Sustainable Palm Oil
Finance in Indonesia

Aligning responsible finance opportunities with Indonesia’s corporate commitments to sustainable palm oil

Mapping the drivers of future risk exposure for investors
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How insurance companies can back sustainable palm
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Biodiesel investors must screen for sustainable palm
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In September 2014, four of Indonesia’s largest palm oil players and the Indonesian Chamber of Commerce and Industry (Kadin) signed the Indonesia Palm Oil Pledge (IPOP), which commits them to work together to improve the environmental performance of the Indonesian palm oil industry. This Pledge includes industry-leading benchmarks, proactive government engagement on policy reform and a principle of no planting on high carbon stock or peat lands.

This commitment is very important both nationally and globally, especially since Indonesia is the world’s largest producer of palm oil, reaching 29 million tons in 2014. The majority of Indonesia’s palm oil production has been exported to meet the 20 million tonnes of Crude Palm Oil (CPO) and Palm Kernel Oil (PKO) demanded globally from key importing countries such as India, Europe and China and over 60 others.

According to the Indonesian Palm Oil Association Gabungan Pengusaha Kelapa Sawit Indonesia (GAPKI), in the domestic market, demand for palm oil is projected to continue increasing, particularly as biodiesel implementation takes hold.

It is projected that the target of 20% of bio diesel in 2016 would demand an additional 8 million kilolitres of palm oil for the domestic market.

The Indonesia Business Council for Sustainable Development (IBCSD) and Kadin have always played an active role in working with business and government, providing input to policies and regulations that lead to conservation and incentives for business to take part. Developing a policy framework that supports the implementation of the pledge and the development of production processes in the palm oil sector is a priority.

Since some of the main challenges facing the sector relate to the financing and capacity of small-scale palm oil production, IBCSD and Kadin Indonesia encourage related stakeholders to actively address this challenge through the development of innovative financial mechanisms. I would like to convey my gratitude to Earth Security Group who have been willing to inform and facilitate this dialogue that I believe could result in some new ideas to support the development of insurance and investment mechanisms.

Shinta Widjaja Kamdani
CEO, Sintesa Group; Vice Chairwoman for Environment, Climate Change and Sustainable Development Committee, Indonesian Chamber of Commerce and Industry Kamar Dagang dan Industri (Kadin); President, Indonesia Business Council for Sustainable Development (IBCSD).
Summary

Global demand for palm oil is expected to grow 32% to 60 million tonnes by 2020. Indonesia and Malaysia together account for 80% of global palm oil supplies, where production has boomed through land expansion and forest clearing.

This briefing identifies three areas of market growth that offer Indonesian investors and financial institutions the opportunity to align their investments to support the growth of sustainable palm oil innovation in their market strategies, products and financing vehicles.

This brief by the Earth Security Group (ESG) provides Indonesian investors with direction for more innovative financing strategies. ESG and its Indonesian partners are supporting the development of these opportunities with a network of financial institutions.

In 2014, the Indonesian Chamber of Commerce and Industry (Kadin) facilitated a pledge from palm oil companies to zero deforestation in Indonesia. Financial institutions playing into high-growth investment areas must ensure their alignment to these commitments in order to put Indonesian palm oil growth onto a sustainable track and manage their risk exposure:

Key Action 1
Weather insurance for agriculture to incentivise sustainable palm
As the insurance sector in Indonesia grows steadily in the next few years, the exposure of palm oil production to extreme weather will increase the demand for agriculture insurance. Climate change will cost Indonesia approximately 2.5% to 7% of GDP by the end of the century, yet total insurance penetration in Indonesia remains very low at 1.8% of GDP. Innovative agricultural insurance products with variable risk premiums for sustainable oil palm can create market incentives to support resilience. See pages 8–9

