Friends of the Earth United States

Executive Summary

Contact: Jeff Conant, Senior International Forests Program Director • jconant@foe.org • (510) 900-0016

A Climate of Risk: CalPERS' Exposure to Risk in the Palm Oil Sector

Executive Summary

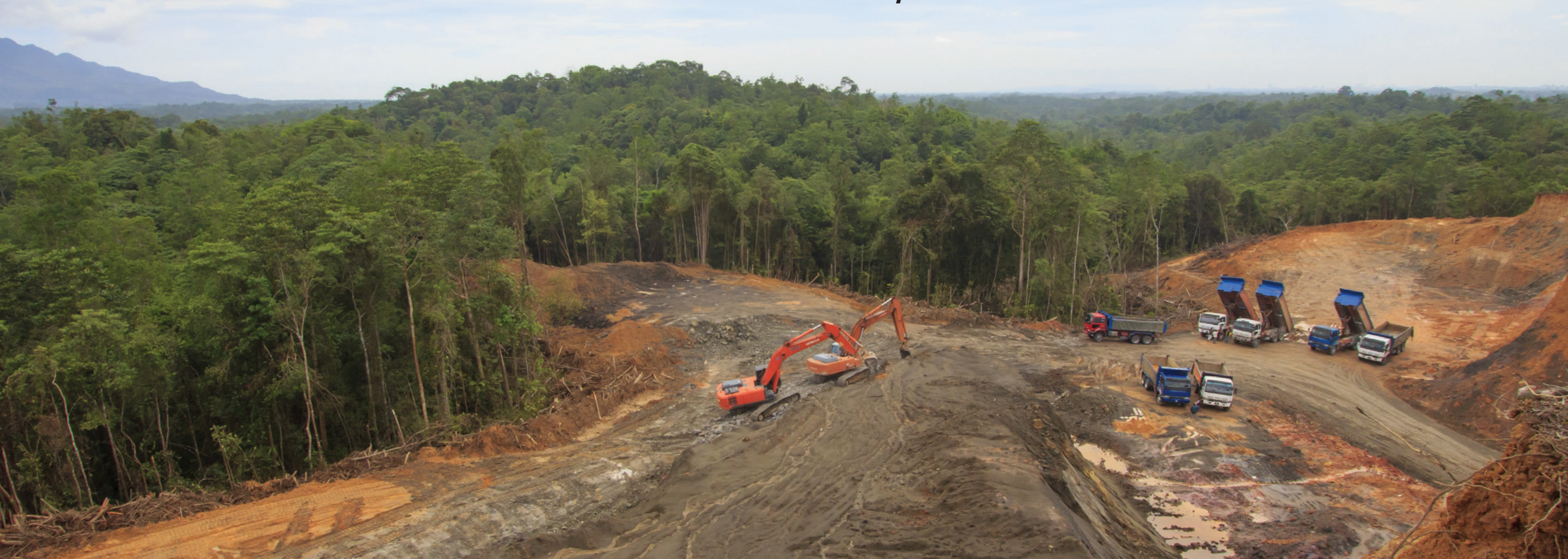
The California Public Employees' Retirement System (CalPERS) is the largest public pension fund in the United States, with $320 billion in assets under management. CalPERS is also widely recognized as a public investor with a strong commitment to environmental and social responsibility in its investments.[i] Within the field of pension finance, CalPERS positions itself as an outspoken leader in corporate engagement on climate change,[ii] and claims to be giving increased attention to financial climate risk in its portfolios. CalPERS implements its approach to climate risk and to Environmental, Social and Governance (ESG) largely through proxy voting[iii] and direct engagement with company boards and staff.

