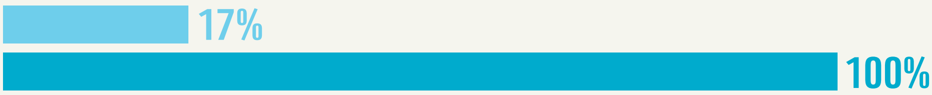
These steps include engaging with companies to improve ESG management in palm oil supply chains (including using shareholder resolutions); [52] establishing a working group on palm oil; [53] establishing a disclosure-based risk assessment system for forest commodity users (CDP Forests Program [54]); and creating principles for responsible investment in farmland. [55] Some investors screen out palm oil companies due to concerns over the sustainability of their production methods, such as NBIM, which divested 27 palm oil companies in 2012. [56]

INVESTORS – DISCLOSURE AND ESG INTEGRATION

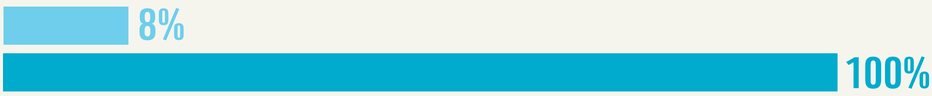
Does the investor provide disclosure of its holdings?
In many markets transparency has increased accountability to beneficiaries.



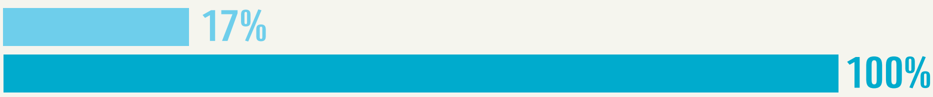
Does the investor disclose its corporate governance policy?
A corporate governance policy allows a consistent, evidence-based approach to discharging ownership responsibilities.



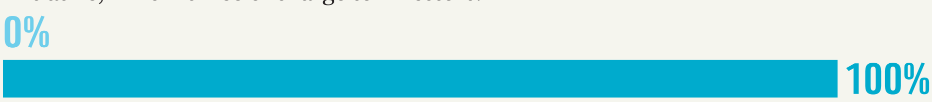
If the corporate governance policy is published, does it include specific reference to ESG?
The absence of disclosure on ESG-related engagement suggests domestic funds are not considering material ESG risks.



Does the investor specifically allocate funds to sustainability solutions providers?
Sustainability problems offer many potential equity opportunities and a fast-growing requirement for debt funding. yet the domestic funds show very little interest in these areas.



Is the investor a member of any relevant international collaborative initiative?
The domestic funds have not even become signatories to CDP, the major climate initiative, which is free of charge to investors.



KEY RECOMMENDATIONS

INVESTORS

- Integrate ESG into portfolios:
  - Analyse key top-down sustainability risks and take steps to mitigate/hedge them where feasible;
  - Analyse key bottom-up ESG risks to holding companies and engage/re-value accordingly.
- Adopt relevant active ownership practices such as:
  - Publish the voting and engagement policy;
  - Extend corporate governance policy to include ESG;
  - Disclose holdings and voting record;
  - Collaborate with other investors to address major ESG issues.
- Access knowledge and best practices by joining international collaborative initiatives such as PRI, CDP and ACGA.
- Asset owners should require external managers to implement ESG practices.
- Manage down significant systemic risks and assist the transition to sustainable finance through engaging with banks to encourage ESG practices, such as those recommended in the bank section.
- Manage and mitigate ESG risk for forest risk commodity company holdings through:
  - Engaging issuers to encourage higher standards and certification;
  - Joining multi-stakeholder standards (such as RSPO and FSC) and supporting the efforts of other financial services members to improve ESG management.

SECURITIES MARKET REGULATORS

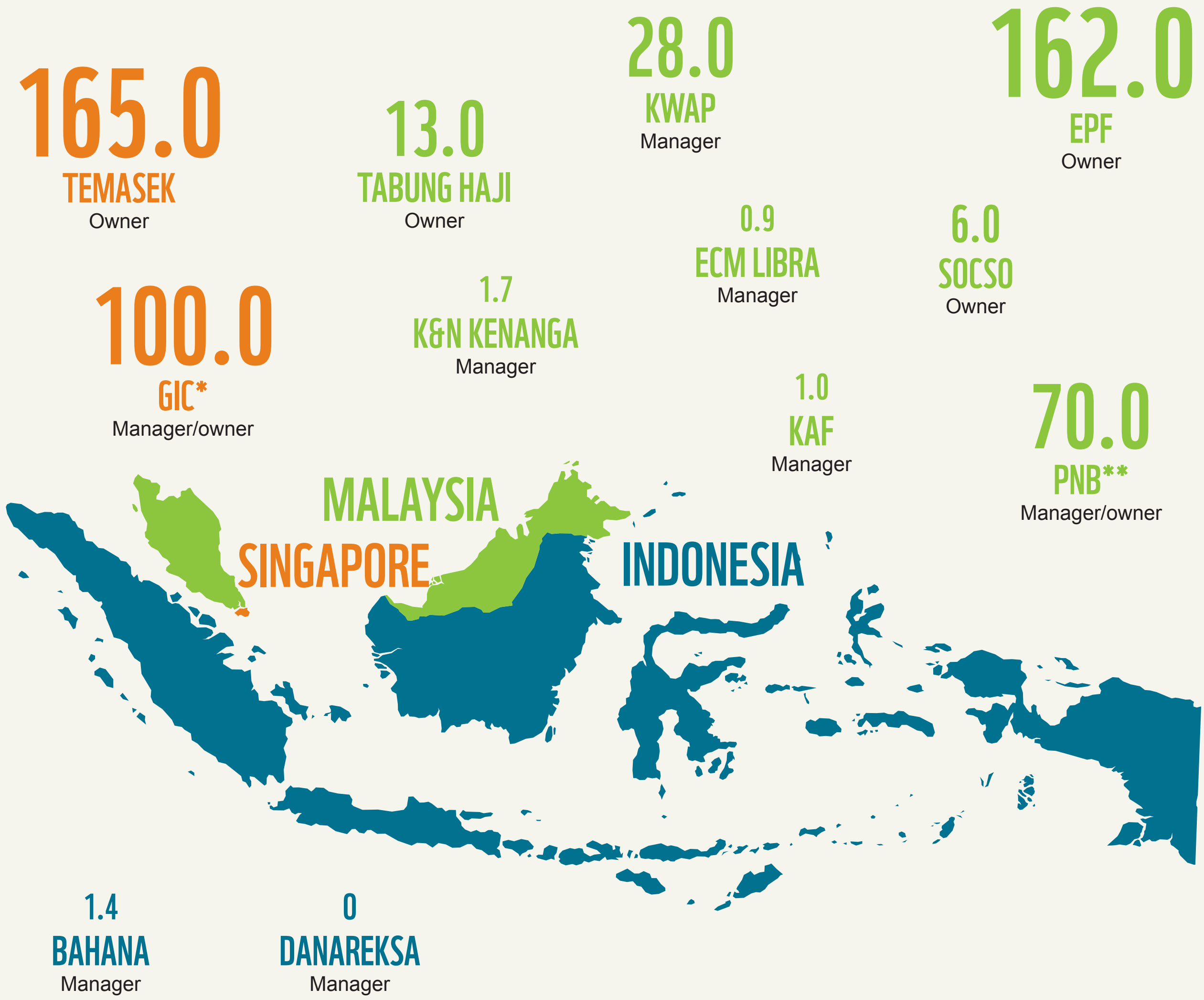
- Support increased levels of active ownership, including through promotion of stewardship codes for institutional investors.

1. RESPONSIBLE INVESTMENT PRACTICES BY DOMESTIC INVESTORS

1.1 INVESTORS REVIEWED

Investors were selected on the basis of identified holdings in the sample group of forest risk commodity companies. The asset owners and managers domiciled in Singapore, Indonesia or Malaysia with the largest holdings or most frequent mentions on lists of owners were selected for further research.[57] Asian subsidiaries of international investors were not selected.

APPROX AUM (US$ BN) [58]



*GIC manages money solely on behalf of the Singapore government and consequently has characteristics similar to an owner.
**PNB has received holdings in companies from the Malaysian government. It repackages such stakes through its unit trust subsidiaries into savings products primarily for Bumiputeras. This gives PNB some asset owner characteristics.

ASSET OWNERS AND ASSET MANAGERS

One critical distinction when considering why and how investors adopt ESG practices is that between asset owners and asset managers. The main difference is that asset owners are the legal owners of assets, while asset managers act on behalf of the legal owners. This distinction can create different incentives and responsibilities in relation to ESG.

Asset owners typically have to meet a liability owed to beneficial owners, such as pension fund members. The relationship to the beneficial owners can also extend beyond meeting financial liabilities. Frequently the class of beneficial owner, such as trade union members or health professionals, will provide a basis for considering ESG issues. This may be explicit in an investment mandate or mission, but can be an implicit expectation of members. [59]

Long duration issues such as climate change, ageing populations or resource scarcity may be relevant over the timescales of asset owners' liabilities. Consequently it can make sense to invest some portion of assets directly in addressing these systemic risks. [60]

In many cases asset owners outsource day-to-day investment decisions, such as buying and selling of stocks, to asset managers. The terms specified in an investment management agreement will include items such as the contract duration, benchmark, fee structure and reporting requirements.

As investment mandates are by nature shorter term than the fund's liabilities, this can create a mismatch between the time horizon and incentives of the asset manager to that of the asset owner. Asset owners can address some of these differences in incentives through specifying adoption of ESG practices in their investment management agreements with asset managers. [61]

1.2 BRIEF OVERVIEW OF SIGNIFICANT DOMESTIC FUNDS WITH HOLDINGS IN FOREST RISK COMMODITY COMPANIES

There are significant differences in the make-up of institutional investment institutions in the three countries, primarily due to different structures and maturities of pension provision and administration in each country.

MALAYSIA

1.2.1 MALAYSIA

In Malaysia pensions are guaranteed by funds specifically created for the purpose, such as the Employee Provident Fund (EPF) and Kumpulan Wang Persaraan (Diperbadankan) (KWAP). The schemes are either run on the basis of defined contribution, with a guaranteed minimum return and a higher target, or as defined benefit. In both cases, beneficiaries have a call on the assets in the fund. The funds are primarily invested in Malaysia and increasingly overseas as the funds grow in size.

The Malaysian government's investment holding arm is Khazanah Nasional Berhad, which is a significant investor. However, none of the sample companies appeared to have the fund as a direct shareholder, so it was not covered in the study.

Malaysia has a number of other significant asset owners. These include Tabung Haji, which manages pilgrimage-related savings; and Social Security Organisation (SOCSO) – also known as Perkeso – a fund for providing social security protection, such as support for injured workers.

Permodalan Nasional Berhad (PNB) is another significant fund. It provides savings schemes primarily for indigenous Malaysians, or Bumiputera. PNB is unlike other asset managers in that it can receive shares in state-owned enterprises that it repackages into its saving schemes.

ECM Libra, K&N Kenanga and KAF are all asset managers listed on Bursa Malaysia.

SINGAPORE

1.2.2 SINGAPORE

In Singapore, long-term compulsory savings are paid into the Central Provident Fund (CPF) on the basis of defined contributions. The CPF functions somewhat like a long-term deposit account, with scheme participants receiving returns on their contributions linked to government savings/bond rates with a guaranteed minimum. Where individuals have a sufficient balance and wish to do so they may invest in shares either directly or through a specified set of authorized asset managers.

The CPF uses cash balances to purchase Special Singapore Government Securities that are issued and guaranteed by the Singapore government, which invests the money alongside other reserves via the Monetary Authority of Singapore and GIC. As a consequence general pension arrangements in Singapore do not include a single fund investing in equities with a direct obligation to scheme members. Instead, GIC manages an international portfolio of investments on behalf of the Singapore government.

Temasek is a sovereign wealth fund. Its initial holdings were government-established industry champions. Over time the fund has invested returns from these companies internationally. Consequently it is increasingly taking on the characteristics of a fund, rather than a holding company for state-owned companies.

For Singapore, there were no other standalone asset management businesses with significant representation on the available shareholder lists for the sample forest risk commodity companies.

INDONESIA

1.2.3 INDONESIA

In general, the equity market is less developed in Indonesia than in Singapore and Malaysia. Companies typically have lower proportions of shares traded on Indonesia's stock market than in the other two countries.

The Indonesian system for pension provision is undergoing changes. Historically it was based on defined contribution, though there are plans to change this to defined benefit. The main fund that manages pensions is known as BPJS and has assets under management of around US$13 billion, according to its 2013 annual report.[62] BPJS was not included in the list of investors reviewed, as it was not possible to link any of the companies in the sample to the fund. Bahana and Danareksa are state-owned financial groups that include asset management businesses.

1.3 FACTORS THAT MAY INFLUENCE ADOPTION OF ESG PRACTICES BY INVESTORS

The purpose of the review of investors' public information is to understand the rationale for and extent to which domestic investors are currently adopting ESG practices in general, and in regard to holdings in forest risk commodity companies.

The review first considers a range of issues that may affect the propensity or approach that investors take to adopting ESG practices. Selected features of the domestic investors are discussed under the following headings.

- The interests of beneficial owners
- The implications of different mandates/missions
- Investment styles
- CSR activities
- Exposure to high-risk industries

1.3.1 THE INTERESTS OF BENEFICIAL OWNERS

The expectations of beneficial owners of funds can be an important factor driving responsible investment by asset owners. For example in the US, UK and Australia, student campaigns on climate change have led to the divestment of fossil fuels at a number of university endowment funds in the last few years. Concerns for the interests of beneficial owners have often resulted in pension funds taking a lead in responsible investment, such as at the California Public Employees Retirement System (CalPERS) and the UK's Universities Superannuation Scheme (USS).