Key Action 2
Biodiesel investment to screen for sustainability
Indonesia’s mandatory targets of 25% biodiesel for transportation and industry and 30% for electricity generation by 2025 is expected to require an additional 4 million hectares of palm oil to come into production, despite current production accounting for only 20% of the 2015 biodiesel targets. The deforestation pressure associated with this increased demand creates risks for Indonesia’s energy investors, who gain exposure to land conflicts and deforestation, as well as the government’s carbon reduction commitments. The emerging ISPO biofuels scheme provides an opportunity for companies and the government to collaborate in order to adopt ambitious sustainability targets for biofuel investments and sourcing to minimise the risks. See pages 10–11

Key Action 3
New SME credit lines to spur sustainability and land tenure rights
Small- and medium-scale palm oil production is expected to continue to grow. Smallholder farms account for roughly 30% of land under palm oil cultivation, a total of 2.4 million hectares, and 38% of production. However, poor land management, corruption and weak tenure rights result in widespread land conflicts. The absence of formal land titles hampers the ability of smaller producers to access formal credit, and removes incentives for productivity investments. Commercial banks offering credit backed by alternative forms of collateral can stimulate investment in palm oil productivity and strengthen incentives for formal land tenure rights. Productivity gains will reduce deforestation pressure and improve virtuous cycles of sustainable growth in the rural economy. See pages 12–13
Indonesia’s economic growth is sensitive to commodity price volatility. Indonesia’s rich natural resources, including coal, palm oil, geothermal energy and gas, underpin its growth prospects and business opportunities. Strong GDP growth (4.9% in 2014) in South-East Asia’s largest economy has improved Indonesia’s credit outlook, however the economy remains sensitive to volatile global commodity prices and reliant on foreign financing due to a small domestic capital market.\(^1\) Crude Palm Oil (CPO) prices are near five-year lows as a result of weak demand from China and India, the world’s two largest CPO importers.\(^2\) Weaker exports to these key markets in 2014 were partially offset by higher export growth to Pakistan (up 84%) and the Middle East (up 16%).\(^3\)

Increasing palm oil productivity is a priority for Indonesia. Oil palm produces more oil volume per hectare annually than any other edible oil, up to 9 times more than the next most productive crop.\(^4\) The palm oil industry is an important source of revenue for the Indonesian economy (roughly 5% of GDP), foreign exchange,\(^5\) rural employment\(^6\) and a determinant of its inflation rate.\(^7\) However, productivity gains in palm oil have been slow. In 2014, the price differential between palm oil and soybean decreased to US$ 160 per metric tonne due to enhanced soybean productivity. Increased investment in infrastructure is needed to drive productivity gains and reduce pressure on forests.\(^8\)

Palm oil-driven deforestation is likely to grow as a reputation risk. Indonesia has surpassed Brazil as the world’s most significant deforester, losing over 6.02 million hectares of forest between 2000 and 2012.\(^9\) Illegal burning of forest and peat land has caused thousands of conflicts with vulnerable local communities\(^10\) and is a major contributor to transboundary haze in the ASEAN region, costing the region billions in health costs and economic disruption.\(^11\)

Western-driven sustainability requirements are undermined by a shift in global demand. Western markets have driven sustainability requirements through initiatives such as the Roundtable on Sustainable Palm Oil (RSPO) and recent buyer commitments from multinationals such as Cargill, Wilmar and Unilever. As primary imports of Indonesian palm oil shift away from the EU towards India (27%), China (15%) and Malaysia (8%), the EU’s bargaining power in western market-led sustainability schemes decreases.\(^12\)

The spotlight on palm oil finance is intensifying. Roughly 20 investment managers control over 80% of equity financing invested in the palm oil sector.\(^13\) The Malaysian, Singaporean and Indonesian stock exchanges account for 90% of the total market capitalisation for plantation companies. The take-up of sustainability criteria by these stock exchanges has been slow and weak screening processes transfer the risk directly to individual investment funds and asset managers.\(^14\) In Indonesia, where many of the largest companies are privately owned, local banks and private lenders play a major role in palm oil finance. Weaker sustainability screens and standards have allowed for increased and systemic reputational risk in their portfolios. A greater focus of civil society organisations on the financing of palm oil companies will increasingly gather pace and momentum.\(^15\)

