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Current practices and innovations in smallholder palm oil finance in Indonesia and Malaysia

Long-term financing solutions to promote sustainable supply chains

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Key messages

- Providing long-term financing to oil palm smallholders for urgently needed replanting purposes has the potential to promote more sustainable supply chains in palm oil production. This is required as demand for palm oil is expected to rise significantly in the coming decades.
- High costs and risk in agricultural lending deter banks from providing finance to oil palm smallholders which, however, is urgently needed mainly for replanting. Depriving smallholders from access to finance leads to continued deforestation (often 'slash and burn') instead of replanting as well as usage of low-quality crop and other unsustainable agricultural practices.
- By providing access to long-term finance, oil palm smallholders are encouraged to replant rather than exploit additional agricultural land through deforestation. There is also an urgent need to support farmers with income generation alternatives to bridge the 3-5 years of production gap after replanting. Recognizing the key role of smallholders in meeting the large and growing global demand for palm oil, various innovative financing schemes initiated by the private sector, commercial banks, impact investors, development finance institutions and governments have emerged.
- This brief evaluates past and current policies and financing schemes as well as their outcomes for smallholders in terms of income security, sustainable practices and the environment in the palm oil industry in Indonesia and Malaysia. It also analyzes financing schemes that could contribute to sustainable smallholder oil palm development in such a way that the supply base of smallholders can be secured or can expand with improved sustainability practices compared to past and existing schemes.

Introduction

The production of palm oil is expected to rise in the coming decades due to the increasing world population and overall living standards per capita. Smallholder farmers make up a large share of the palm oil production in Indonesia and Malaysia, the world's main palm oil producing countries (FAOSTAT 2016). Palm oil smallholders are farmers with an average of two hectares of land each and can be distinguished by their different organizational models (Daemeter Consulting 2015):

1. Small-scale independent smallholders linked to the supply chain via local agents.
2. Larger scale independent smallholders linked to the supply chain via local traders or mills.
3. Smallholder groups or smallholder-managed cooperatives that trade directly with mills.
4. Smallholders who manage plots linked with company plasma schemes[1].
5. Company-managed smallholder-owned plantations (leased community-lands).

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1 Under this scheme, smallholder oil palm plantations are developed in a 'plasma' area around a 'nucleus' estate that is under the responsibility of a private company (Budidarsono et al. 2013).

Many of these smallholders experience substantial benefits from returns of oil palm cultivation (Rist et al. 2010). However, benefits are often unequally distributed within and amongst smallholder communities (Rist et al. 2010) due to the lack of inclusive land use planning, free prior and informed consent, knowledge of and experience in best management practices and financial capital to accomplish sustainable farming. These barriers affect smallholders regardless of their organizational structure, which is why this report does not differentiate between independent smallholders and smallholders organized in cooperatives or plasma schemes.

It is important to note that oil palm plantation development by companies and smallholders is playing a key role in tropical forest cover loss and land use conflicts (Gerber 2011). Palm oil finance is urgently needed as in the next 25 years (2017-2041) every year around 175,000 hectares of oil palm require replanting, resulting in a long-term financing need of USD 700 Million per annum (Directorate General of Estate Crops 2015).

Oil palm plantation development in Indonesia and Malaysia has been strong in recent decades, and broadly applied financing schemes and policies regarding export taxes and subsidies have played a fundamental role in this. However, the outcomes of these policies and financing schemes have not always benefited smallholders, local communities or the environment.

The objective of this study was to evaluate past and current policies and smallholder financing schemes in the palm oil industry in Indonesia and Malaysia. The outcomes of these models for smallholders were also evaluated, in terms of income security, sustainable practices and environmental impact. Finally, financing schemes that could contribute to more sustainable smallholder oil palm development were analyzed, and compared to past and existing schemes. The focus of this study is on oil palm smallholders, who play a crucial role in the palm oil production industry and account for the vast majority of oil palm cultivation in Malaysia, even more so in Indonesia.

The study looked at the following questions:

- What are the main past and current financing models in Indonesia and Malaysia and what role did these play; what are the outcomes of these models for smallholders in terms of income security, sustainable practices and the environment?
- What are potential innovative financing schemes that can benefit oil palm smallholders, especially in the long term?
- What are the key enabling conditions for innovative financing models to foster sustainable and inclusive development?