Similar considerations may apply for KWAP and EPF. KWAP is the fund for government employees. Although its remit is not specifically Islamic, it caters to its Muslim beneficiaries through ethical restrictions: "KWAP shall always and whenever possible, refrain from investing in companies principally engaged in alcohol, tobacco, gaming and manufacturing equipments primarily designed or designated for military purposes."

1.3.2 THE IMPLICATIONS OF DIFFERENT MANDATES/MISSIONS

Sometimes funds or asset management companies have an explicit mandate that requires or provides a strong rationale for active ownership, either in general or on specific issues. This is often the case for charities. For example, the UK's Joseph Rowntree Charitable Trust "is a Quaker trust which seeks to transform the world by supporting people who address the root causes of conflict and injustice". The trust makes grants from its investment returns and provides the following reason for its approach to ESG: "We believe that the most effective way to align our investments with our values is to use fund managers who take a responsible investment approach." The trust also undertakes collaborative engagements on ESG.

One of the clearest examples from the sample set of a mission affecting the choice of securities is Tabung Haji, which provides pilgrimage-related savings and services for Malaysian Muslims. As such, the fund specifies that it only makes Sharia-compliant investments.

SOCSO may provide a further example. Its mission includes that it should “increase awareness on occupational safety and health that will ultimately improve the Employees’ social wellbeing.” Currently SOCSO’s primary efforts to improve Malaysian workers’ health and safety standards are through awareness-raising initiatives. SOCSO may also wish to discuss health and safety policies, practices and performance with companies in which it has debt or equity holdings. This is particularly appropriate in the context of forest risk commodity plantations, where there are known health and safety issues and large workforces.

1.3.3 INVESTMENT STYLES – TOP-DOWN AND BOTTOM-UP

Differences in investment strategy are relevant when investors integrate ESG into their portfolios. One of the key distinctions is between top-down strategies that start with economic factors and asset allocation, as compared with bottom-up approaches that start with considerations of company fundamentals.

Bottom-up strategies often result in concentrated portfolios with significant holdings in a smaller number of companies, frequently with illiquid positions. As it is harder to trade out of such positions, a bottom-up investor is more likely to look in depth at company-level risks and opportunities, such as ESG issues.

On the other hand, a top-down investor is more likely to consider thematic issues and concentrate on ESG factors that are relevant to groups of companies, rather than going into depth at one or two companies.

Often the strategy adopted is a function of a fund’s history and mandate. For example, the two Singaporean funds are on either side of this divide, with Temasek’s approach more bottom-up, while GIC’s is more top-down.

Temasek runs concentrated portfolios which reflect its concentrated holdings in national industry champions. GIC on the other hand runs more diversified portfolios on the basis of a projected return model. This is also due to GIC running global, rather than domestic, portfolios.

As a result of these factors, GIC may be more sensitive to issues that could present systemic risks, such as climate change, that may not be fully factored into its model for long-term returns. Indeed, GIC was one of a number of investors globally that supported an in-depth study of investment risks due to climate change compiled by Mercer.[63] Potentially GIC could consider advocacy and engagement in relation to climate change mitigation.

Temasek appears more interested in understanding where ESG risks and opportunities could affect the stocks it holds. It notes: “We have a vested interest in advocating clean water, clean air, clean energy, safe food and waste reduction. Among our investments are global leaders in water technologies and waste management, including waste-to-energy plants.” The natural driver for Temasek to promote high ESG standards is to enhance growth at its companies, rather than address systemic risks that may affect the market.

1.3.4 CSR ACTIVITIES

Corporate social responsibility (CSR) can refer to a range of activities, from pure philanthropy through strategic community investment, to addressing core business issues such as human capital management or innovation to take advantage of emerging social and environmental trends. Where investors are making efforts to manage CSR internally, it may also be logical to encourage portfolio companies to make such efforts.

The majority of funds provided some information on CSR-related initiatives. Some covered human capital management and disclosed information related to training.

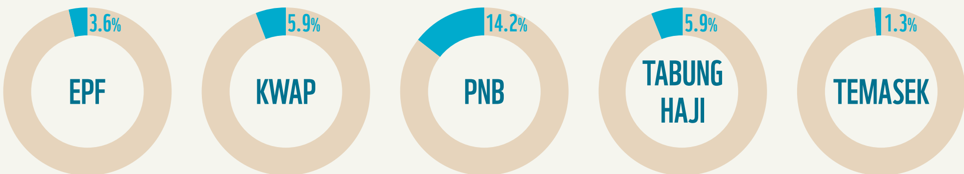
Tabung Haji was the only fund to reference forest production in its CSR disclosure. This fund's plantation assets are primarily held through its 72 per cent share in Bursa Malaysia-listed TH Plantation. The management of ESG issues at the plantation subsidiary is covered under CSR disclosure and reported for Tabung Haji. Disclosure includes reference to zero burning, recycling nutrients, soil conservation, trapping rainwater and substituting organic for chemical fertilizers. This is a positive start, but it leaves out many of the material ESG issues with commercial implications identified in *Chapter 4 – The commercial case.*

1.3.5 EXPOSURE TO HIGH-RISK INDUSTRIES

Consideration of ESG is most relevant where there is exposure to high-risk industries, such as forest risk commodity production. The argument is strongest for investors with a concentration of exposure, however, any relationship with a company from high ESG risk industries can trigger issues such as reputational risk. Investors can find value in joining relevant multi-stakeholder initiatives such as the RSPO, to benefit from their expertise and use this to develop sector-level policies to help mitigate and manage the impacts of high ESG risk.

The following table sets out the proportions of funds held in the selected forest risk commodity companies, with a selection of notable investments the funds have made in the sector.

DOMESTIC FUNDS ACTIVE IN FOREST RISK COMMODITY COMPANIES



EPF	KWAP	PNB	TABUNG HAJI	TEMASEK
5,843	1,633	9,948	781	2,086
Exposure (US$ millions)[64]	Exposure (US$ millions)[64]	Exposure (US$ millions)[64]	Exposure (US$ millions)[64]	Exposure (US$ millions)[64]
Notable holdings	**Notable holdings**	**Notable holdings**	**Notable holdings**	**Notable holdings**
•Genting Plantations •United Plantations •Sime Darby •Kuala Lumpur Kepong •IJM Plantations	•Felda Global Venture •Genting Plantations	•Sime Darby •Felda Global Venture	•TH Plantations •Felda Global Venture	•Olam International •CTP Holdings

1.4 DOMESTIC INVESTOR ADOPTION OF ESG PRACTICES

The second stage of the review identifies the ESG activities that the domestic investors disclose under the broad headings of transparency, approach to stewardship, Sharia/ethical screening, solutions-oriented investment, and approach to manager selection.

As a group, the domestic investors covered have started the journey to greater stewardship and consideration of ESG in their activities, but have not got very far.

All of the investors bar one disclose adoption of at least one ESG practice. Nevertheless, on the basis of the available disclosure, none of the investors are structured in their approach to ESG management or in addressing the risks and opportunities that ESG and sustainability issues present to their portfolios or individual holdings. This suggests there are several potential areas of value creation for the investors covered.

The Malaysian asset owners disclose the most on stewardship. They all sit on the steering committee for the new Code for Institutional Investors, although they are not yet signatories. This Code explicitly addresses sustainability issues in addition to corporate governance.

Currently only EPF and KWAP have published their voting policies. In KWAP's case the corporate governance principles and voting guidelines[65] state that "KWAP shall actively engage with its investee companies via:
i. Meetings and dialogues with the management;
ii. Active participation in AGMs and EGMs;
iii. Writing to express its concerns; and
iv. Board representation, where applicable.
KWAP also includes requirements for its investee companies to manage ESG issues.

Tabung Haji, the pilgrim fund, is the only investor that explicitly addresses forest commodity ESG issues. This is essentially through the CSR activities of its plantation division, TH Plantation, which is listed on Bursa. These CSR activities touch on some of the forest-related issues highlighted in this study.

Of the two Singaporean funds, Temasek provides disclosure on its relations with investee companies in its charter. It also mentions that it has investments in solutions providers for several sustainability themes, namely clean water, clean energy, safe food and waste reduction.

The Indonesian fund managers are smaller. Nevertheless, they both reference some stewardship activities.

1.4.1 DOMESTIC INVESTOR DISCLOSURE SUMMARY TABLE

The following table records the presence of concrete disclosures by the funds. Where the funds provide general rather than concrete statements, such as where they discuss interactions with company management outside of an approach to stewardship, these activities are covered in the detailed discussion below.

The table includes four international funds for comparison. Their level of consideration of transparency and approach to ESG is far higher than that of the domestic funds.

		INDONESIA		MALAYSIA								SINGAPORE		GLOBAL			
REVIEW AREA		Bahana	Danareksa	ECM Libra	EPF	K&N Kenanga	KAF	KWAP	PNB	SOCSO	Tabung Haji	GIC	Temasek	BlackRock	CalPERS	NBIM	USS
TRANSPARENCY	Holdings disclosed*	NA	NA	NA		NA								NA	●	●	●
APPROACH TO STEWARDSHIP	Corporate governance policy disclosed				●			●						●	●	●	●
	Policy includes ESG							●						●	●	●	●
	Votes disclosed													●	●	●	●
	Stewardship code involvement**				●			●	●	●	●			●			●
SCREENING	Sharia/ethical exclusions	●	●	●		●	●	●	●		●			●	●	●	●
	Solutions-oriented investment		●										●	●	●	●	●
EXTERNAL FUNDS	Manager selection*	NA	NA	NA		NA		●	NA		●			NA	●	●	●
COLLABORATIVE INITIATIVES	PRI													●	●	●	●
	CDP													●	●	●	●
	ACGA													●	●	●	●

*Holdings disclosure is more relevant for asset owners that are accountable to beneficiaries. Asset managers are selected by their clients, the asset owners, and hold assets for multiple asset owners. Asset managers are not included in these two parts of the assessment.
**The Malaysian funds sit on the steering committee, however they are not signatories to the Code.

1.4.2 COMPARISON TO INTERNATIONAL INVESTORS

The international funds reviewed were chosen for their significance in their respective markets. They are the California Public Employees Retirement System (CalPERS), the US's largest public pension fund; the Universities Superannuation Scheme (USS), the UK's largest pension scheme; Norway's Norges Bank Investment Management (NBIM), manager of Government Pension Fund Global of Norway, one of the world's largest sovereign wealth funds; and BlackRock, which is the world's largest asset manager and is listed in the US.

As is evident from the table, the international investors all demonstrate a much more considered approach to ESG through their disclosure.

In the case of CalPERS and NBIM, the major stewardship codes do not apply in their home markets. Nevertheless, both funds take many of the steps stewardship codes generally promote and are both highly active in promoting improved ESG management.

The international investors are members of all of the major collaborative initiatives reviewed.

CASE STUDY - NBIM [66]

Government Pension Fund Global is the Norwegian sovereign wealth fund. It has an investment management mandate with Norges Bank, which is undertaken by Norges Bank Investment Management (NBIM). The investment mandate specifies certain elements of responsible investment that the Bank must undertake on behalf of the Fund, including entering into dialogue with companies, development of principles and expectations to companies' behaviour, contribution to and alignment with international standards, and environment-related investments, and in certain cases exclusion of companies based on their environmental performance. As at the end of 2014, the fund had invested 42 billion kroner in environment-related investment mandates, which will increase to 60 billion kroner in the coming years.

NBIM implements responsible investment in a variety of ways. In 2014 it released the first annual report on how responsible investment is implemented in the fund. In 2014 it grouped its work under three main headings of standard setting, ownership, and risk management.

OWNERSHIP:

NBIM's main tool for implementing responsible investment practices is through dialogue with companies. Ownership covers voting at Annual General Meetings (AGMs) and other direct interactions with companies. NBIM voted at 10,519 meetings in 2014, of which 4,486 were in Asia. NBIM held 2,641 meetings with companies in the year. ESG issues were raised at 623 of these meetings.

NBIM has chosen three areas of particular importance in its ownership dialogue, and has developed expectation papers for each area to explain the bank's expectations to investee companies. The areas are children's rights, water management, and climate change. The expectation paper on climate change is new as of 2015.

For the climate change focus area, initiatives in 2014 included undertaking a GHG analysis of all companies in the equity portfolio and assessing climate risk management at 415 portfolio companies in high climate risk sectors. NBIM's document *Climate Change Strategy Expectations to Companies* sets out the steps it believes companies should take to manage relevant risks in four areas:

A. Integrate relevant climate change challenges and opportunities in investment planning.
B. Integrate material climate change risk in risk management.
C. Report material climate change risks and GHG emissions
D. Transparency on interaction with policymakers and regulators, and positions on climate change legislation and regulation.

The document states that companies should consider risks under different scenarios, including that of regulation to limit climate change to two degrees.

STANDARD SETTING:

Standard setting includes among other initiatives: foundation sponsorship of ACGA; membership of CDP; lead-sponsorship of CDP's Water Programme; and membership of CDP's Forest Programme.