Indonesia is taking ownership of the agenda. Indonesia has committed to achieving a 26% greenhouse gas (GHG) emissions reduction by 2020, extending its forest moratorium to 2015.\(^16\) President Widodo’s initial structural reforms are set to improve the country’s economic and social fundamentals.\(^17\) The Indonesian Government has made a bid to increase regulatory oversight of the industry through the Indonesian Sustainable Palm Oil (ISPO) legal standard. Despite initial delays in implementation, ISPO is seeking the certification and compliance of all Indonesian plantations by 2015.\(^18\) In 2014, Kadin, together with four leading palm oil groups, Asian Agri, Golden Agri Resources (GAR), Wilmar and Cargill, signed the Indonesian Palm Oil Pledge (IPOP) to improve the environmental performance of the sector, including the principle of no planting on high carbon stock or peat lands.\(^19\)

Introduction
Finance innovations to support Indonesia’s palm oil pledge
Earth Security Outlook: Indonesia
Indonesia’s resource pressures underscore the risks but also open opportunities for sustainable investments in key growth markets

Figure 1

Earth Security Index
Indonesia
Resource pressures and strategic financial innovation

Energy / Carbon Intensity
Indonesia emits 0.4 kg CO$_2$ per unit of industrial value added, twice the EU average, which increases the pressure to decarbonise the energy mix.

Innovation 2
Biodiesel investment to screen for sustainability
Indonesia’s mandatory targets of 25% biodiesel for transportation and industry and 30% for electricity generation by 2025 is expected to require an additional 4 million hectares of palm oil to come into production, despite current production accounting for only 20% of the 2015 biodiesel targets. The deforestation pressure associated with this increased demand creates risks for Indonesia’s energy investors, who gain exposure to land conflicts and deforestation, as well as the government’s carbon reduction commitments. The emerging ISPO biofuels scheme provides an opportunity for companies and the government to collaborate in order to adopt ambitious sustainability targets for biofuel investments and sourcing to minimise the risks.
See pages 10–11

Energy / Domestic Supply
Indonesia’s high-energy intensity per unit of GDP reflects inefficient energy use, exposing its energy matrix to future domestic supply challenges as demand grows.

Governance / Rule of Law
Indonesia ranks 114 out of 177 country on Transparency International’s Corruption Perception Index.

Innovation 3
New SME credit lines to spur sustainability and land tenure rights
Small- and medium-scale palm oil production is expected to continue to grow. Smallholder farms account for roughly 30% of land under palm oil cultivation, a total of 2.4 million hectares, and 38% of production. However, poor land management, corruption and weak tenure rights result in widespread land conflicts. The absence of formal land titles hampers the ability of smaller producers to access formal credit, and removes incentives for productivity investments. Commercial banks offering credit backed by alternative forms of collateral can stimulate investment in palm oil productivity and strengthen incentives for formal land tenure rights. Productivity gains will reduce deforestation pressure and improve virtuous cycles of sustainable growth in the rural economy.
See pages 12–13
The Earth Security Index. ESG’s data-driven country risk dashboard identifies Indonesia’s critical pressures for the palm oil sector, and the sustainable investment opportunities that are most strategic to offset the risks.

In the visual, higher scores in each dimension represent higher pressure. The index is constructed with publicly available data. Read more about the Earth Security Index and its applications at www.earthsecurity.org.

In the text below, 3 areas of investment innovation are identified in relation to key pressures.

**Land / Tenure Insecurity**
Only 30% of Indonesia’s land is covered by the Basic Agrarian Law (1960) and a lack of consistency and weak enforcement undermine its application. 1,500 major land conflicts remain unsettled due to a lack of civil resolution process, while media reports mention up to 8,000 land conflicts were recorded in 2014.