However, CalPERS' attention to climate risk and ESG issues is not uniform across all its equity holdings. Roughly 12 percent of total Greenhouse Gas Emissions globally are caused by deforestation, and some 80 percent of global deforestation is driven by agriculture.[iv] The vast bulk of this deforestation, including the conversion of Southeast Asia's carbon-rich peat lands, is caused by industrial-scale commodity crops: palm oil, soy, timber, pulp and paper, cattle, and rubber. In Indonesia alone, estimated CO_2 emissions from the palm oil sector is around 250 million tons per year – roughly equivalent to the annual emissions of Spain.[v]

CalPERS holds about $400 million in palm oil plantation companies – companies whose activities are directly responsible for vast negative environmental and social impacts. While this is a minute share of CalPERS' overall holdings, these holdings expose CalPERS and its beneficiaries to a host of material risks including risks related to Responsible Business Conduct as defined by the Organization for Economic Cooperation and Development (OECD). Depending on how CalPERS addresses these risks, this exposure also calls into question CalPERS' adherence to the UN Guiding Principles on Business and Human Rights, and the UN Principles on Responsible Investment, to which it is a signatory.

Numerous palm oil companies in which CalPERS holds shares are engaged in well-documented activities that pose significant risks of adverse impacts to the environment and human rights, with associated material risks. These companies have made a business model of cutting down rainforests, including within forest reserves and on lands claimed by indigenous communities; burning peat lands, one of the most carbon-dense ecosystems in the world; and employing forced and child labor.

Roughly 12 percent of total Greenhouse Gas Emissions globally are caused by deforestation, and some 80 percent of global deforestation is driven by industrial agriculture. In Indonesia alone, estimated CO_2 emissions from the palm oil sector is around 250 million tons per year – roughly equivalent to the annual emissions of Spain.



Palm oil is also associated with forest crimes such as illegal logging.[vi] A 2014 investigation by the Environmental Investigation Agency[vii] documented astonishing levels of criminality in the palm oil sector, finding that palm oil is a primary driver of illegal logging in Indonesia, and that "the unprecedented growth of plantations has been characterized by illegality."[viii] For example, EIA examined 51 companies that should have obtained environmental approval from provincial agencies, and found that about 50 percent of the companies examined were operating without a permit. Another study found that 82 percent of timber processed in Indonesia was undocumented and likely illegal.[ix]

While many companies in the sector are engaged in efforts to reform their practices to various degrees, illegal activity continues to run rampant. A 2016 study by Indonesian activists found that palm oil grown on destroyed tiger and elephant habitats continues to be present in the supply chains of industry giants such as Wilmar and Golden Agri-Resources, despite these companies' commitments to reform.[x]

Not surprisingly, many companies in the sector go to great lengths to cover their footsteps, thereby misleading investors and the public, leading to a persistent climate of risk.

> When IOI Group was suspended from the Roundtable on Sustainable Palm Oil (RSPO) for failing to protect peat areas and forests[xi] it's share price dropped 18 percent -- from positive $30 million in the second quarter of 2015 to negative $14.8 million a year; several major brands including Unilever, Kellogg and Nestlé canceled supply contracts with IOI Group, and Moody's downgraded the company's credit rating.[xii] ***CalPERS holdings (2016): $12,016,712 USD***[xiii]

> Felda Global Ventures (FGV) faces a possible $5 million liability for violating RSPO's principles and criteria because the company's wholly-owned subsidiaries deforestation practices are not compliant with their buyers' procurement policies.[xiv] ***CalPERS holdings (2016): $2,309,381 USD***[xv]

> In 2012, Kuala Lumpur Kepong (KLK) planned to develop 30,000 hectares of oil palm estates in Collingwood Bay, Papua New Guinea.[xvi] In 2014, indigenous peoples' communities contested KLK's plantation plans and the Papua New Guinea courts declared KLK's leases null and void.[xvii] These concessions may become stranded land, leading to financial write-offs by KLK management.[xviii] ***CalPERS holdings (2016): $10,359,770 USD***[xix]

> Wilmar International was subject to a 2016 Amnesty International investigation revealing systemic forced labor and child labor on its plantations and those of several of its suppliers.[xx] Wilmar was named in a 2017 court ruling[xxi] that ordered the provincial government of Central Kalimantan to review the permits of companies associated with the massive forest and peat land fires in 2015. Ongoing social conflict that plague Wilmar's Guatemalan suppliers could result in suspension of Wilmar's European supplies from that region. ***CalPERS Holdings (2016): $12,472,193 USD***[xxii]