RISK MANAGEMENT:

Risk management covers a range of activities, including monitoring and in certain cases exclusion of companies that pose a financial threat to the fund due to environmental and/or social risk. The fund also has an ethical council that can recommend to the bank to exclude companies on a case by case basis, due to serious breaches of ethical norms. The fund has divested from companies on the basis of environmental and social risk. There have been 114 such divestments in the past three years, with 49 in 2014. Divestments in 2014 included 22 coal, oil sand and cement companies on the basis of GHG emissions. Deforestation risk led to divestment of 27 Malaysian and Indonesian palm oil producers in 2012, 11 Indonesian coal companies in 2013, and 5 Indian coal companies in 2014.

1.4.3 DETAILED REVIEW OF DOMESTIC INVESTOR ESG ACTIVITIES

0
INVESTORS
NONE OF THE DOMESTIC INVESTORS DISCLOSED THEIR HOLDINGS

1.4.3.1 TRANSPARENCY/HOLDINGS DISCLOSURE

Where holdings are disclosed, beneficial owners are able to hold accountable the funds investing money on their behalf. Consequently transparency is an important first step and an enabler for asset owners on the path to responsible investment. In fact, Aviva, a UK life insurance company, recommends that governments should ensure that all asset owners with more than US$1 billion under management publish a report to the beneficial owners and society on how they have integrated sustainability considerations into their investment management agreements, or to explain why they have not done so.[67]

The level of transparency over holdings varies significantly between domestic investors. EPF discloses 30 listed companies in which it is a significant investor in terms of percentage of the company owned. Temasek discloses some of its largest holdings. KWAP provides sector breakdowns, while GIC does not. For the asset management companies, where available, the fund reports typically disclose the five largest holdings in each fund.

This contrasts with the international funds. The asset owners, CalPERS and NBIM disclose all their holdings in detail on an annual basis, while USS provides the financial value of its top 100 holdings and the list of names of smaller holdings as at the end of the prior quarter.

The question of disclosure applies differently to asset managers, which typically hold assets on behalf of a mixture of different clients. Asset manager BlackRock provides the names of holdings as part of its disclosure on voting.

1.4.3.2 APPROACHES TO STEWARDSHIP

The bedrock of stewardship or active ownership is the voting process through which investors appoint directors to company boards and make major decisions concerning their holdings. Investors typically use a policy to ensure consistency in their approach to companies and convey their reasoning if they do not support management.

Ownership policies can extend to cover broader aspects of dialogue with companies, including environmental and social issues. All of the international investors undertake such engagement. For example, CalPERS works with US-based advocacy group Ceres to call on major US companies to stress test their business models for the effects of regulation that would limit climate change to two degrees. Water is one of NBIM's engagement focus areas. Its document *NBIM Investor Expectations: Water Management* sets out clearly what it expects investee companies to do to manage this issue.

The domestic investors mention differing levels of active ownership in respect of their holdings. These are much less developed than the international investor examples. In the case of the Malaysian asset owners, EPF, KWAP, PNB, SOCSO and Tabung Haji are all on the steering committee of the Malaysia Code for Institutional Investors that promotes stewardship, including engagement on sustainability issues. However, these funds are not yet signatories of the Code.

EPF and KWAP both publish their corporate governance principles and voting

2 INVESTORS

ONLY 2 OUT OF 12 DOMESTIC INVESTORS DISCLOSE THEIR CORPORATE GOVERNANCE POLICY AND ONLY 1 HAD ESG INCLUDED IN THE POLICY

policies. KWAP's includes a section on sustainability and ESG under other investment monitoring practices, which states that investee companies must manage the ESG aspects of their operations and includes the following requirements for investee companies:

" i. Adopt sound corporate governance and business ethics policies;
ii. Effectively manage their relationships with stakeholders including customers, employees (eg: employee benefits and corporate culture), suppliers, vendors, the community and the environment;
iii. Adopt long term environmental policies which exceeds statutory requirements and promote usage of resources in more productive, efficient and sustainable manner; and
iv. Embark on long term social sustainability which includes community development activities and policies that take into account the welfare, health and safety within the company's area of operation."

The policy goes on to recommend that the board ensures the investee companies disclose these policies and their implementation via an ESG report in their annual report and corporate website.

The Indonesian funds both mention relationships with companies. In the case of Bahana, "good cooperation" is maintained to obtain the latest information. For Danareksa, relations with companies are mentioned in the description of the private equity division: "We pride ourselves on working closely with the companies we back in the private sector". However, no details are provided as to the nature of these relationships and whether they extend to monitoring environmental or social standards and promoting improvements.

Of the two Singaporean funds, Temasek discloses some stewardship information. The relationship with investee companies is mentioned in the Temasek Charter. Steps include support for "the formation of high calibre, experienced and diverse boards to guide and complement management leadership." However, Temasek subsequently notes that in relation to companies it "does not direct their business decisions or operations."

1.4.3.3 SOLUTIONS-ORIENTED INVESTMENT

Several of the asset managers offer funds that invest in high impact sectors where ESG issues are prevalent, however, none of the funds are specifically marketed as investing in sustainability themes or solutions. Bahana offers an infrastructure fund; Danareska offers a commodity fund; and ECM Libra offers a resource equity fund.

Regarding its private equity division, Danareska states: "It is a founding principle of our firm that we always seek to achieve the most competitive financial returns for investors, as well as definable social and environmental benefits." However, no implementation details are provided.

Temasek notes it has investments in clean water, clean energy, safe food and waste reduction. GIC mentions it has investments in private equity across a range of sectors including natural resources, however, there is no emphasis on sustainability drivers.

Alternatively there are investments in listed companies where the investment thesis targets companies with higher performing sustainability practices. KWAP, PNB and

Khazanah each own a third of Valuecap, which is due to establish a MYR 1 billion fund investing in ESG leaders, benchmarked against the recently-launched FTSE4Good Bursa Malaysia Index which is an ESG index for the Malaysian market. [68] However, this form of investment does not directly drive solutions to sustainability problems.

1.4.3.4 SHARIA/ETHICAL INVESTMENT

Many investors screen out companies involved in certain types of “unethical” activity. This approach typically reflects the concerns of beneficial owners, and is often (but not always) based on religious norms. For example, NBIM has to follow ethical guidelines from the Council of Ethics, which state that NBIM’s investment universe shall not include companies that are involved in severe environmental damage, serious or systematic human rights violations, or gross corruption.

Apart from the Singapore-based funds, all of the investors reviewed have some form of Sharia investment. The fund managers from Malaysia and Indonesia offer Sharia funds in their product range. Tabung Haji only invests in Sharia-compliant investments, while KWAP avoids “sin” stocks wherever possible. EPF and SOCSO invest in Islamic-compliant debt or sukuk, however, there is no statement that this is done for ethical reasons.

Islamic finance primarily relates to screening out companies in certain sectors and avoiding earning money from interest. This is in accordance with Sharia rules. So far there has been little convergence between the concepts of Islamic finance and that of RI. However, the concept of environmental stewardship is a tenet of Islam and is consistent with the corporate governance concept of stewardship. Consequently there may be space for greater convergence between Islamic finance and stewardship, particularly as set out in the Malaysian Code for Institutional Investors.

Neither GIC nor Temasek mention Islamic finance or any other form of ethical exclusion.

0

INVESTORS

NONE OF THE DOMESTIC INVESTORS ARE MEMBERS OF INTERNATIONAL COLLABORATIVE INITIATIVES SUCH AS PRI, ACGA AND CDP

1.4.3.5 MANAGER SELECTION

Asset owners task asset managers with managing funds to obtain appropriate investment expertise or diversification. In these cases the investment management agreement may specify that the asset manager should adopt ESG approaches in managing the fund.

Some funds disclosed the basis for assessing external managers. In the case of Tabung Haji, asset managers must have Sharia capability. KWAP is increasing the number of external managers, including those managing Sharia funds. There were no other disclosures relating to consideration of ESG in asset manager selection.

CalPERS, USS and NBIM incorporate ESG into asset manager selection.

1.4.3.6 COLLABORATIVE INITIATIVES

None of the domestic investors are members of the international collaborative initiatives cited. All of the international investors are signatories or members for each of the initiatives reviewed. NBIM is also a signatory to the CDP Forest Program.

2.1 REASONS INVESTORS ADOPT ESG PRACTICES

Investors around the world increasingly seek to embed ESG analysis into their investment processes and ownership practices.[69] This is in line with the view that ESG issues can affect investment returns.[70] It also reflects a growing recognition of investor responsibilities to underlying or beneficial owners that are broader than the buying and selling of investments alone.[71] Asset managers are also adopting related practices due to demand from asset owner clients.[72]

2.1.1 FINANCIAL RELEVANCE OF ESG AT THE PORTFOLIO LEVEL

There are many ways in which ESG is relevant to investment returns. Top-down styles of analysis consider long-term systemic risks or trends and highlight the implications for portfolios, while bottom-up styles consider effects at the company level.

The concept of universal ownership[73] set out at the start of the report is useful in analysing the interests of asset owners at the portfolio level. Institutional investors are highly diversified and long term, with exposures that are representative of overall capital markets. As such, their portfolios are exposed to the growing and widespread costs of environmental damage caused by companies.

Climate change is one of the most significant top-down ESG factors. A global temperature increase of more than two degrees above pre-industrial levels is considered dangerous.[74] This is due to problems such as increased drought and flooding, reduced agricultural yields and sea level rise, among other effects that have significant implications for food security and global economic growth.[75] An era of instability with increased food price volatility, damage to infrastructure, and increased supply chain disruption could undermine returns to overall portfolios.

These risks are being taken increasingly seriously. The World Economic Forum's Global Risk Report ranks perceptions of the risk of failure of climate change adaptation in the top 10 risks for both impact and likelihood.[76] Similarly, S&P finds that "Climate change is likely to be one of the global mega-trends impacting sovereign creditworthiness, in most cases negatively", with the impacts felt through effects on economic growth.[77]

Mitigation also presents challenges. For example, research has shown that the world cannot meet the two degree target on climate change if currently known reserves of fossil fuels are burnt.[78] This presents a risk of tighter regulation, undermining the valuations of fossil fuel companies. The Bank of England is to review risks to financial stability such regulation may pose if the need to maintain a safe climate makes a large proportion of fossil fuel company reserves unburnable and results in severely mispriced carbon-intensive assets.[79]

In its recent publication *One Bank Research Agenda*,[80] the Bank of England states that "Fundamental changes in the environment could affect economic and financial stability and the safety and soundness of financial firms, with clear potential implications for central banks" and that the "impact of environmental change is not limited to the insurance industry".

Many institutional investors are considering how to address related risks to their portfolios.[81] Responses include increasing investments in climate change solutions, advocating for tougher regulation, and engaging with portfolio companies on improved carbon efficiency.[82] These steps extend beyond use of fossil fuels to mitigation of agriculture and deforestation related emissions, such as through investor support for the CDP Forest Program among others.

Other major top-down issues include resource scarcity, inequality, and ageing population. These present systemic risks to markets,[83] with some companies positioned better than others on each major issue. These may also warrant investor engagement, public advocacy, and careful stock consideration in a similar way to that demanded by climate change.

2.1.2 FINANCIAL RELEVANCE OF ESG AT THE COMPANY LEVEL

Bottom-up analysis seeks to identify relationships between sustainability/ESG and company performance. Company-level ESG issues include, among others, human capital management, product safety and labour conditions on the social side; and energy efficiency, carbon/forest footprint, water management and pollution under environment.

A September 2014 review of 190 sources titled *From the Stockholder to the Stakeholder* by Oxford University and Arabesque Partners,[84] a sustainable investment boutique, finds a strong link to enhanced business and investment performance from high ESG standards. For the papers that it reviewed:

"1. 90 per cent of the cost of capital studies show that sound ESG standards lower the cost of capital.
2. 88 per cent of the studies show that solid ESG practices result in better operational performance.
3. 80 per cent of the studies show that stock price performance is positively influenced by good sustainability practices."

2.1.3 SIGNIFICANCE OF ESG ISSUES IN FOREST RISK COMMODITY COMPANIES

The ESG factors considered in *Chapter 4 – The commercial case* include a number of good management practices that will result in increased yields, reduced input costs, and avoided stoppage costs. Investor and company interests are fully aligned in these cases. They are also aligned in the longer term as forest risk commodity production is highly susceptible to environmental risks that are exacerbated by climate change, such as weather patterns and water shortages. It is therefore not in companies' own long-term interests to contribute further to climate change through allowing supply chain practices such as deforestation, forest degradation and peatland conversion.

Managing some of these issues carries opportunity costs, such as not planting on or cutting down high carbon stock (HCS) areas including peatland and primary forest areas and other HCV forests, or using reduced impact logging. A recent WWF study shows that the multiple benefits more than outweigh the main costs.[85] Nevertheless, companies may take the benefits of better management practices without incurring the costs of forest land or peatland set aside, continuing to engage in deforestation and forest degradation with negative impacts on biodiversity, local communities and climate change. This is not in the interests of long-term, diversified investors.

Forest risk commodity production is a significant contributory factor to climate change, with deforestation accounting for 10-15 per cent of total emissions according to the CDP Forest Program.[86] This number excludes GHG emissions arising from planting on peatland or from palm oil mill effluent (POME) that further increase the overall emissions caused by forest risk commodity production. As a result, it is not possible to properly address climate change without forest risk commodity companies playing a role.

The question for investors is whether the risks of climate change to the portfolio are more significant than potential opportunity costs of land set aside to some forest risk commodity company holdings. The universal owner argument indicates that the portfolio effect is dominant as climate change is expected to have broad and negative implications for economic activity across multiple sectors, likely reducing returns from the market as a whole. This suggests an alignment of interests between such investors and other stakeholders seeking to preserve forests and HCS areas.