**Land / Degradation**
Indonesia alone represents 2.7% of total degraded area globally, ranking 8th in the severity of land degradation. Up to 53% of its territory is exposed to land degradation.

**Land / Deforestation**
Indonesia experienced the world’s largest increase in deforestation in the last decade, with an accelerating rate of over 20,000 km² per year from 2011 to 2012.

**Climate / Exposure to Extremes**
Indonesia is one of the top 30 countries at most extreme risk to climate change according to Climate Change Vulnerability Index.

**Innovation 1**
Weather insurance for agriculture to incentivise sustainable palm
As the insurance sector in Indonesia grows steadily in the next few years, the exposure of palm oil production to extreme weather will increase the demand for agriculture insurance. Climate change will cost Indonesia approximately 2.5% to 7% of GDP by the end of the century, yet total insurance penetration in Indonesia remains very low at 1.8% of GDP. Innovative agricultural insurance products with variable risk premiums for sustainable oil palm can create market incentives to support resilience. See pages 8–9.
Indonesia’s Insurance Sector

Penetration and Density

Source Otoritas Jasa Keuangan (2012)

Figure 2

Indonesia’s Insurance Sector
Premium Growth

Source Otoritas Jasa Keuangan (2012)

Figure 3

Indonesia’s Insurance Sector
Penetration and Density

Source Otoritas Jasa Keuangan (2012)

Innovation 1
Weather insurance for agriculture to incentivise sustainable palm

As the insurance sector grows, Indonesian insurance companies and international firms must create a new generation of risk management products that incentivise resilience and sustainable palm oil, placing it centrally to risk premium calculations.

— Palm oil plantations are increasingly affected by climate change.

— Extreme weather events have reduced palm oil output between 5–20% at points during the past five years.

— Indonesia’s insurance sector is poised for growth, but also exposed to insured losses from catastrophic events.

Indonesia is highly exposed to weather extremes and climate change. It ranks 6th out of 162 countries for flood hazard and 36th out of 184 countries for drought.20 Climate change is projected to expose Indonesia to shorter but more intense rainy seasons.21 Between 2011 and 2013, strong ‘El Niño’ caused below average rainfall and a drier spell, while strong ‘La Niña’ increased floods and storms in the Western Pacific,22 highlighting the increased uncertainty associated with weather extremes.

Climate change affects oil palm growing conditions. Weather is one of the key determinants in the palm oil supply equation23 and palm oil is amongst the most-vulnerable crops to El Niño.24 Previous El Niño effects caused production losses of up to 55%, reducing CPO volumes.25 In 2014, Sime Darby’s net profit decreased by 51%, associated with a 7% drop in Fresh Fruit Bunches (FFB) oil palm production from adverse weather conditions and weaker CPO prices.26

On the other hand, La Niña’s wetter conditions have reduced output by up to 15%, affecting pollination rates and rotting fruit.27 In turn, deforestation and land degradation from palm oil expansion increases the exposure of plantations to climatic conditions, in particular the increased likelihood of fire in degraded forests during droughts.28

Indonesia needs infrastructure investments. To address under-investments, the Indonesia Investment Coordinating Board (BKPM) has targeted US$ 42 billion worth of investments in 2015 (15% growth on 2014 realised investment), much of which is expected to be driven by private investment through public-private partnerships.29 The Asian Development Bank (ADB) has pledged to disburse at least US$ 1.5 billion in loans in Indonesia to support infrastructure projects.30
This means that public financing geared towards disaster reduction could also be a source of financing for new insurance schemes in particular in collaboration with government agencies.