The results of the full report are summarized in this info brief. A number of past and current financing schemes in Indonesia and Malaysia were evaluated through a literature analysis and field assessment. In Malaysia, the main long-term financing challenges faced by smallholders have been solved by large government-sponsored financing schemes and are, thus, less relevant for discussion here. As such, the case studies regarding current innovative financing schemes are restricted geographically to Indonesia. The report proposes potential models to increase the mobilization of long-term finance to smallholders in the palm oil sector, as well as reflects on the key enabling conditions for that to happen.

Results

Bringing sustainable long-term finance to oil palm smallholders is a major challenge. Smallholders face difficulties meeting the lenders' requirements to see sustainable production, loan collateral and sufficient cash flows, while Financial Service Providers (FSPs) are equally constrained by the high risk and costs involved in smallholder lending. The inability to gain access to finance, in particular to long-term loans, ultimately impedes smallholders' growth, negatively impacting productivity and hindering their ability to meet basic sustainability standards.

In both Indonesia and Malaysia, the development of smallholder oil palm plantations was strategically adopted in rural poverty alleviation programs, which often involved large-scale resettlement of landless families. In the early phases, smallholder support schemes (FELDA, Federal Land Development Authority in Malaysia and PIR-Trans, *Perkebunan Inti Rakyat Transmigrasi*; estate transmigration program in Indonesia) were heavily dependent on state funding. However, in recent decades, the state has gradually withdrawn their support, enabling the emergence of more commercially-oriented investment models, often involving the private sector and smallholders organized in cooperatives. Figure 1 gives an overview of the financing schemes for replanting that are available to oil palm smallholders in Indonesia and Malaysia.

Focusing on large-scale plantation development, the models seen do not always effectively address the needs of oil palm smallholders. Smallholders under both the PIR-Trans and the KKPA (*Koperasi Kredit Primer untuk Anggota*; Primary Cooperative Credit for Members) schemes reported various issues and challenges. These were related to the implementation of the financial models, including long delays in receiving allocated land and credit, inaccessibility of allocated plots, restrictions on traditional intercropping, and high land reclamation costs (Vermeulen and Goad 2006). The smallholders also experienced poorly maintained infrastructure, low decision-making power and management issues within cooperatives. They equally reported credit interest rates which were too high, along with high installation costs (Feintrenie 2013). Wider social and environmental impacts, such as deforestation, overexploitation of water resources and rising costs of living were also evident (Vermeulen and Goad 2006; Bissonnette and De Koninck 2015). To achieve sustainable and inclusive palm oil supply chains, new financing and support mechanisms will need to be developed that both meet smallholder needs and address environmental and social challenges in the sector.

Multiple innovative financing schemes have been developed recently that aim to address and overcome the challenges of traditional financing schemes. Implemented by different initiators such as commercial banks, impact investors, development finance institutions and government agencies, they target both independent and plasma smallholders.

Smallholders systemically lack access to long-term finance, due to high operational costs for lenders, limited collateral and insufficient financial (and other) data to make well-informed credit decisions. In particular, the cash flow gap for farmers