Aside from buy-sell decisions, informed engagement can help companies address and prioritize the relevant issues and so improve their standards. It can only be to the long-term benefit of investors to have better quality companies to choose from.

2.2.1 RI, STEWARDSHIP CODES, GUIDELINES AND SIGNIFICANT INITIATIVES

The business and moral case for action on sustainability issues has led to a drive for standards to help investors implement ESG considerations and map their responsibilities. The UN-backed Principles for Responsible Investment (PRI)[87] had spearheaded the international movement to incorporate longer term and broader factors into investment. As of January 2015 it has 1,325 signatories, which together had US$45 trillion in assets under management (AUM).

Alongside the development of RI the concept of stewardship has become prevalent in recent years. Following the UK's lead in 2010, a number of countries, including Japan and Malaysia, have implemented codes to set out investors' responsibilities as stewards of the assets they manage.[88]

The stewardship codes outline investors' responsibilities. These typically start with the mechanisms through which investors hold company boards and management teams to account – primarily through board director elections at general meetings. The emphasis is therefore on disclosure of the basis of investor voting behaviour, the voting policy, and in some cases the votes themselves.

As a result of these trends, stewardship codes usually focus more on corporate governance than on environmental and social factors. However, Malaysia's stewardship code, the Code for Institutional Investors, explicitly incorporates sustainability considerations under Principle 5.[89] The Minority Shareholder Watchdog (MSWG), which provides research and advocacy on corporate governance in Malaysia, spearheaded the development of the Code.

The Asian Corporate Governance Association (ACGA)[90] is the most significant international investor collaborative group on corporate governance issues operating in Asia. It is a member organization that provides research, advocacy and education on corporate governance, primarily on behalf of institutional investors with a significant footprint in the region. ACGA produces a biennial ranking of Asian markets' corporate governance standards, CG Watch, which includes factors such as sustainability and stewardship.

CDP is a further major global initiative. This organization works with investors, companies and cities to address climate change and natural resource risks. It has 822 investor signatories managing US$95 trillion in assets. These support a request for companies to disclose details of their carbon emissions and plans for reducing them.[91] CDP also runs forest and water programmes.

2.2.2 RI AND FOREST RISK COMMODITY COMPANIES

In addition to more general investor initiatives on ESG, there are a number of international initiatives to encourage RI in forest risk commodity production.

These include CDP's forest program, which at the time of its 2014 report acted on behalf of 240 investor signatories representing US$15 trillion in assets. Under the programme, companies with forest commodity supply chains complete a survey to help them better understand and manage related deforestation risks. The commodities covered are palm oil, timber, soy, beef and biofuels.

Companies participate through responding to the CDP forest information request. The questions focus on business risk management, covering areas such as risk assessment and analysis, measuring and monitoring of production, traceability and governance systems. Questions on policy include high-level policy statements; membership of certification bodies/multi-stakeholder initiatives; and level of engagement with suppliers.

The PRI also has a working group on palm oil. This comprises 25 investors with US$2 trillion under management that directly engage with companies on ESG issues in palm oil supply chains. The investor group is represented on the RSPO through Generation Investment Management, which chairs the working group. Generation reports on the activities of the group to RSPO through its Annual Communication On Progress. The investor group commenced activities in 2010 engaging mainly with buyers in the EU. Subsequently it has engaged with buyers in India and China. It is now moving upstream to engage with producing companies.

In the US, the advocacy organization Ceres has coordinated filing of shareholder resolutions at a number of FMCG company AGMs to request responsible palm oil sourcing policies.[92] There are seven such resolutions for 2015, with seven in 2014 and ten in 2013.

A further initiative is the Principles for Responsible Investment in Farmland. A group of investors developed guidance for farmland investment, which was subsequently integrated into the PRI in July 2014.[93] Separately the Committee on World Food Security, a forum within the United Nations, released the Principles for Responsible Investment in Agriculture and Food Systems in October 2014.[94]

As an asset class, timber does not have a specific set of investor guidelines setting out standards for responsibility. However, in December 2012 New Forests, an asset manager focussed on responsible forestry with a significant footprint in Southeast Asia, released a paper titled *Responsible Investment in Emerging Timberland Markets*.[95]

Further, the IFC's Performance Standard 6 relates to Biodiversity Conservation and Sustainable Management of Living Natural Resources.[96] It applies whenever a fund has the IFC as an investor or where a company is seeking IFC funding for an activity. The IFC Standards serve as a benchmark for high performance in environmental and social sustainability.

CHAPTER 3

Chapter 3 covers company disclosure on the most material ESG issues based on WWF's 2050 Criteria. It reviews a sample of 40 companies – 21 involved in palm oil, 10 in timber, and 9 in pulp & paper – listed on the Singapore Stock Exchange, Bursa Malaysia and Bursa Efek Indonesia (IDX). The chapter also sets out relevant ESG disclosure regulations for the Singaporean, Indonesian and Malaysian equity capital markets.

Photo: Emptying out harvested palm fruit, Sumatra, Indonesia.

CHAPTER 3 COMPANY DISCLOSURE AND REGULATION

KEY FINDINGS

- Forest risk commodity companies currently provide low levels of disclosure on material ESG issues.
- The current disclosure levels are insufficient for investors to assess management of ESG risks and opportunities.
- Based on the available disclosure companies are not optimising shareholder value through their ESG management.
- There is a role for tighter regulation on disclosure to support investors in assessing ESG performance.

This section reviews ESG disclosure levels of leading locally-listed forest risk commodity companies and finds significant gaps. It considers existing disclosure regulations in Singapore, Indonesia and Malaysia to highlight where enhanced regulations could address the disclosure gaps.

The disclosure review found that as a group the forest risk commodity companies covered provided low levels of disclosure on ESG management. In general palm oil companies provided more disclosure than timber and pulp & paper companies. This may reflect the larger average size of the palm oil companies.

19%

ONLY 19% PROVIDED ADEQUATE DISCLOSURE ON LEGALITY OF THEIR SUPPLY BASE

PALM OIL

There were a number of areas for which very few (less than 25 per cent) companies provided disclosure of a policy or equivalent practices. These include issues such as chemical use, soil and water management, which is surprising given these are important agricultural management practices – but perhaps unsurprising given the historical focus on land acquisition as the key driver of growth.

There were a few questions for which more than half of the companies reviewed provided minimum disclosure, which were GHG emissions, local and indigenous communities, labour standards and pest management.

Slightly over half (57 per cent) of the companies provided a policy on GHG emissions. The detailed question considers whether companies capture methane from POME, which can be used for electricity generation with resultant cost savings. Less than half (48 per cent) of companies assess their emissions and less than a fifth (19 per cent) have a time-bound target for reducing them. This is a glaring omission for an industry that is central for to climate change concerns via deforestation and peat land conversion and which will be highly impacted by weather variability.

On the issue of legality of production, harvesting and trading in compliance with applicable local, national and ratified international law and regulations, only 19% of companies provided adequate disclosure regarding their supply base, which is alarming given the requirements for legality from most buyers and traders.

TIMBER/PULP & PAPER

The only question for which more than 25 per cent of companies provided adequate disclosure was the question on legality of production and sourcing. This is a significant omission given the requirements for legality in key importing markets such as the US, EU and Australia.

11%

ONLY 11% OF COMPANIES DISCLOSED POLICIES ON REDUCING GHG EMISSIONS

Only two companies provided policies or equivalent practices on reducing GHG emissions. The rest did not meet the minimum policy threshold set out in the detailed disclosure questions (see appendix 1). Either they did not provide information on waste processing/reduction, or they did not invest in renewable energy at their facilities, or, for plantation companies, they did not provide information on minimising use of fertilizers. It is hard to see what the reason for failing to undertake or disclose any of these elements of good management practice could be.

The overall picture is of poor disclosure, likely indicating management practices that fail to optimize returns to shareholders.

KEY RECOMMENDATIONS

- Create value through improved ESG management practices, with a focus on yield improvements[97] that contribute to secure reliable long term supply chains, responsible land-use planning[98] and optimized use of natural resources, rather than land acquisition or a mining approach (i.e. harvest and go).
- Highlight core sustainability strategy and implementation to banks and investors.
- Confirm that suppliers also meet mitigation criteria to ensure that mill output is fully responsible; responsible operating practices apply through the entire supply chain, beyond companies' own plantations to external or independent suppliers of FFB, timber or pulp.
- Voluntarily adopt disclosure practices as outlined in the 2050 Criteria that enable investors to assess and compare ESG standards and performance.
- Become members and undergo certification by multi-stakeholder initiatives such as the RSPO and FSC.

KEY RECOMMENDATIONS FOR SECURITIES MARKET REGULATORS

- Regulators should strengthen ESG disclosure through the following steps:
  - Make ESG disclosure mandatory where it is not already so;
  - Specify minimum levels of statistical information (such as the seven KPIs covered in the Corporate Knights 2014 report[99]) or the KPIs recommended by the Hong Kong stock exchange[100]
  - Provide sector-specific guidelines setting out the issues and specific KPIs for companies in high impact sectors to cover, including their sourcing activities.

3.1 COMPANY DISCLOSURE ASSESSMENT

PERFORMANCE VERSUS DISCLOSURE

The key question is whether and how well companies are managing ESG issues, rather than what the company is disclosing. Although disclosure is an imperfect tool, it does allow some inferences about company management practices.

It is possible that some companies are taking actions without providing disclosure. For instance, the disclosure review found that few of the Indonesian palm oil companies state that their oil palm is legally sourced. There are Indonesian laws regulating the Indonesian palm oil industry, and the new requirement for ISPO certification (based on existing laws) will help ensure legal compliance. So it is possible that some companies are in legal compliance but fail to disclose accordingly.

Nevertheless, where a company applies appropriate ESG policies, it generally makes sense to provide disclosure and enjoy any related benefits such as enhanced reputation and investor interest/valuation. Consequently, the absence of disclosure presents a concern that companies are not addressing the issues outlined.

The implication is that many forest commodity companies are not capturing the full value associated with improved ESG management, as set out in *Chapter 4 – The commercial case*, and do not have adequate ESG risk management policies and protocols in place.

Importantly, as the sample companies are among the largest in the region and are listed, they are likely to have the best disclosure. Smaller or private companies likely reveal even less about their operations and are likely to have lower ESG performance levels.

For investors, the overall challenge is that current disclosure levels are not sufficient to assess the companies to which they have allocated capital on their ESG performance. This inhibits their ability to make well-informed valuations and stock picking decisions.

STRUCTURING THE REVIEW

The tables below present, for each key performance criterion, the proportions of companies that provide relevant ESG disclosure from a selected sample. The sample comprises 40 Singapore, Indonesia and Malaysia listed companies with significant forest risk commodity exposure, including 21 palm oil companies, 10 timber companies, and 9 pulp & paper companies.

The companies were selected for review on the basis of market capitalization in each of the palm oil sector and the timber and pulp & paper sectors, with disclosure for the latter two sectors considered together. The full list of companies reviewed is provided in the table in the executive summary.

The main emphasis of the review is to determine whether appropriate policies are disclosed. However, companies often disclose appropriate practices without specifically describing them as a policy. In such instances disclosure is assessed on the basis of whether the practices are equivalent to a policy of a minimum standard.

Conversely, some companies provide policy statements that are lacking in substance, i.e. there are no details provided of appropriate steps to manage the given issue. In these cases, the disclosure is not considered equivalent to a policy for the purpose of establishing the proportions provided in the table.

Appendix 1 sets out the full list of questions used to assess disclosure. The features of the disclosure assessment used for this report include that it is based on specific actions growers use to manage specific ESG risks; that it is focussed on material issues across the full range of environmental and social issues; and that it is based on public information provided by the companies. The purpose of the assessment is to understand the proportion of companies that disclose different types of information, and by inference the proportion that implement these management practices.

One area of complexity for integrated forest risk commodity companies is whether the policies apply to external raw materials that are bought in as well as to raw materials grown in owned plantations or concession areas.

PALM OIL

The supplier base for palm oil is quite complex. Most of the companies have their own plantations as well as external suppliers. Integrated palm oil companies may take in supply from third parties at their mills or at their refineries. Suppliers could be tied smallholders, independent smallholders, or independent growers of fresh fruit bunches (FFB) or independent mills. In many cases the statements on ESG provided are not clear enough about their scope to distinguish whether or which types of supplier are included. For clarity, the questions do not require companies to include suppliers in their scope and the companies are assessed on the basis of their own plantations apart from the question on legality, which applies to all externally sourced raw materials. However it is important to note that sustainability has to extend throughout the entire supply chain.

TIMBER/PULP & PAPER

There are major differences in the operations of timber and pulp & paper companies in that some operate plantations, some log from natural forests, and some are purely involved in processing/distributing timber or pulp & paper products. For each company, a positive response to the disclosure question requires a positive response to each detailed question that is relevant to the company's operations. This means that an integrated company is assessed both on its own plantations/concessions as well as externally sourced raw materials.

PROPORTION OF PALM OIL COMPANIES PROVIDING RELEVANT ESG DISCLOSURE (21 COMPANIES)

Priority areas protection

1 Does the company disclose policy or equivalent practices relating to priority areas or those on which it will not plant?

43%

GHG emissions

2.1 Does the company disclose a policy or equivalent practices relating to GHG emissions?

57%

2.2 Does the company disclose an assessment of any of its GHG emissions?

48%

2.3 Does the company disclose time-bound targets to reduce GHG emissions from current operations?

19%

Legal production

3 Does the company disclose that its product, including externally sourced raw materials, is produced/ harvested in compliance with all applicable local, national and ratified international laws and regulations?