**Local insurance companies can leverage the knowledge of the global insurance sector to deal with structural challenges and greater exposure to climate change.** The highly fragmented sector faces a number of challenges that undermines its growth potential. These include: limited capacity in relation to technical capabilities; international rating requirements; limited access and knowledge transfer with international reinsurers; high market fragmentation; and limited underwriting capacity. Indonesia continues to be a catastrophe-prone region. Increased exposure due to climate change and limited post-catastrophe claims handling abilities remain key challenges to insurers’ underwriting profitability. While the ‘2014 New Insurance Law’ still allows foreign investment of up to 80% in the sector, many international insurers are struggling to break into the market due to the challenging process of market entry.

**Indonesia is the second largest recipient of Overseas Development Assistance (ODA) for Disaster Risk Reduction (DRR).** From 2006–2011, Indonesia received US$ 558.4 million of DRR ODA (80% from Japan), primarily for flood management and response. In 2012, the government allocated roughly 1% of GDP to DRR.

**Other untapped opportunities.** Indonesia is a huge market for sharia-compliant insurance products; 80% of Indonesia’s 245 million population is Muslim. Mobile insurance platforms also present an area of opportunity, given high levels of mobile access and comfort in mobile monetary transactions. In 2011, the financial services authority announced incentives to insurance companies that offer micro insurance products by reducing the cost of agent certification.

**Weather information to support effective risk management.** A lack of publicly available information and projections on how extreme weather patterns are likely to affect palm oil production and prices impedes effective risk management. This is despite sufficient time series of weather data from The National Weather Service of Indonesia [BMKG].

**Figure 4**

**Indonesian insurance market share**

Showing the dominance of market share by the top 5 non-life insurance companies. By 2013, the top 5 out of 83 non-life insurance companies dominate the market, accounting for 57% of market share in 2013.

<table>
<thead>
<tr>
<th>Year</th>
<th>US$ Billion</th>
<th>Source</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5</td>
<td>11.3%</td>
<td>PWC (2013) MSCI (2012)</td>
<td>11.5%</td>
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<tr>
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<td>1.5</td>
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<td>PWC (2013) MSCI (2012)</td>
<td>5.2%</td>
<td>5.2%</td>
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<td>1.0</td>
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<tr>
<td>0.5</td>
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<table>
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<tr>
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<tr>
<td>78 other companies</td>
<td>5%</td>
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<td>5%</td>
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The insurance industry can play a larger role in critical long-term investment and in the provision of risk coverage for infrastructure loans and bonds for meeting grey and green infrastructure requirements that could address sustainability challenges in the land use sector. Indonesia’s insurance sector is poised for rapid growth. Swiss Re estimates that Indonesia’s total insurance penetration is around 1.8% of its GDP, much lower than Singapore (6%) and Malaysia (5%). Less than 10% of the population has access to insurance, but market momentum is building as insurance expenditure and premium prices enjoy double-digit growth.

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Looking beyond the current oil price low, investing in biofuels will become increasingly attractive in the next five years. Biodiesel subsidies are increasing, improving the profitability of the sector. The additional pressures this will create on land conflicts and deforestation requires investors to develop a sound strategy for investing in sustainable biofuels, selecting preferred suppliers, defining high-risk zones, and implementing appropriate investment screens. The emerging ISPO biofuel scheme provides an opportunity for government and business collaboration to avoid risk exposure.

— The Association of Indonesian Biofuel Producers (APROBI) projects that by 2020 domestic consumption of biodiesel in Indonesia will be 9 times today’s output.

— The failure of the ethanol industry to take off means growth will be met primarily through oil palm expansion, intensifying sustainability pressures. Palm oil growth facilitated through deforestation would carry 8–21 times the GHG emissions of conventional diesel.

— ISPO, the government’s mandatory legal standard to improve palm oil practice, is developing a biofuels scheme to align production of biodiesel and biodiesel feedstock in Indonesia with European sustainable biodiesel sourcing regulations.