> Land rights conflicts and failure to obtain Free, Prior and Informed Consent (FPIC) delay and derail project operations and disrupt cash flows, often despite government assurances. In 2009 Sime

Photo by Victor Barro

Darby, the world's largest palm oil producer, signed a 63-year concession agreement with the government of Liberia for 220,000 hectares of land. By 2016, due to ongoing land conflicts, the company had planted only 10,440 hectares;[xxiii] investors continue to value Sime Darby's Liberian project assuming full concession development, having not yet recognized serious stranded assets risk.[xxiv] ***CalPERS holdings (2016): $17,145,900 USD***[xxv]

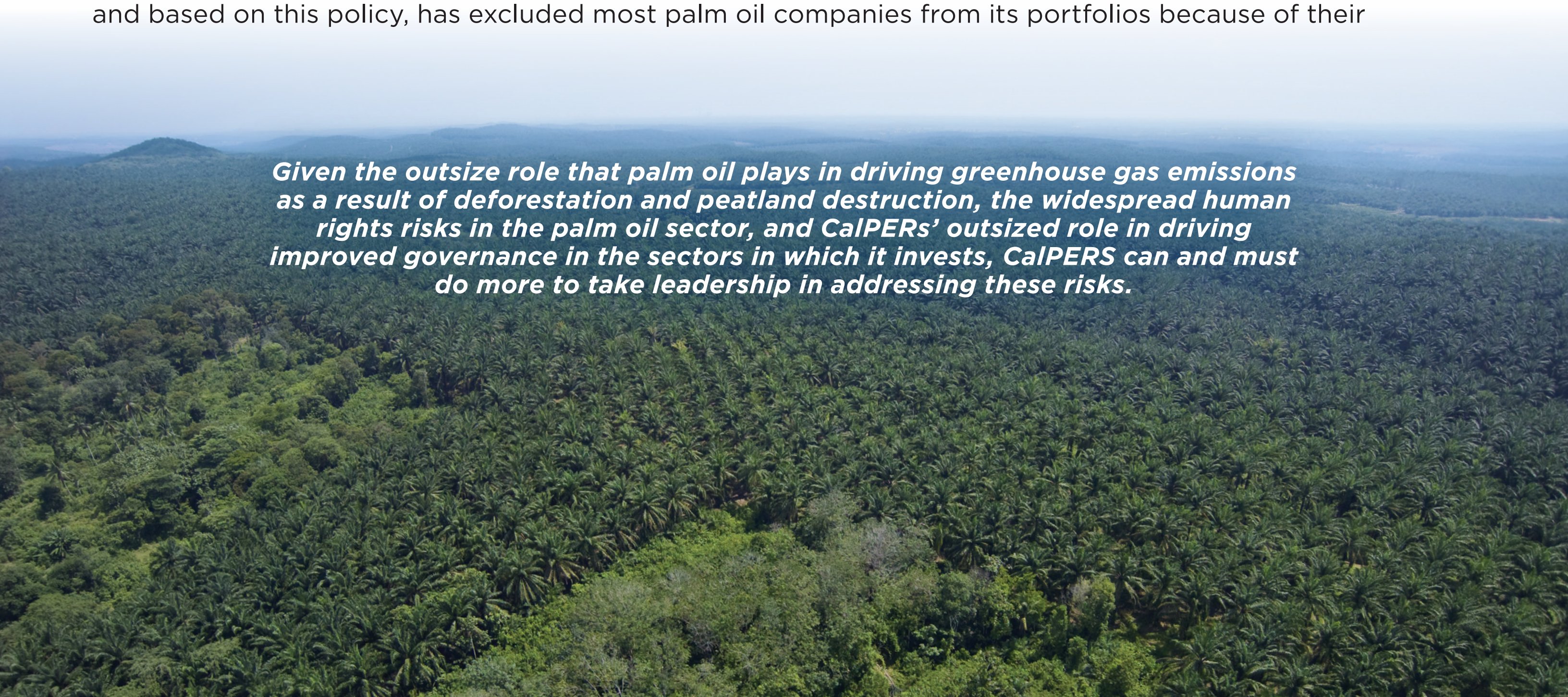
> Contested land banks reduce the present value of future cash flows, leading to stranded assets, which negatively affect financial valuation.[xxvi] Currently in Indonesia, 6.1 million hectares comprise "stranded land" on the balance sheet of palm oil estates, an area slightly less than the size of the Republic of Ireland and equal in size to 10 million football fields.[xxvii]