19%

Local & indigenous Communities

4 Does the company disclose a policy on local and indigenous communities?

52%

Chemical use

5 Does the company disclose a policy or equivalent practices on chemical use?

5%

Pest management

6 Does the company disclose an integrated pest/weed management plan (IPMP) or equivalent practices? [101]

67%

Nutrient management

7 Does the company disclose a nutrient management plan (NMP) or equivalent practices?

43%

Soil management

8 Does the company disclose a soil management plan (SMP) or equivalent practices?

19%

Water management

9 Does the company disclose a water management plan or equivalent practices?

24%

Labour rights

10 Does the company disclose that it uses ILO standards in relation to labour or provide relevant protections?

57%

Occupational health & safety

11.1 Does the company disclose its OHS policy or relevant practices?

14%

11.2 Does the company provide OHS statistics?

48%

PROPORTION OF TIMBER/PULP & PAPER COMPANIES PROVIDING RELEVANT ESG DISCLOSURE (19 COMPANIES)

Priority areas protection

1 Does the company disclose policy or equivalent practices relating to preservation of priority areas in line with its activities?

21%

Local & indigenous communities

2 Does the company disclose a policy or take equivalent actions relating to local and indigenous communities in areas from which it sources?

17%

Legal production

3 Does the company disclose that it has a due diligence system in place to manage the risk that its product is not produced/harvested and traded in compliance with all applicable local, national and ratified international laws and regulations?

26%

Ecosystem functions

4 Does the company disclose relevant policy relating to preserving and enhancing biodiversity and ecosystem services?

0%

Area-based management

5 Does the company disclose relevant policy relating to area-based management of the plantations and forests from which materials are drawn?

0%

GHG emissions

6.1 Does the company disclose a policy relating to GHG emissions or equivalent practices?

11%

6.2 Does the company disclose any assessment of its GHG emissions (e.g. scope 1, 2 and 3)[102]?

5%

Occupational health & safety

7.1 Does the company disclose its OHS policy or equivalent practices?

0%

7.2 Does the company provide OHS statistics?

0%

Labour rights

8 Does the company disclose that it uses ILO standards in relation to labour or provide relevant protections?

11%

Water management

9.1 Does the company disclose a water management plan or equivalent practices?

5%

9.2 Does the company disclose a water discharge plan or equivalent practices?

11%

3.2 THE ROLE OF REGULATION TO ADDRESS THE CURRENT DISCLOSURE GAP

DISCLOSURE REGULATION AS AN AID TO CAPITAL MARKETS DEVELOPMENT AND EFFICIENCY

Tighter regulation is one way to address the disclosure gap. Indeed, a 2013 study [102] found that stock exchange policies that are "mandatory, prescriptive, and broad" have the highest correlation to sustainability disclosure excellence.

Such regulation would increase transparency and the ability of investors to assess companies and allocate capital, thereby increasing the efficiency of capital markets in each country. Greater transparency and management attention should lead to improved industry ESG standards, improved competitiveness, and better long term economic performance.

Further, the improved transparency and improving ESG standards would help address international investor concerns about investment in forest risk commodity companies and attract more investor capital into forest risk commodity sectors.

In the first quarter of 2012, NBIM, the manager for Norway's Government Pension Fund Global, the largest pension fund in the world, divested from 23 palm oil companies due to the "unsustainable practices" of these companies. NBIM states in its Annual Report: "We expect companies that cause deforestation through their production to take steps to reduce the scope of this deforestation or replant the affected areas we sold our stakes in 23 companies that by our reckoning produced palm oil unsustainably." [103]

NBIM is not alone in finding that ESG concerns can be a barrier to investment in the palm oil sector. WWF's 2012 Palm Oil Investor Review surveyed 35 international investors with exposure to palm oil. In response to the key challenges preventing investment in the industry, the most cited responses were reputational risk (72 per cent), lack of company ESG disclosure (59 per cent), and poor environmental performance (56 per cent).

CURRENT ESG DISCLOSURE REGULATIONS

Regulation on ESG comes in various forms. It includes disclosure of company ESG management, general provisions on the adoption of ESG or CSR, and specific rules on how to manage distinct environmental or social issues. This section only considers disclosure.

The main sources of regulation for company reporting on ESG are company acts, listing rules, corporate governance codes and sustainability guidelines. Of these, company acts and listing rules create binding obligations, while corporate governance code provisions are typically based on "comply or explain", in which a company may comply or explain why it has not complied. Guidelines are voluntary in nature.

The three markets covered all provide some form of regulation or guidance to companies on ESG disclosure. Indonesia and Malaysia have mandatory disclosure requirements, while Singapore currently only has guidelines. The table below sets out the major provisions.[104]

ESG DISCLOSURE BY COUNTRY

INDONESIA

COMPANY LAW

Rule 40 Limited Liability Companies Law Article 66 states that annual reports should contain a "report on the implementation of Social and Environmental Responsibility".[105]

In 2012, regulation No.KEP-431/BL/2012 was issued stating that listed companies should provide the following information on CSR policies, types of programmes, and expenditure on: environmental performance including all environmental certifications, labour practices, social and community empowerment, and product responsibility.[106]

CORPORATE GOVERNANCE CODE

Indonesia's Code of Good Corporate Governance sets out its purpose in the opening section including: "5.4. Stimulating the company awareness of social responsibilities in particular the environmental and societal interests of the communities in which a company operates." This purpose is achieved through guidelines in a number of areas including Part II on general principles under point 3. Responsibility, and in Part VI, the Rights and Roles of Other Stakeholders. However, the Code does not set out ESG disclosure requirements aside from the last point Part VI, 3.3 Community and User of Products and Services, where it notes that in case of negative impacts "the company shall convey any information to the communities that could be affected by such company's activity."[107]

MALAYSIA

LISTING RULE

Bursa Malaysia listing rule 9.25 requires companies to disclose in their annual reports items as set out in Appendix 9C, which includes the obligation in paragraph 29 to provide: "A description of the corporate social responsibility activities or practices undertaken by the listed issuer and its subsidiaries or if there are none, a statement to that effect."[108]

CORPORATE GOVERNANCE CODE

The Malaysian Code on Corporate Governance recommendation 1.4 states: "The board should ensure that the company's strategies promote sustainability". The related commentary states that attention should be given to ESG and: "The board should ensure the company discloses these policies and their implementation in the annual report and corporate website."[109]

SINGAPORE

STOCK EXCHANGE GUIDANCE

In 2011 the Singapore Stock Exchange (SGX) issued a policy statement on sustainability and its voluntary Guide to Sustainability Reporting for Listed Companies. It states that companies that operate in high-impact sectors such as agriculture, forestry and paper should "set the tone and undertake sustainability reporting".[110]

In 2013 SGX issued the Investor's Guide to Reading Sustainability Reports to support investors seeking to interpret sustainability information.[111]

In October 2014 SGX announced that sustainability reporting will move into the "comply or explain" regime following a one-year consultation process. [112]

CORPORATE GOVERNANCE CODE

A revised Code was released in 2012. While the new version does not include related disclosure requirements, it clearly sets out ESG-related responsibilities for the Board under Guidance 1.1:

"(d) Identify the key stakeholder groups and recognise that their perceptions affect the company's reputation;
(e) Set the company's values and standards (including ethical standards), and ensure that obligations to shareholders and other stakeholders are understood and met; and
(f) Consider sustainability issues, e.g. environmental and social factors, as part of its strategic formulation." [113]

GAPS IN DISCLOSURE DESPITE RULES

Although Malaysia and Indonesia have mandatory rules on disclosure (while Singapore has only voluntary guidelines), the company review highlights significant disclosure gaps on material issues across the board.

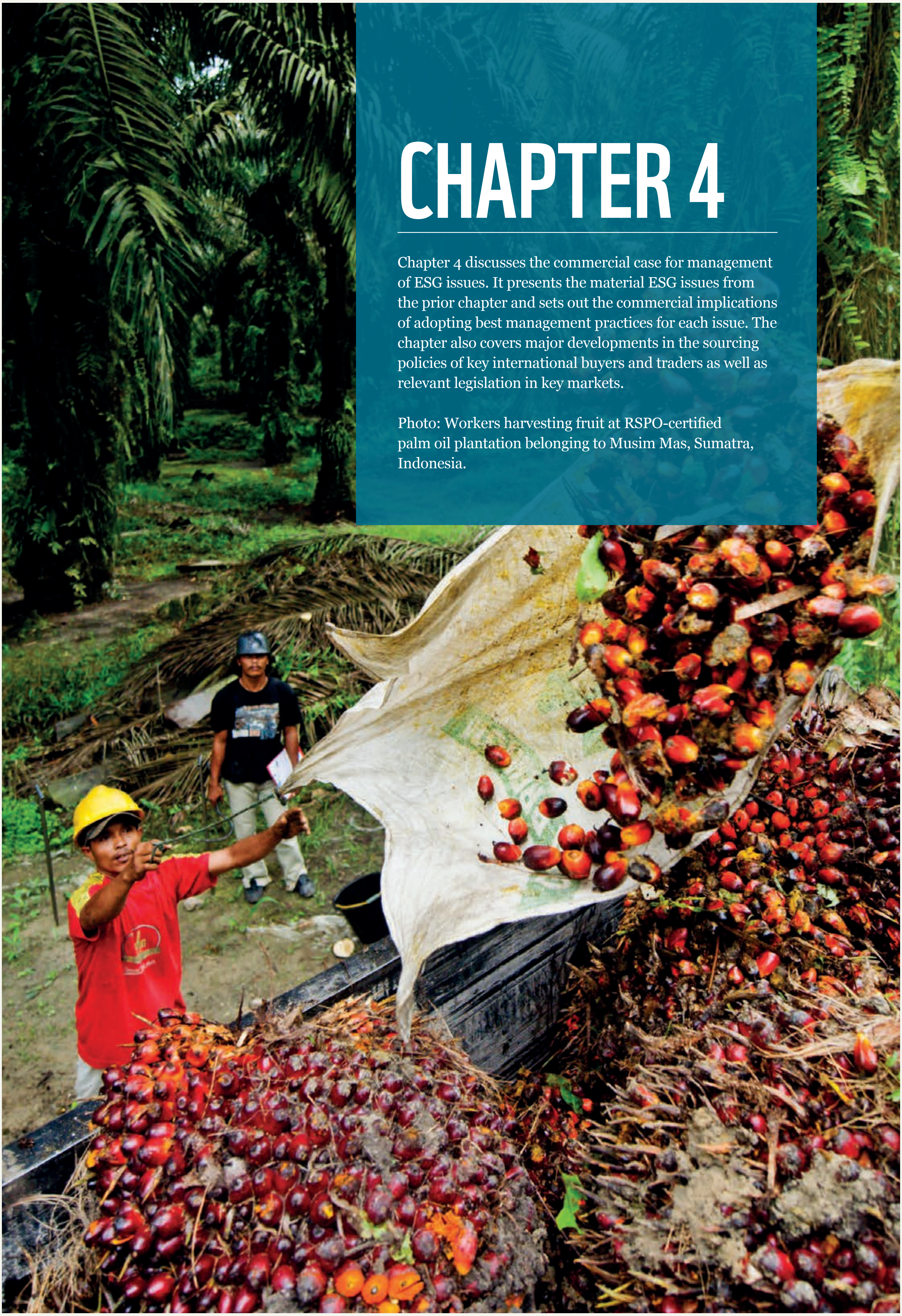
This suggests that companies are either in breach of the rules, which is an enforcement problem, or that the rules are not prescriptive enough to direct companies to provide appropriately detailed information to investors. A close inspection of the associated guidelines suggests the problem is in the rules themselves.

One issue is that they may leave open the option to explain an absence of disclosure rather than mandating it. Another is that the rules are structured in a general manner, without setting out the importance of presenting statistical information. Further, disclosure is categorized under generic headings, such as environment or society, which do not provide clear guidance for companies.

The simplest way for regulators to ensure that investors have comparable information on material issues such as land-use change, engagement with local communities, and agricultural practices is to set out the disclosure requirements in detail. As material ESG issues are different for different sectors, this can only be achieved through sector-specific disclosure rules.

Consequently our recommendation for regulators is to be far more prescriptive in their ESG disclosure guidelines. Regulators should:

- Make ESG disclosure mandatory where it is not already so;
- Specify minimum levels of statistical information (such as the KPIs covered in the 2013 Corporate Knights report); and[114]
- Provide sector-specific guidelines setting out the issues and specific KPIs to cover in high impact sectors such as forest risk commodity companies.



CHAPTER 4

Chapter 4 discusses the commercial case for management of ESG issues. It presents the material ESG issues from the prior chapter and sets out the commercial implications of adopting best management practices for each issue. The chapter also covers major developments in the sourcing policies of key international buyers and traders as well as relevant legislation in key markets.

Photo: Workers harvesting fruit at RSPO-certified palm oil plantation belonging to Musim Mas, Sumatra, Indonesia.

CHAPTER 4 THE COMMERCIAL CASE

KEY FINDINGS

- There is a strong commercial case for forest risk commodity companies to take action to improve ESG management.
- The business drivers to improve ESG management are different for each different issue and require detailed consideration.
- Recent commitments from trading companies to remove deforestation and exploitation from their supply chains strengthen the commercial case for the entire industry.
- Recent commitments from large consumer goods companies to source responsibly produced commodities provide further commercial rationale for improved ESG management.