Indonesia’s energy mix is shifting. In 2014, government fuel subsidies amounted to 16% of public spending in 2014. The removal of the subsidy for low-octane gasoline and an 83% reduction in the subsidy scheme for diesel at IDR 1,000 (US$ 0.08) per litre of diesel freed up US$ 22 billion of government spending. These subsidies are now being redirected to the biofuels sector. The government has set biofuel targets of 25% for transportation and industry, and 30% for electricity generation, by 2025. Furthermore, the mandatory amount palm oil blended in biodiesel has been set to double to 20% by 2020. This has already encouraged further investment and a doubling of growth in biodiesel production in 2013.

Palm biodiesel will expose energy investors to land-use conflicts and GHG emissions. Indonesia is the 3rd largest emitter of GHG globally. The majority of its emissions come from land-use changes (37% of total emissions are due to deforestation and 27% due to peat fires). Biodiesel investments are expected to expose energy investors to land-related conflicts and deforestation risks.

A sector expected to grow. The government is moving to increase its 10% diesel oil-biodiesel mix target (B10) towards a 20% mix (B20). Whilst biodiesel targets have lagged behind due to logistics and infrastructure challenges, raw material scarcity, low domestic demand and volatility in global palm oil prices, APROBI estimates that biodiesel consumption could increase by 30% in 2015, as demand grows beyond the transport sector to industry and power generation.

Subsidies to increase profitability. Subsidies for biodiesel production were doubled to US$ 30 cents (IDR 4,000) per litre in 2014. Subsidies are expected to continue to grow as the government shifts the recently scrapped fuel subsidies into more productive sectors, such as biofuel production.

Figure 5

<table>
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<tbody>
<tr>
<td><strong>2015</strong></td>
<td>Conventional Energy: 39% (Oil: 22%, Gas: 22%, Coal: 29%) Renewable Energy: 10% (Biofuel: 5%, Biomass: 5%, Geothermal: 7%, Others*: 6%)</td>
</tr>
<tr>
<td><strong>2025 (projected)</strong></td>
<td>Conventional Energy: 25% (Oil: 22%, Gas: 22%, Coal: 30%) Renewable Energy: 6% (Biofuel: 5%, Biomass: 5%, Geothermal: 7%, Others*: 6%)</td>
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* Hydro, Nuclear, Coalbed Methane, etc.
**New investment rounds expected.**

In 2007, over 50 joint cooperation agreements between international and domestic biodiesel producers and investors were signed to develop production capacity in the sector with a total investment value of US$ 12.4 billion. In 2008, investment commitments to the industry included Sinopec (China), the Sampoerna Group, Bronzeak (UK) and Samsung (South Korea). Pertamina’s (Indonesia’s state-owned oil and natural gas corporation and its distributor of biodiesel) third tender will allocate 1.7 million kilolitres of biodiesel over 2014–2015.

Offers have already been allocated to Sumatra (115,000 kl/year), Nusa Tenggara (28,000 kl/year), Kalimantan (335,000 kl/year), Sulawesi and Papua (372,000 kl/year). The China National Offshore Oil Corporation (CNOOC) and Hong Kong Energy together with Sinar Mas have invested US$ 5.5 billion in Papua and the Kalimantan region.

**ISPO’s biofuel scheme.** ISPO have initiated a ‘Scheme for Palm Oil (CPO) as Renewable Energy (Bioenergy)’ that is expected to align the production of biodiesel and biodiesel feedstock in Indonesia with European sustainable biodiesel sourcing regulations.

Europe had accounted for 88% of Indonesian biodiesel and biodiesel exports before dropping 60% when the 2013 non-tariff trade barriers came into effect. Biodiesel investors should monitor the development of the scheme closely, and use it as a benchmark to mainstream sustainability into their investments. Equally, ISPO should consider how to position its scheme so that investors can adopt this as a standard, while overcoming challenges of international acceptance, conflicts with RSPO and low certification rates.