Given the outsized role that palm oil plays in driving greenhouse gas emissions as a result of deforestation and peatland destruction, the widespread human rights risks in the palm oil sector, and CalPERS' outsized role in driving improved governance in the sectors in which it invests, CalPERS can and must do more to take leadership in addressing these risks. CalPERS' Governance and Sustainability Principles, commit it to requiring investee companies to integrate considerations of climate change into risk management and mainstream business activities and to disclose material risks and opportunities posed by climate change.[xxviii] These principles also require CalPERS to ensure that its investees "adopt maximum progressive practices toward the elimination of human rights violations in all countries or environments in which the company operates." Its membership in the UN Principles for Responsible Investment further commits it to integrate ESG issues into its investment decision making, as long as this is consistent with fiduciary responsibility.

There should be no doubt that addressing risks from deforestation is directly in line with fiduciary responsibility. Increasingly, direct environmental factors and human rights considerations – both magnified by climate change — drive business opportunities. Consequently, financiers and investors are increasingly recognizing the materiality of risks associated with exposure to climate change, environmental destruction and human rights violations[xxix] — a trend that is driving the world's largest companies to commit to reducing their impact on global forests.

BlackRock has stated that companies who fail to address deforestation risks in their supply chains may be putting themselves at financial risk as a result of climate change and that climate factors are underappreciated and underpriced because they are "less visible" to investors.[xxx] But these risks are rapidly becoming more visible and beginning to have significant impacts for business — a fact that is leading the financial sector to adopt policies to evaluate and mitigate the risks.

A number of leading financiers have taken serious steps to address palm-oil driven deforestation: The Norwegian Sovereign Wealth Fund (NBIM) has a climate change policy that sets out expectations to all companies in its portfolio to reduce their contribution to climate change and rainforest destruction, and based on this policy, has excluded most palm oil companies from its portfolios because of their



unsustainable business practices.[xxxi] Global banks, including JPMorgan Chase, HSBC, BNP, Citi, Rabobank, and Goldman Sachs all maintain lending policies that require enhanced due diligence for palm oil sector-companies, and most of these policies specifically require that customers in forest-risk sectors to adopt, implement, and report on No Deforestation No Peat No Exploitation policies across their supply chains, as a matter of risk management.

CalPERS' actions are watched and emulated by other funds, and thus have an amplified effect on markets, giving CalPERS a uniquely powerful position to leverage its responsibility to become a leader in addressing the material and ethical risks related to forest-risk commodities such as palm oil. CalPERS can continue to risk driving human rights abuses and environmental destruction that are contrary to its values and its fiduciary duty – or it can can choose to act as a leader by developing clear guidelines for its investment in sectors exposed to forest-risk commodities. **In calling on CalPERS to address its responsibility, Friends of the Earth is emphatically not asking CalPERS to simply divest from this sector – though exclusion of bad actors must be a consideration in driving effective change.** Rather, we call on CalPERS to take an approach aligned with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines on Responsible Business Conduct for Institutional Investors, by:

1) **Evaluating** its exposure to deforestation and land risk, and disclosing the associated material risks. This is in keeping with calls that CalPERS disclose climate risk in its portfolios. As a public investor, CalPERS is already required to provide annual disclosure of the securities in which it invests. **CalPERS should also evaluate and report on its exposure to deforestation-risk and make public its efforts to address these risks.**

2) **Committing** to a policy that requires investee companies to meet specific performance indicators showing their adherence to a deforestation-free, peat-free and land grab-free approach. **CalPERS should develop a set of investment guidelines and due diligence practices to address deforestation, peatland destruction and land-rights risks.** An elaboration of what such a policy should include is laid out in Friends of the Earth's report, ***Are You Invested in Exploitation?*** As part of such a policy, CalPERS should adopt the Reporting Guidance for Responsible Palm,[xxxii] which would require all palm oil companies in CalPERS' portfolios to systematically disclose their deforestation and human rights risk. In keeping with the OECD guidelines, and in order to increase its leverage, **CalPERS should build alliances with other institutional investors to establish a routine practice of monitoring all palm oil and agrocommodity investees** – with a particular emphasis on those that have a demonstrated history of risk.