This section sets out the commercial relevance for forest risk commodity companies of taking steps to improve ESG management. The ESG issues identified and accompanying mitigating actions are based on WWF's 2050 Criteria, which identifies the most material ESG risks and the key performance/mitigation criteria required for RI in different agricultural, forest and seafood commodities. The business case is presented first for palm oil then for timber and pulp & paper considered together.

The analysis sets out the business case for companies, which is equally relevant to providers of capital. The approach a company takes to ESG also provides a signal to banks and investors about its overall management quality.

In addition to company-level effects, ESG mismanagement may have implications for providers of capital in other parts of their portfolios. For example, a failure to address climate change could have negative implications for their overall investment or lending portfolios. These effects are considered more broadly in *Chapter 1 – Banks and ESG integration* and *Chapter 2 – Investors and responsible investment*.

THE COMMERCIAL CASE

There are multiple factors in the commercial case for forest risk commodity companies to enhance ESG management. Some of these are part of good agricultural/forestry practices that support yields at plantations, such as soil, nutrient and water management.

Palm oil plantations that have taken steps to improve ESG practices have already seen benefits. WWF in collaboration with CDC and FMO published a report in 2012, *Profitability and Sustainability In Palm Oil Production*, based on palm oil company experiences of improving practices in line with RSPO certification. The study showed that:

- Sustainability (RSPO) certification can reduce the risk of disruptions due to community protests. For a processing facility, this can result in millions of dollars of cost savings.
- Certification can reduce labour turnover.
- Certification can lead to productivity improvements.

WWF will soon be publishing a research report on the business case for FSC certification. The research undertaken thus far shows that in the case of FSC, there is a significant increase in product quality control and therefore less cost associated with managing contingencies, waste and unexpected events. Other additional benefits of FSC may include increased value of forest assets.

Another factor is that these industries are themselves highly vulnerable to environmental risks, such as weather variability and water scarcity, that will increase as a result of climate change. Over the long term it makes no sense for these industries to allow supply chain practices involving deforestation, forest degradation and peatland conversion that contribute to climate change and so undermine their own business prospects. In the shorter term, poor ESG performers are more exposed to risks of land-use change regulation and GHG regulation of the agriculture sector. Both of these factors, climate change/weather variability and regulation risk, can lead to stranding of assets throughout the agricultural supply chain.[115]

A factor that has grown in significance in the last few years is market access, both in terms of changing end customer demands and route to market. Issues such as deforestation, once a feature of normal economic development, have become controversial and a potential barrier to sales. This section considers market access first, before reviewing the individual ESG factors in detail.

MARKET ACCESS

In palm oil market access requirements are changing primarily due to end customer demand and more recently due to the adoption of strong supplier policies by palm oil traders resulting in tighter sustainability conditions for the route to market. In timber regulatory barriers to selling illegal timber or pulp & paper products are increasing alongside demand for responsibly-sourced products as a result of sourcing commitments at large customers.

4.1 PALM OIL

EARLY INITIATIVES BY PRODUCERS

After exploring the causes of the significant haze problems in the 1990s, stakeholders formed the RSPO in 2004. The aim was to develop a robust international sustainability standard that ensured that palm oil could be produced in ways that prevented loss of forests that were valuable for wildlife and local communities. Early efforts by major grower members of the RSPO have led to almost one-fifth of global production now being RSPO-certified.

CHANGING END CUSTOMER DEMANDS

To match grower efforts, initial NGO campaigns and consumer boycotts pushed leading EU and US branded goods companies to adopt sourcing policies with commitments to purchase RSPO-certified sustainable palm oil (CSPO). Examples include Unilever,[116] Nestlé,[117] General Mills,[118] Proctor & Gamble [119] and Mars.[120]

In addition to the largest companies, national initiatives in Belgium, France, Germany, Denmark, The Netherlands and the United Kingdom have made commitments to source sustainable palm oil. Industry and governments have spearheaded these national initiatives to forge alliances towards CSPO commitments.[121]

ROUTE TO MARKET

In the last year the drive to improve standards has moved further up the supply chain to include a new set of commitments from palm oil traders. Building on certification of sustainable palm oil, the new policies bring minimum standards to each company's entire supply chain – most significantly to independent operators within their supply base.

Three of the largest traders – Wilmar, Bunge and Cargill – have committed to remove product from their supply chains that contributes significantly to climate change or biodiversity loss or involves exploitation.

As much of the world's supply of palm oil moves through these traders, this has significant implications for growers. Where they are not meeting the required standard, growers will find it harder to access their markets, as the route to market via these traders will be effectively closed to them. Even where alternative customers are found with lower sustainability requirements, the customers are likely to be tighter on price, while the grower may have reduced logistics options and higher associated costs.

Due to the complexity of sourcing and the challenges of instigating changes to business practices at their suppliers, the traders' new policies include the commitment to develop implementation timelines, which will take several years. The traders will also have to work with their suppliers to help them transition their operating practices so as to meet these policies.

Investment in traceability systems is a further key element in ensuring that suppliers are operating at the appropriate standard. This is a particular factor for mill operators that buy in FFB, as they need to ensure they do not contaminate their output with illegal or unsustainable FFBs. As such, palm oil companies need to ensure that their suppliers meet the mitigation criteria in order to ensure their products are able to meet the requirements of traders and customers.

CORPORATE APPROACHES TO PALM OIL SUSTAINABILITY

WILMAR

Key elements

- No development of HCV forests or High Carbon Stocks (HCS) areas
- No development on peat regardless of depth
- No exploitation of people and local communities

Scope

"All Wilmar operations worldwide" & "All third-party suppliers"

Timeline

"Effective immediately, Wilmar will not engage in development of HCS, HCV, or peat, nor knowingly source from suppliers engaged in development of HCS, HCV, or peat"

CARGILL

Key elements

- No deforestation of HCV land
- No development on peat
- No exploitation of rights of indigenous peoples and local communities

Scope

"All palm oil and palm products that Cargill produces, trades or processes"

Timeline

"We will publish annual time-bound implementation plans. (Beginning December 2014)"

BUNGE

Key elements

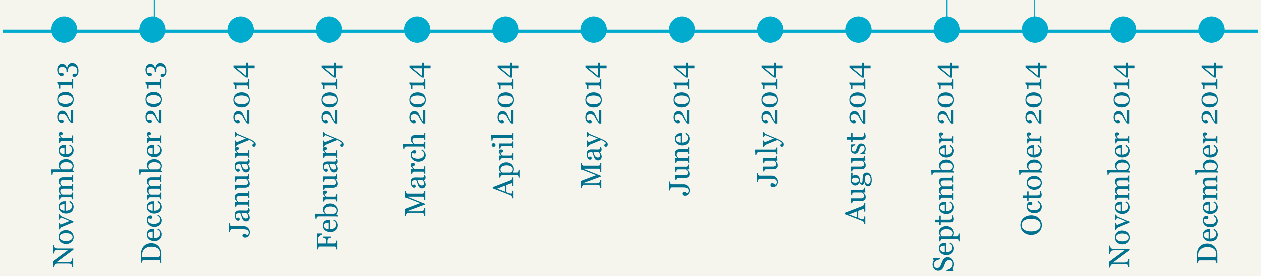
- Protect HCV areas
- Protect peat, regardless of depth
- Protect labour standards
- Respect communities

Scope

"100 percent of the palm oil and palm derivatives it trades, processes and utilizes in commercial and consumer products worldwide"

Timeline

Bunge will collaborate with suppliers and other relevant stakeholders to develop time-bound implementation plans



COMMERCIAL CASE FOR ACTION ON ENVIRONMENTAL AND SOCIAL ISSUES IN PALM OIL

	MITIGATING ACTIONS	COMMERCIAL IMPLICATIONS [123]
PRIORITY AREAS PROTECTION	**Prohibit planting areas that are:** ▪ Primary forest ▪ Peatland ▪ High conservation value (HCV) areas Manage HCV areas Ensure that suppliers adopt these measures	**There is an opportunity cost where companies choose not to plant on certain areas. However, planting or sourcing from suppliers that plant on primary forest, peatland or HCV areas runs various risks:** ▪ Reputational issues, customer/consumer boycotts ▪ Fewer routes to market due to commitments from traders ▪ Soil erosion and disruption of water catchment areas with attendant negative impact on yields and dependent communities ▪ Community tension from loss of areas of economic (e.g. livelihoods, nutrition, water) or cultural/religious value can lead to incidents and production stoppages Where development is illegal, this can lead to licences being revoked and confiscation of land
GHG EMISSIONS	Assess and manage down emissions Prohibit planting on areas with high carbon stocks (HCS) – primary forest and peat (own operations and suppliers) Manage/restore existing peat plantations Restore soil carbon, such as through use of cover crops and returning empty fruit bunches (EFB) to the fields Minimize fertilizer use Capture methane from POME Increase use of renewable energy in mills Implement measures to deal with fires in and around plantation areas Eliminate land clearance practices based on burning	Climate change presents direct risks to the industry, while addressing climate change requires prohibition of land conversion from peat and forest. Company-level effects are complex and appear to favour action. ▪ Increasingly variable weather due to climate change reduces production through damage to crops, reduction in yields and increased difficulty harvesting ▪ Variable weather can result in commodity price spikes that create supernormal profits – for companies that have not suffered significant falls in production ▪ Overall depressed production and volatility that lowers perceived quality of earnings may result in lower valuations for palm oil assets **The steps to address climate change are mainly positive aside from land set aside:** ▪ Setting aside land represents an opportunity cost, though restricted market access and tighter regulations are reducing benefits from planting on primary/HCV forests ▪ Growing on primary/HCV forest and peat (in own operations or at suppliers) can result in customer/consumer boycotts, disruption to micro-climate potentially reducing yields, and for peatland higher costs/lower yields ▪ Restoring soil carbon with cover crops and EFB supports yields in the long term and reduces input costs such as fertilizers ▪ Reduced fertilizer use reduces input costs, targeted application improves yields ▪ POME methane capture can save energy costs (e.g. when used to power mills) and can generate income by selling surplus power ▪ Fires can damage plantations and local haze can create problems harvesting crops ▪ Open burning is also illegal and can result in fines and now civil suits under Singapore's new haze laws which have extra-territorial application [124]

	MITIGATING ACTIONS	COMMERCIAL IMPLICATIONS [124]
LEGAL PRODUCTION	Follow applicable laws (local, national, and ratified international laws and regulations) in all areas of operation Hold legal rights to operate on the area of land and ensure that all plantation boundaries fall within legal concession zone	**Where laws and standards have not been followed there are multiple risks:** ■ Operating licences are revoked or concessions repossessed, presenting risks to the balance sheet ■ Fines and sanctions ■ Customer/consumer boycotts
LOCAL AND INDIGENOUS COMMUNITIES	Ensure that communities in affected areas give their free, prior and informed consent (FPIC) to developments following a transparent and comprehensive consultation process	**Where local or indigenous communities launch significant protests, this can lead to:** ■ Stoppages at operating units ■ Customer/consumer boycotts/reputation impact ■ Loss of social licence to operate resulting in closure of operations Local communities can often act as a source of labour or supply FFB as smallholders, hence good relations provide for more secure supply of labour and FFB
CHEMICAL USE	**Reduce and manage chemical use through:** ■ Implementing chemical management plans such as integrated weed management plan (IWMP), integrated pest management plan (IPMP), nutrient management plan (NMP) ■ Phasing out use of WHO Class I and II chemicals ■ Implement appropriate safety measures for workers, suppliers and the local community	■ Chemical use is an input cost that can be reduced through careful management ■ Chemical use raises risks of OHS or pollution incidents, with attendant risks of stoppages, lower labour availability and compensation costs ■ Chemical use can degrade land quality over time reducing yields Harm to local communities can result in conflicts, operational stoppages, and reputational impact
PEST MANAGEMENT	**Reduce pesticide usage through IWMP and IPMPs covering:** ■ Use of biological controls in place of chemical ones (such as owls) ■ Phase out of paraquat ■ Appropriate application rates and altering of active ingredients	**WMP and IPMPs can:** ■ Reduce chemical costs while maintaining yields ■ Reduce risk of polluting runoffs ■ Reduce risks of chemical OHS incidents and related stoppages/compensation ■ Reduce risk that weeds/pests develop resistance to active ingredients requiring higher inputs over time
NUTRIENT MANAGEMENT	**Improve nutrient management through a NMP covering:** ■ Use of (leguminous) cover crops ■ Regular soil and foliage testing ■ Variable rate technologies for fertilizer application ■ Return EFB to fields	■ Effective nutrient management reduces input costs, reduces pollution and GHG emissions, and increases yields through better targeting of fertilizers ■ Cover crops prevent soil depletion and fix nitrogen in the soil, reducing fertilizer requirements ■ Return of biomass to the soil maintains the long-run productivity and value of the land