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**Figure 6**

**Indonesia’s Top Biodiesel Producers**

<table>
<thead>
<tr>
<th>Biodiesel Producers</th>
<th>Production Capacity (kilolitres/year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PT. Wilmar Bioenergy Ind.</td>
<td>1,192,800</td>
</tr>
<tr>
<td>PT. Musim Mas</td>
<td>477,120</td>
</tr>
<tr>
<td>PT. Cemerlang Energi Perkasa</td>
<td>454,400</td>
</tr>
<tr>
<td>PT. Ciliandra</td>
<td>284,000</td>
</tr>
<tr>
<td>PT. Pelita Agung Agri Industries</td>
<td>227,200</td>
</tr>
<tr>
<td>PT. Darmex Biofuels</td>
<td>170,400</td>
</tr>
<tr>
<td>PT. Petro Andalan Nusantara</td>
<td>170,400</td>
</tr>
<tr>
<td>PT. Damai Sejahtera Sentosa</td>
<td>136,320</td>
</tr>
<tr>
<td>PT. Sumi Asih Oleo Chem.</td>
<td>113,600</td>
</tr>
</tbody>
</table>

**Figure 7**

**Summary of Indonesia Biofuel Sector**

<table>
<thead>
<tr>
<th>Ethanol</th>
<th>Biodiesel</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Producers</td>
<td>20</td>
<td>26</td>
</tr>
<tr>
<td>Installed Biofuel Production Capacity * (kilolitres / year)</td>
<td>573,000</td>
<td>5,670,000</td>
</tr>
<tr>
<td>Biofuel Production (kilolitres / year)</td>
<td>331,700</td>
<td>740,000</td>
</tr>
<tr>
<td>2009</td>
<td>1,700</td>
<td>330,000</td>
</tr>
<tr>
<td>2010</td>
<td>0</td>
<td>740,000</td>
</tr>
<tr>
<td>2011</td>
<td>0</td>
<td>1,800,000</td>
</tr>
<tr>
<td>2012</td>
<td>0</td>
<td>2,200,000</td>
</tr>
<tr>
<td>2013</td>
<td>0</td>
<td>2,450,000</td>
</tr>
<tr>
<td>2014</td>
<td>0</td>
<td>3,650,000</td>
</tr>
</tbody>
</table>

* Aggregate capacity of biodiesel producers
Innovation 3
New SME credit lines to spur sustainability and land tenure rights

While small- and medium-sized plantations are expected to play a greater role in production, a lack of collateral, weak land-ownership rights and poor banking infrastructure have so far prevented the development of new credit lines. Credit providers can play a role in supporting sustainable palm oil. New business models and credit lines targeted to SMEs can develop alternative forms of collateral and strengthen incentives to formalise land tenure rights. Productivity gains will help to avoid deforestation and promote virtuous cycles of sustainable growth in the rural economy.

- Upfront investments are needed to meet global demand (500,000 hectares of palm must be replanted per year over 10 years to meet the growing demand).
- Small-scale production will play a large role in future expansion, requiring capital investments and improved input efficiency and management.
- Doubling the productivity of oil palm yields could avoid the clearance of 1 million hectares of forests.

Small- and medium-sized producers require investment in productivity. Small- and medium-sized producers cultivate roughly 30% of Indonesia’s oil palm area, accounting for 27% of total Indonesian palm oil production in 2000 and 38% in 2011, figures expected to grow with future expansion. Smallholder yields per hectare are also up to 14% lower than the average yields on large plantations, creating ample opportunities for improved productivity and profits on existing cultivated land.

Financing the rural economy. In 2012, Indonesia’s central bank, Bank Indonesia, set a portfolio lending requirement of 20% to micro, small and medium sized enterprises by 2018, driving increased lending to the agricultural industry. In 2013, the government set a maximum size of 100,000 hectares for plantations in order to protect smallholders — a law that does not apply to listed companies on the Indonesia Stock Exchange (IDX). Indonesian Law No. 19/2013 provides for improved access to capital for smallholders through the creation of 'Banks of Farmers' comprised a Finance Agency to grant credit and Agriculture Business Risk Insurance.