3) **Excluding** companies that do not meet CalPERS' stated policy on deforestation and land risk, and that fail to respond to engagement, in order to reduce, and eventually eliminate, exposure to deforestation and land-rights risk throughout its portfolios. To establish clear lines of accountability, **CalPERS and its allied investors should institute a threshold for excluding companies that fail to meet CalPERS' policies, and a timetable for compliance.**

4) **Repairing** the harm that's been done by requiring investee companies to provide remedy for past harms, implementing robust grievance mechanisms, committing to ecosystem restoration and, fundamentally, supporting models of agriculture that regenerate agroecosystems and build cultural resilience.[xxxiii] In an era of increasingly destructive climate events and increasingly destructive impacts on biodiversity, water, livelihoods, labor rights, land rights, and forests, it is urgent that solutions be implemented quickly, and at scale. These solutions exist and are well-recognized: from agroecological practices like organic fertilization, reduced tillage, drip irrigation, biological pest control, intercropping and agroforestry to improved labor and human rights practices and respect for indigenous and community land tenure, there is no lack of knowledge regarding ways to make agriculture resilient, restorative, and regenerative in ways that can transform it from a climate problem to a climate solution. **CalPERS can and must do more to support this transformation.**

ENDNOTES

1 https://www.calpers.ca.gov/page/investments/governance/sustainable-investing/esg
2 https://www.calpers.ca.gov/docs/corporate-engagement-climate-change.pdf
3 http://www.ceres.org/
4 Kissinger, Gabrielle, Martin Herold, and Veronique De Sy. "Drivers of Deforestation and Forest Degradation." Wageningen University. World Bank Group.10. https://www.forestcarbonpartnership.org/sites/fcp/files/DriversOfDeforestation.pdf_N_S.pdf.
5 http://unfccc.int/resource/docs/2015/sbi/eng/21.pdf
6 Ibid, and Scientific American, "Palm Oil Set to Grow Indonesia's Climate Changing Emissions: Draining peatlands and replacing forests with palm oil plantations may cause Indonesian pollution to soar, despite pledges", Oct 10. 2012; Jason Tedjasukmana Time Magazine, "Land Wars: Indonesia Unrest Shows Risks of Resource-Led Growth, Feb. 2012; Voice of America, "Demand for Palm Oil Fuels Land Conflicts in Africa, Southeast Asia", November, 2013; Worldwatch Institute, "Oil Palm Industry Takes Land, Promises Livelihood", 2008; Rhett Butler, Dead tigers, dead people: logging by paper industry worsens human-tiger conflict in Sumatra, alleges report, January 2013.
7 EIA, "Permitting Crime: How palm oil expansion drives illegal logging in Indonesia." December 2014.
8 ibid.3
9 Forest Trends, Consumer Goods and Deforestation: An Analysis of the Extent and Nature of Illegality in Forest Conversion for Agriculture and Timber Plantations.2014
10 "Companies with zero-deforestation commitments still using illegal palm oil."Eco-Business.8 April 2016. http://www.eco-business.com/news/companies-with-zero-deforestation-pledges-still-using-illegal-palm-oil/
11 "Suspension Negative for IOI Group." The Star Online. 29 March 2016. http://www.thestar.com.my/business/business-news/2016/03/29/rspo-suspension-negative-for-ioi-group/.
12 "Moody's Reviews IOI Corporation Berhad's Baa2 Ratings for Downgrade." Moodys.com. 10 May 2016. https://www.moodys.com/research/Moodys-reviews-IOI-Corporation-Berhads-Baa2-ratings-for-downgrade--PR_348708.
13 CalPERS 2015-2016 Annual Investment Report. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2016.pdf