	MITIGATING ACTIONS	COMMERCIAL IMPLICATIONS [124]
SOIL MANAGEMENT	**Improve soil management through a soil management plan (SMP) covering:** ■ Use of cover crops ■ Contour planting in appropriate areas/steep slopes ■ Protection of riparian areas ■ Return EFB to fields	**Without effective soil management:** ■ Topsoil is lost ■ Nutrients are depleted ■ Salinity and pH levels are rendered unsuitable ■ Soil erodes This leads to declining yields in the medium to long run and potentially unplantable areas of land Riparian area protection assists water management. This reduces risks of flooding and drought, either of which can damage crops, reducing yields Avoiding development on steep slopes prevents soil erosion, maintains soil productivity in the long term and hence the value of land concessions
WATER MANAGEMENT	**Address water related risks through a water management plan (WMP) covering:** ■ Assessment and management of water needs in growing areas in light of changing weather patterns, downstream human and environmental needs, and soil holding capacity ■ Management of discharges to water from facilities and related impact on communities and environment	■ Incidents of water shortage in water-stressed areas will result in crop damage or failures ■ Reduction of excessive water use will also reduce input costs ■ Precise water use prevents over/under-watering that can lower yields ■ Flooding in areas of high pollutants or discharge of polluted water can affect relations with and health of downstream stakeholders, potentially resulting in stoppages, compensation costs, fines or licencing issues
LABOUR RIGHTS	**Use high labour standards equivalent to ILO, including:** ■ Prohibit child, forced or bonded labour ■ Allow staff free association ■ Provide training and other resources to smallholders to enhance outputs and increase income ■ Ensure transparent market pricing information for independent smallholders	**Palm oil is labour-intensive and labour is increasingly tight (particularly in Malaysia):** ■ Traders' sourcing policies may restrict route to market for companies with labour relations issues ■ Growers with a poor reputation may find it harder to attract workers ■ Where there is unrest, stoppages can reduce mill utilization and productivity ■ There is evidence that a better paid/treated workforce is more productive, with lower turnover, which reduces training and recruitment costs [125] ■ Enhanced outputs from smallholders raise overall yields ■ Fair and transparent pricing increases loyalty of independent smallholders and prevents side selling or irregular supplies of FFB
OCCUPATIONAL HEALTH & SAFETY	**Reduce and manage OHS incidents through:** ■ Appropriate targets ■ Formal review of incidents ■ Provide appropriate personal protective equipment and training, including on chemical use	**Overall a high level of incidents reflects negatively on management quality:** ■ Incidents can affect profitability in a number of ways including stoppages, repairs to assets, reduced motivation and productivity, compensation payments, and fines ■ A reputation for poor OHS may affect the ability of a company to recruit staff

4.2 TIMBER, PULP & PAPER

CHANGING END CUSTOMER DEMANDS

The customer base for timber and pulp & paper companies is more fragmented than is the case for palm oil. Nevertheless, leading buyers are increasingly committing to responsibly sourced wood and fibre, restricting the market for companies that are not able to meet these requirements. This is especially the case for high premium export markets.

WWF's Global Forest and Trade Network (GFTN) is a partnership of companies, communities, NGOs and entrepreneurs to create a new market for environmentally-responsible forest products. There are 186 participating companies including Marks & Spencer, B&Q and IKEA. These must commit to credible certification for their products. Requirements include:

- Forest companies that are not yet certified must confirm that they are operating legally and commit to a time-bound action plan to achieve credible certification for all of their forest management units within 10 years.
- Manufacturers and processors of wood and paper products, retailers, distributors and other end users must commit to eliminating the use of wood and pulp from unacceptable sources, and increase credibly certified sourcing.

Other notable consumer goods company commitments to responsible sourcing of forest products include:

- Kimberly Clark has committed to sourcing 100 per cent of its wood fibre, by 2015, from suppliers that have received third-party certification of their forestry activities; and 90 per cent of the fibre, by 2025, in its tissue products from environmentally preferred sources. This includes FSC-certified wood fibre, recycled fibre and sustainable alternative fibres.
- P&G committed to having 40 per cent of the virgin wood fibre used in its tissue/towel products FSC-certified by 2015, and has exceeded this a year in advance to achieve 54 per cent certification.
- German retailer EDEKA has committed to 100 per cent recycled (for preference) or FSC paper, tissue and timber for all its own brand products by 2015.

Overall there is increasing transparency in the pulp & paper sector, with 25 of the most important pulp and paper manufacturers having participated in the WWF Environmental Paper Company Index (EPCI) 2013. Participating companies are scored against three aspects: impacts on forest ecosystems from fibre sourcing; emissions from manufacturing processes such as water pollution and GHG emissions; and reporting and environmental management systems. Active participation in the EPCI highlights a growing commitment to transparency, which is the first step on the way to more responsible sourcing and is a reflection of changing market access conditions in the pulp & paper sector.

ROUTE TO MARKET

In timber and pulp & paper, strong regulations such as the Lacey Act in the US and Timber Regulation in the EU play a role in restricting access to market for illegal timber products, illegality being one of the key elements of low ESG standards. The following table shows major requirements of new timber regulations in the EU, the US and Australia.

EU

EU Timber Regulation

Businesses must implement systems to prevent illegal timber products from being placed on the EU market. A due diligence system must be in place to assess and minimize risk of illegal wood products entering the supply chain

US

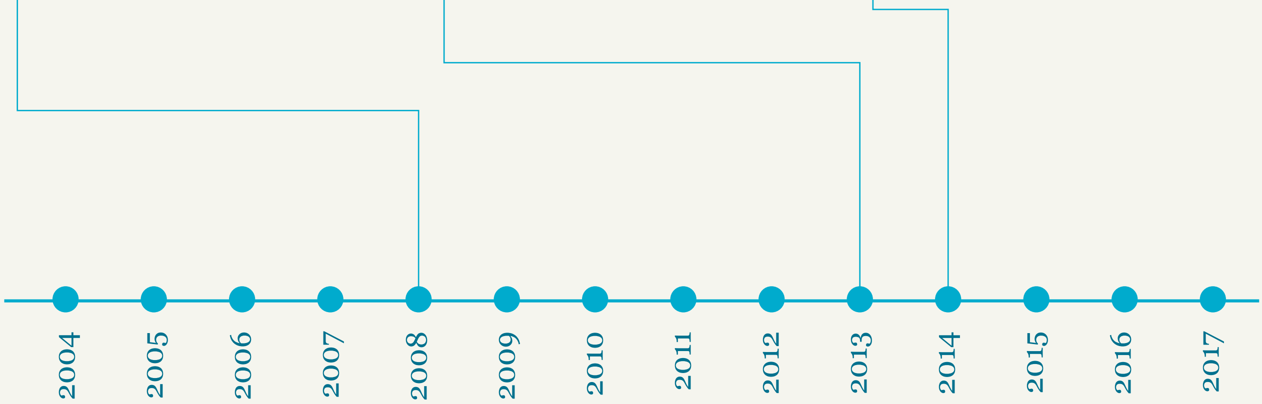
Lacey Act

Bans trade in illegally sourced wood products. Importers are required to declare country of harvest, genus and species, product's volume and value [122]

AUSTRALIA

Illegal Logging Prohibition Act

Importers and domestic processors have to implement a due diligence system to minimize the risk of importing or processing illegal logged timber



COMMERCIAL CASE FOR ACTION ON ENVIRONMENTAL AND SOCIAL ISSUES IN TIMBER, PULP & PAPER

	MITIGATING ACTIONS	COMMERCIAL CASE
PRIORITY AREAS PROTECTION	**Plantation companies:** Prohibit planting areas that are: ■ Primary forest ■ Peatland ■ HCV **Companies that log in natural forests:** ■ Assess HCV areas and implement management plans ■ Ensure that source forest is not converted to other land uses Source only from suppliers that take the above steps	**Plantation/logging companies:** Planting or logging in these areas can lead to reputational issues and customer/consumer boycotts Such product has fewer routes to market due to increased regulatory requirements Community tension can lead to incidents and production stoppages Destruction of HCV areas that provide critical ecosystem services can result in soil erosion, disruption of water catchment areas with attendant negative impact on yields and dependent communities **Sourcing:** Reputational and route-to-market issues can apply Suppliers that face community issues may provide less consistent supply
LOCAL AND INDIGENOUS COMMUNITIES	Ensure that communities in affected areas give FPIC to developments to developments following a transparent and comprehensive consultation process Ensure that local communities benefit from forest management activities (i.e. employment) and provide community zones, health, education and welfare services Source only from suppliers that take the above steps	**Plantation/logging:** Where local or indigenous communities launch significant protests,[126] this can lead to: ■ Stoppages at operating units ■ Customer/consumer boycotts/reputation impact ■ Licences being diminished or revoked **Sourcing:** Companies can face reputational issues or supply stoppages where suppliers have problems
LEGAL PRODUCTION	Follow all applicable laws in each area of operation Prohibit sourcing from suppliers where this can stimulate armed conflict, or where there is legitimate concern of human rights abuse	**Plantation/logging:** ■ Increased regulation such as the Lacey Act in US and FLEGT in EU restricts access to market for illegal timber ■ Where legal standards have not been followed there is a risk that licences are revoked or assets repossessed, presenting risks to the balance sheet **Sourcing:** Companies that source illegal timber face: ■ Restricted markets due to tightened regulation ■ Greater potential for supply disruption

	MITIGATING ACTIONS	COMMERCIAL CASE
ECOSYSTEM FUNCTIONS	Manage logging concessions in ways that enhance ecosystem services/ biodiversity Operate plantations in ways that minimise damage to biodiversity and maintain/enhance soil quality and water cycling capacity Source only from suppliers that take these steps	**Plantation/logging:** Ecosystems provide the following services that can be disrupted through indiscriminate practices: ■ Climate and water regulation ■ Pest reduction ■ Pollination services ■ Soil preservation ■ Nutrient cycling ■ Carbon storage ■ Flood protection **Failure to preserve these services creates a variety of potential risks including:** ■ Lower yields ■ Crop damage ■ Reduced long-term economic value of forest ■ Disputes with other stakeholders leading to stoppage/ compensation ■ Increased sensitivity of yields to climate changes **Sourcing:** Where suppliers fail to preserve ecosystem services there is greater risk of supply disruptions due to stakeholder conflict, flooding or stoppages
AREA-BASED MANAGEMENT	Work collaboratively with other operators to manage forests and plantations at an area-based level, rather than site-based level	This means including a protected area network that is well managed with regard to watersheds, HCVs and biological corridors
GHG EMISSIONS	Assess and manage down GHG emissions[127] Prohibit conversion of natural or primary forest (own operations and suppliers) Minimise fertilizer use Minimize energy use Invest in renewable energy in mill operations Reduce waste to landfill	**Climate change presents direct risks to the industry, while addressing climate change requires prohibition of land conversion from forest. Company level effects are complex and appear to favour action:** ■ Increasingly variable weather due to climate change can reduce production due to damage to trees and increased difficulty harvesting ■ Variable weather can create commodity price spikes that create supernormal profits – for companies that have not suffered significant falls in production ■ Overall depressed production and volatility that lowers perceived quality of earnings may result in lower valuations for palm oil assets **The steps taken to address climate change have mainly positive commercial impacts that can be realised in the short term. Land set-aside is the exception:** ■ Setting aside land presents an opportunity cost, though restricted market access and tighter regulations are reducing benefits from planting on primary/HCV forests ■ Growing on primary/HCV forest (in own operations or at suppliers) can result in customer/consumer boycotts ■ Reduced fertiliser use reduces input costs, targeted application improves yields ■ Renewable energy in mills can save energy costs ■ Innovation around reduced waste to landfill often identifies new product or new efficiencies, e.g. use of bark or black liquor (residue from pulp mills) for renewable energy generation **Sourcing:** A restriction to suppliers that actively manage carbon may result in minor cost increases in the short term. However, in the longer term, climate change-induced production price volatility may be more significant

	MITIGATING ACTIONS	COMMERCIAL CASE
OCCUPATIONAL HEALTH & SAFETY	**Reduce and manage OHS incidents through:** ■ Appropriate targets ■ Formal review of incidents and grievance procedures ■ Provide appropriate personal protective equipment and training, including on chemical use	**Overall a high level of incidents reflects negatively on management quality:** ■ Incidents can affect profitability in a number of ways including stoppages, repairs to assets, reduced motivation and productivity, compensation payments, and fines ■ A reputation for poor OHS may affect the ability of a company to recruit staff
LABOUR RIGHTS	**Use high labour standards equivalent to ILO, for example:** ■ Prohibit child, forced or bonded labour ■ Provide a living wage and social benefits ■ Allow staff free association	■ Growers/loggers with a poor reputation may find it harder to attract workers ■ Where there is unrest, stoppages can reduce mill utilization and productivity ■ There is evidence that a better paid/treated workforce is more productive, with lower turnover, which reduces training and recruitment costs
WATER MANAGEMENT	Assess and manage water needs and availability in growing areas in light of changing weather patterns (ensure suppliers do so)[128] **Manage discharges to water from facilities:** ■ Ensure use of appropriate bleaching technologies ■ Ensure water treatment is in place to mitigate pollution from chemicals and oxygen deprivation	**Plantation/logging:** ■ Failure to manage issues such as silting of waterways due to logging can lead to problems transporting product ■ Draining local groundwater can lead to water availability problems and depress yields over the longer term **Mills:** ■ Mismanagement of water can lead to availability problems and stoppages ■ Reduction in water use reduces input costs ■ Polluting discharges can lead to disputes with local communities, which can in turn result in stoppages, reputation problems, compensation costs and the risk of licences being revoked

CONCLUSION

This report sets out the case for financial institutions to adopt ESG practices and assesses the approaches leading banks and investors in Singapore, Indonesia and Malaysia take to ESG management. It compares them with international financial institutions demonstrating good ESG practices.

Photo: Rain forest timber awaiting conveyance down the Kinabatangan river. East Sabah. Borneo. Malaysia.

CONCLUSION

The report uses locally listed palm oil, timber and pulp & paper companies as a central case study due to the importance of forest risk commodities in the transition to a sustainable global economy as well as the importance of these sectors to the domestic economies and institutions. The report finds that disclosure on material ESG issues by these companies is highly inadequate and sets the disclosure levels in the context of a detailed and robust commercial case for sound management of these issues.