Building community assets. Smallholders doing business with large plantations receive loans from companies for seedlings, fertilisers, and supplies, but often struggle to make repayments. The cost of land certification is high (US$ 315 per plot) and independent smallholders are often unfamiliar with the application process. Government financial support for financing plantation revitalisation (according to 2006 Regulation of the Minister of Agriculture No. 33) has recently been shelved, leaving smallholder associations such as Serikat Petani Kelapa Sawit (SPKS) to campaign for new alternative financing mechanisms and partnership models.

Micro-lending innovation is happening. The following initiatives show that innovation in micro-lending is possible. Scaling up these opportunities will require banks to have a more innovative role to connect initiatives into more extensive networks of pooling capital.

- In 2011, Sinar Mas Agro Resources and Technology (SMART) initiated a financial scheme to guarantee state-owned bank credit to smallholders (at a 6% interest rate for the initial 4 years, and 10.5% thereafter) and provide training in sustainable management practices. In return, the company collects palm oil from the smallholders under a price mechanism controlled by the local government.
- In 2012, PT Bank Mandiri disbursed a total of US$ 14.9 million in loans via palm oil cooperatives, covering 1,700 farmers.
- SPKS, a palm oil smallholder union, has proposed a new ‘fair partnership’ model through the 2014 Plantation Act (Law 39) as an alternative to partnership schemes with large plantation companies under a centralised management system (Decree 33/2006 Minister of Agriculture). The model would oblige mills to process 80% of CPO from independent smallholders and 20% from their own plantation, with financial support provided by the local government or regional institution through a banking system.
- Kadin initiated a smallholder scheme in 2014 to boost productivity for 1 million independent palm oil smallholders in order to avoid 1 million hectares of land clearance by arranging funding from financial institutions through palm oil cooperatives that will provide loans at affordable interest rates.
Insecure land tenure is a barrier to financing rural enterprises. Indonesian small-scale farmers are largely excluded from formal financial services, as they do not meet the lending conditions relating to collateral and creditworthiness. 90% of Indonesian smallholders do not have a formal title to their land. Microfinance also faces significant operating cost barriers in rural Indonesia where visiting clients can be prohibitively expensive. 8000 conflicts were recorded in 2014 in relation to insecure and informal land title and exploitative labour conditions in the palm oil sector.

The issuance of palm oil concession permits and land holdings through customary laws of local communities have been created faster than the National Land Agency (BPN) can formally title them. In Central Kalimantan over 81% of oil palm plantations were found to be operating without the required permits from the Ministry of Forestry. Finding ways of building alternative forms of collateral out of informal land tenure systems is a challenge, requiring a new way of securing the legal basis for property. In the Philippines, for example, the ‘certificate of ancestral domain’ has provided a mechanism to formally recognise the rights of ownership of indigenous peoples in accordance with the law.

Strengthening small producers is in the interest of large companies. In 2014, Asian Agri was ordered to pay a US$ 205 million fine and US$ 65.2 million for lost state revenues from tax evasion by its subsidiaries. The operational risks of exploitative conditions and turning away suppliers without capacity to attain certification standards can lead to protests, roadblocks, boycotts and operational disruptions. Direct lost revenue and opportunity costs have been estimated at US$ 10–15 million.

Small and medium-sized producers operating in weak local governance contexts are associated with highly unsustainable land clearance methods, which often create liabilities for larger estates.

Financing innovations requiring public-private collaboration. An Indonesian Government pilot scheme has facilitated access to insurance to protect smallholder rice growers from crop losses (80% of losses are covered by the state and 20% by the farmer). The scheme provides a loan guarantee that incentivises banks to lend to smallholder farmers. Mobile payments are also a growing opportunity to provide cheaper, more efficient, traceable and transparent payment methods for high volume and low-value transactions. Partnerships between commercial banks, insurance companies and cooperatives can also reduce transaction costs.
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Photography
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The image shows palm oil seeds.