14 Thoumi, G. (2017, September 1) The Chain: Felda Global Ventures Stops Peat Clearance, Faces Potential Deforestation Liability Equal Q2 2017 Net Income (blog post). Washington, DC: Chain Reaction Research. https://chainreactionresearch.com/2017/09/01/the-chain-felda-global-ventures-stops-peat-clearance-faces-potential-deforestation-liability-equal-q2-2017-net-income/
15 CalPERS 2015-2016 Annual Investment Report. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2016.pdf
16 Ling, G. H. (2012, October 5). KL Kepong acquires land in PNG. AmResearch Company report. Kuala Lumpur, Malaysia: AmResearch Sdn Bhd. Retrieved from http://www.amesecurities.com.my/gc/download/Kuala%20Lumpur%20Kepong%20121005.pdf
17 Thoumi, G. (2016, November 28). The chain: KLK withdraws from customary land in Collingwood Bay, Papua New Guinea; KLK increases hostile bid for MP Evans [blog post]. Washington, DC: Chain Reaction Research. https://chainreactionresearch.com/2016/11/28/the-chain-klk-withdraws-from-customary-land-in-collingwood-bay-papua-new-guinea-klk-increases-hostile-bid-for-mp-evans/
18 Op cit.Thoumi, G. 2016
19 CalPERS 2015-2016 Annual Investment Report. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2016.pdf
20 Amnesty International. "The Great Palm Oil Scandal: Labour Abuses Behind Big Brand Names. (2016). https://www.amnesty.org/en/documents/asa21/5243/2016/en/
21 http://webiva-downton.s3.amazonaws.com/877/40/d/10061/Salinan-Copy-Putusan-Gugatan-CLS-Kalimantan-Tengah.English_version.pdf
22 CalPERS 2015-2016 Annual Investment Report. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2016.pdf
23 https://seekingalpha.com/article/4018194-sime-darby-liberian-crossroads
24 https://seekingalpha.com/article/4018194-sime-darby-liberian-crossroads
25 CalPERS 2015-2016 Annual Investment Report. https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2016.pdf
26 Levicharova, M., Thoumi, G., & Wakker, E. (2017a). Indonesian palm oil's stranded assets: 10 million football fields of undevelopable land. Washington, DC: Chain Reaction Research. https://chainreactionresearch.com/reports/felda-global-ventures-fgvmk/
27 Levicharova, M., Thoumi, G., & Wakker, E. (2017a). Indonesian palm oil's stranded assets: 10 million football fields of undevelopable land. Washington, DC: Chain Reaction Research. https://chainreactionresearch.com/reports/felda-global-ventures-fgvmk/
28 CalPERS' Governance and Sustainability Principles.April, 2017. https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf
29 "Report: Over 70% of Investors See Risk, Investment Opportunities in Climate Change Impact."Sustainable Brands. 16 November 2016. http://www.sustainablebrands.com/news_and_views/stakeholder_trends_insights/talia_rudee/report_over_70_investors_see_risk_investment_
30 Hildebrand, P., Winshel, D. (2016). Adapting portfolios to climate change: Implications and strategies for all investors. N.p.: Black Rock Investment Institute. Retrieved from: https://www.blackrock.com/investing/literature/whitepaper/bii-climate-change-2016-us.pdf
31 "Norway's wealth fund dumps 23 palm oil companies under new deforestation policy," Mongabay New (2013), https://news.mongabay.com/2013/03/norways-wealth-fund-dumps-23-palm-oil-companies-under-new-deforestation-policy/
32 https://www.ceres.org/resources/reports/reporting-guidance-responsible-palm
33 For complete details on the four pillar approach to responsible investment, see Friends of the Earth's report, "Are You Invested in Exploitation? Why US investment firms should quit financing conflict palm oil and commit to human rights," Friends of the Earth, http://webiva-downton.s3.amazonaws.com/877/72/7/8646/Invested_in_Exploitation.Digital.compressed.pdf