On the basis of public disclosure the report finds that with very few exceptions domestic financial institutions are not taking advantage of the opportunities that enhanced ESG management presents. They are also lagging behind international financial institutions that have started to implement ESG practices across a range of functions.

The report also finds that current banking regulations regarding the inclusion of ESG factors in client and credit assessments and current stock exchange regulations regarding sustainability disclosure are either lacking entirely or not strong enough to create the desired impact.

To spur reforms, the report demonstrates how each actor stands to gain from more sustainable, responsible and structured approaches to ESG management.

For banks and investors there are two broad economic reasons. They have an incentive to act both where ESG management presents material risks and opportunities to their specific investee or borrower companies, and where ESG issues such as climate change present a systemic risk to economies and hence to their wider portfolios.

Aside from commercial reasons, many financial institutions have a broader remit. In many cases asset owners have implicit or explicit responsibilities to their members beyond providing a financial return. Some investors have a mandate to carry out social services. Some banks, particularly state-owned ones, have a role in supporting national policy objectives or operate in market segments – such as micro-finance – where social and commercial objectives are better aligned.

For regulators, ensuring that ESG factors are taken into consideration by banks and investors facilitates efficient capital markets and ensures that the finance sector plays its part in the development of sustainable economies.

Forest risk commodity companies stand to benefit from adopting sound management of ESG issues, in terms of business model viability, profitability and improved cost of and access to capital.

In addition to presenting the why, the report gives many examples of how. It sets out many of the practices and processes banks and investors can take to address these risks, identify opportunities, and serve their multiple stakeholders through adopting enhanced ESG management. By linking access to finance and the cost of capital to sustainable operating practices, banks and investors can create powerful incentives for companies to take necessary action. Regulators need to support banks and investors to achieve this.

For the banks and investors covered in this study, the question of ESG practices in the domestic palm oil, timber and pulp & paper sectors is particularly important, due to the concentration of production in the domestic economies. For Singapore, the importance is due to its position as a key commodity trading and financing centre. Without action on deforestation and forest degradation, to which these sectors have historically been linked, it is not possible for the finance industry to address systemic risks to the economy, particularly from climate change.

This concern is one of the reasons that WWF advocates a global shift to zero net deforestation and forest degradation by 2020. The aim is for no overall loss of forest area or forest quality at the global level, while allowing for some flexibility at the regional level to meet local needs.

The report provides a number of recommendations for financial institutions, financial regulators and companies. WWF will support the adoption of these recommendations by committing to:

- Support investment funds, banks and regulators to help them understand and implement relevant recommendations;
- Work with other civil society groups to identify common concerns and harmonize messages;
- Work collaboratively with international investors to engage with Singapore, Indonesia and Malaysia-based investors, banks and regulators and achieve necessary reforms;
- Work with forest risk commodity companies on better management of ESG issues and improved disclosure.

WWF RECOMMENDATIONS FOR FINANCIAL INSTITUTIONS, REGULATORS AND FOREST RISK COMMODITY COMPANIES	
BANKS	■ Develop an ESG strategy and implementation framework including sector policies. Refer to WWF ESG Integration Guide[129] ■ Implement, monitor and report on the ESG strategy ■ Join multi-stakeholder initiatives and other banking initiatives such as BEI or Equator Principles ■ Encourage and support national banking associations to create voluntary sustainable finance guidelines ■ Islamic finance councils may wish to consider whether there is scope to include environmental factors
BANKING REGULATORS	■ Produce national guidelines for banks to support integration of environmental and social risks into credit evaluation processes ■ Support banks through training and capacity-building programmes ■ Introduce reporting standards to increase bank transparency on management of environmental and social risks in portfolios
INVESTORS	■ Use ESG analysis to identify systemic risks such as climate change and enhance valuation/forecasting ■ Step up active ownership to manage systemic and company risks ■ Engage with portfolio companies, especially forest risk commodity companies, to improve ESG standards ■ Access knowledge and best practices by joining international collaborative initiatives such as PRI, CDP and ACGA ■ Engage with locally-listed banks within investment portfolios to support their development of ESG practices
FOREST RISK COMMODITY COMPANIES	■ Create value through improved management practices, with a focus on yield improvements that contribute to secure reliable long term supply chains, responsible land-use planning, and optimized use of natural resources, rather than land acquisition or a mining approach (i.e. harvest and go) ■ Highlight core sustainability strategy and implementation to banks and investors ■ Enhance disclosure including of material ESG issues as outlined in the 2050 Criteria ■ Become members and undergo certification by multi-stakeholder initiatives such as the RSPO and FSC
SECURITIES MARKET REGULATORS	■ Enhance ESG disclosure through mandatory requirements for listed companies, specifying minimum levels of statistical information, with sector-specific guidelines for high impact sectors ■ Support increased levels of active ownership, including through promotion of stewardship codes for institutional investors

APPENDIX

Forest risk commodity company disclosure review questions

Photo: Wahli PLG team survey timber plantation in Indonesia

OUR APPROACH

Forest risk commodity company disclosure review questions

The following assessment template sets out primary disclosure questions for each key performance criterion. These are labeled with numbers. For some primary questions it then sets out detailed questions, labeled with letters, that must all be satisfied for a positive response to the primary question.

These sets of questions present a minimum standard that is required to describe a company's disclosure in each area as a policy. For many areas companies that wish to enjoy the full commercial benefits of improved ESG management will need to implement and adhere to policies that are above the minimum standard, in accordance with the better management practices laid out in Chapter 4.

PALM OIL

The supplier base for palm oil is quite complex. Most of the companies have their own plantations as well as external suppliers. Integrated palm oil companies may take in supply from third parties at their mills or at their refineries. Suppliers could be tied smallholders, independent smallholders, or independent growers of FFB or independent mills. In many cases the statements on ESG provided are not clear enough about their scope to distinguish whether or which types of supplier are included. For clarity, the questions do not require companies to include suppliers in their scope and the companies are assessed purely on the basis of their own plantations apart from the question on legality, which applies to all externally sourced raw materials. However it is important to note that sustainability has to extend throughout the entire supply chain.

ASSESSMENT QUESTIONS FOR REVIEWING PALM OIL COMPANY DISCLOSURE

PRIORITY AREAS PROTECTION

1 Does the company disclose policy or equivalent practices relating to priority areas or those on which it will not plant?

1.a Does the company disclose that it prohibits planting on HCV areas and areas needed to maintain one or more HCVs?

1.b Does the company disclose that it prohibits planting on primary forest?

1.c Does the company disclose that it prohibits planting on peat?

GREENHOUSE GAS EMISSIONS

2.1 Does the company disclose a policy or equivalent practices relating to GHG emissions?

2.1.a Does the company disclose that it invests in methane capture from POME and/or other methods to reduce methane production from POME?

2.2 Does the company disclose an assessment of any of its GHG emissions?

2.3 Does the company disclose time-bound targets to reduce GHG emissions from current operations?

LEGAL PRODUCTION	3	Does the company disclose that its product, including externally sourced raw materials, is produced/harvested in compliance with all applicable local, national and ratified international laws and regulations?
LOCAL AND INDIGENOUS COMMUNITIES	4	Does the company disclose a policy on local and indigenous communities?
	4.a	Does the company disclose that its policy is based on free, prior and informed consent (FPIC)?
CHEMICAL USE	5	Does the company disclose a policy or equivalent practices on chemical use?
	5.a	Does the company disclose three or more examples where it uses biological controls for pests/weeds in place of chemical ones across its plantations?
	5.b	Does the company disclose that it has phased out, or provide a time limit for phasing out, use of paraquat?
	5.c	Does the company disclose that it regularly tests the soil and foliage?
	5.d	Does the company disclose an OHS policy that refers to working with chemicals?
PEST MANAGEMENT	6	Does the company disclose an integrated pest/weed management plan (IPMP) or equivalent practices?
	6.a	Does the company disclose three or more examples where it uses biological controls for pests in place of chemical ones across its plantations?
NUTRIENT MANAGEMENT	7	Does the company disclose a nutrient management plan (NMP) or equivalent practices?
	7.a	Does the company disclose that it uses cover crops?
	7.b	Does the company disclose that it regularly tests the soil and foliage?
	7.c	Does the company disclose that it returns EFB to the fields?
SOIL MANAGEMENT	8	Does the company disclose a soil management plan (SMP) or equivalent practices?
	8.a	Does the company disclose that it uses cover crops?
	8.b	Does the company disclose that it does not plant on steep slopes?
	8.c	Does the company disclose that it does not plant on riparian areas?
	8.d	Does the company disclose that it returns EFB to the fields?
WATER MANAGEMENT	9	Does the company disclose a water management plan or equivalent practices?
	9.a	Does the company disclose an assessment of the company's water use/needs?
	9.b	Does the company disclose how water discharged from its facilities is treated or provide relevant statistics (e.g. Biochemical Oxygen Demand)?

LABOUR RIGHTS

10 Does the company disclose that it uses ILO standards in relation to labour or provide relevant protections?

10.a Does the company disclose that it does not use child labour?

10.b Does the company disclose that staff are free to associate?

OCCUPATIONAL HEALTH & SAFETY

11.1 Does the company disclose its OHS policy or relevant practices?

11.1.a Does the company provide a target for OHS incident reduction (usually zero harm/incidents)?

11.1.b Does the company disclose steps to manage down incident levels, including a full review of every incident?

11.2 Does the company provide OHS statistics?

TIMBER/PULP & PAPER

There are major differences in the operations of timber and pulp & paper companies in that some operate plantations, some log from natural forests, and some are purely involved in processing/distributing timber or pulp & paper products. For each company, a positive response to the disclosure question requires a positive response to each detailed question that is relevant to the company's operations. This means that an integrated company is assessed both on its own plantations/concessions as well as externally-sourced raw materials.

ASSESSMENT QUESTIONS FOR REVIEWING TIMBER, PULP & PAPER COMPANY DISCLOSURE

PRIORITY AREAS PROTECTION

1 Does the company disclose policy or equivalent practices relating to preservation of priority areas in line with its activities?

1.a For companies with plantation operations: does the company disclose that it does not convert land containing natural forest or HCV areas and prohibits planting on peat?

1.b For companies with plantation operations: does the company state that it requires HCV assessments prior to development?

1.c For companies with logging in natural forests: does the company disclose that it assesses HCV areas and ensures that relevant values are enhanced?

1.d For companies that buy in timber/fibre from third parties: does the company disclose that it does not source materials from plantations that have been converted from natural forest or HCV areas, as well as established on peat, or natural forests that are being degraded through unsustainable logging?

LOCAL AND INDIGENOUS COMMUNITIES

2 Does the company disclose a policy or take equivalent actions relating to local and indigenous communities in areas from which it sources?

2.a For plantation and logging companies: does the company disclose that its policy is based on FPIC?

2.b For processing companies: does the company disclose that it only sources from suppliers that have a community policy based on FPIC?

LEGAL PRODUCTION	3	Does the company disclose that it has a due diligence system in place to manage the risk that its product is not produced/harvested and traded in compliance with all applicable local, national and ratified international laws and regulations?
ECOSYSTEM FUNCTIONS	4	Does the company disclose relevant policy relating to preserving and enhancing biodiversity and ecosystem services?
	4.a	For companies that log from natural forests: does the company disclose that it manages the forest in a way that enhances its ecosystem services and maintains or enhances biodiversity?
	4.b	For companies that operate plantations: does the company disclose that it is managing factors such as minimising damage to biodiversity and maintaining or enhancing soil quality and water cycling capacity?
	4.c	For companies involved in processing/trading: does the company disclose that it sources only from suppliers that are managing and enhancing biodiversity and ecosystem services at their concessions or plantations?
AREA-BASED MANAGEMENT	5	Does the company disclose relevant policy relating to area-based management of the plantations and forests from which materials are drawn?
	5.a	For companies that log from natural forests or operate plantations: does the company disclose that it will work with other operators in its production areas to manage watersheds, biological corridors and HCV areas?
	5.b	For companies involved in processing: does the company disclose that it sources primarily from suppliers that work collaboratively at the area level to manage watersheds, biological corridors and HCV areas?
GREENHOUSE GAS EMISSIONS	6.1	Does the company disclose a policy relating to GHG emissions or equivalent practices?
	6.1.a	For companies that manage plantations: does the company disclose that it minimizes its use of fertilizers?
	6.1.b	Does the company disclose that it invests in renewable energy at its facilities, whether mill operations or processing facilities (including sustainably-managed, low-footprint biomass/biofuel)?
	6.1.c	Does the company disclose how it processes its waste and reduces waste to landfill?
	6.2	Does the company disclose any assessment of its GHG emissions (e.g. scope 1, 2 and 3)[130]?
OCCUPATIONAL HEALTH & SAFETY	7.1	Does the company disclose its OHS policy or equivalent practices?
	7.1.a	Does the company provide a target for OHS incident reduction (usually zero harm/incidents)?
	7.1.b	Does the company disclose steps to manage down incident levels, including a full review of every incident?
	7.2	Does the company provide OHS statistics?

LABOUR RIGHTS

8	Does the company disclose that it uses ILO standards in relation to labour or provide relevant protections?
8.a	Does the company disclose that it does not use child labour?
8.b	Does the company disclose that staff are free to associate?

WATER MANAGEMENT

9.1	Does the company disclose a water management plan or equivalent practices?
9.1.a	Does the company disclose an assessment of the company's water use/ needs?
9.1.b	Does the company disclose details of the steps it takes to meet its needs?
9.2	Does the company disclose a water discharge plan or equivalent practices?
9.2.a	For companies with mills/processing operations: does the company disclose how water discharged from its facilities is treated?
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