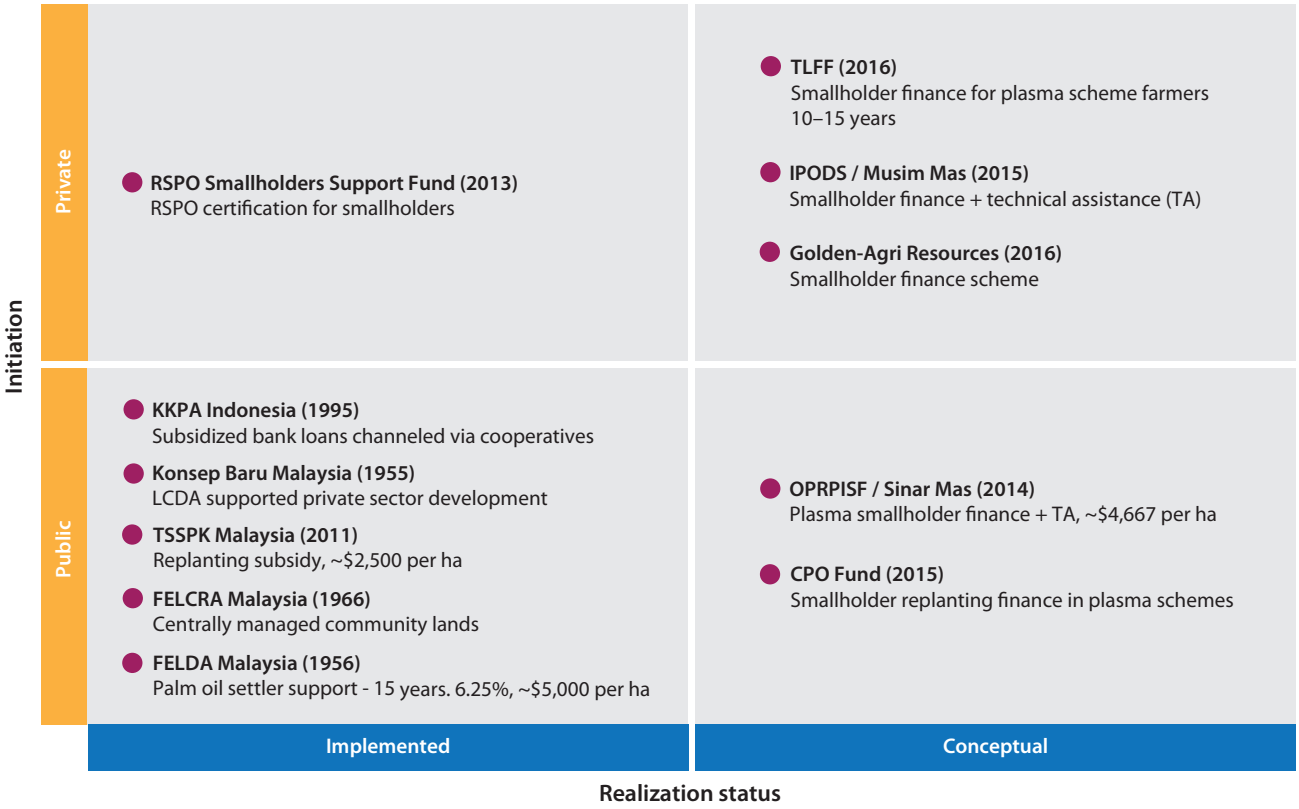

Figure 1. Overview of financing schemes for replanting in Indonesia and Malaysia

Source: PSDonline, "Oil, palm; oil, palm kernel – Export – 2012-2016", USDA Foreign Agricultural Service.

during the replanting period presents a major hurdle for lenders to provide finance to smallholders. Although most innovative financing schemes presented in the report have been developed recently, they have been launched at limited scale due to barriers preventing improved access to finance at scale. No specific financing scheme has yet proven itself to be best practice and new innovative financing schemes continue to emerge. It is therefore too early to determine which models are the most successful and determine the best potential for replication and scaling up in order to reach the hundreds of thousands of independent smallholders that need long-term financing. Banks have not yet addressed the challenges faced in a systemic manner, which continues to make smallholder farmers an unattractive target as a priority business segment.

The urgent need for oil palm replanting already results and will result even more over the coming years in high demand for long-term financing to smallholders. Most Indonesian banks do not yet have the capacity and capabilities to meet this large and growing demand for smallholder loans. As smallholders have good access to well-established government finance schemes, the situation in Malaysia is somewhat different. Most Malaysian oil palm is grown on plantations owned by large companies, for which it is easier to obtain affordable financing from banks.

The Indonesian government has undertaken various initiatives to support replanting and provide financing, for example by creating the Crude Palm Oil (CPO) Fund, that provides replanting loans to farmers. However, financing at scale requires an integrated and programmatic approach, with the government, financial sector, farmer organizations, mills and all other stakeholders in the palm oil supply chain involved. Without active large-scale support from the government (interest rate subsidies, loan guarantees, policy and other measures) it is unlikely that the financial sector will be able to expand and scale up lending and thus support smallholders to bridge the income generation gap they face during the replanting period.

There are a number of key conditions that would help overcome the bottlenecks in smallholder long-term financing and create an enabling environment for sustainable oil palm investments. These are: 1) incentives to meet sustainability requirements including Good Agricultural Practices, RSPO certification and deforestation-free production; 2) land tenure security; 3) improved market linkages between smallholders and mills; 4) support for FSPs to assess and manage risks, and 5) strong and effective smallholder organizations.

Future directions

Although there is increasing interest from the private sector in oil palm smallholder finance, there is still a large gap between demand and supply. Banks and investors still believe that the financing of smallholder farmers leads to high transaction costs and high risks, as there are few financially successful examples

available. Reducing transaction costs and perceived risk levels, and providing successful test cases will encourage the mobilization of private sector financing. The following interventions are recommended:

- **Smallholder farmers** should be given support in order to: fill the income gap during the replanting period; increase their yields in a sustainable matter; obtain the knowledge and capacity for certification; formalize land documentation; and/or get access to mills, which themselves should be incentivized to purchase their fresh fruit bunches under medium to long-term supply arrangements. This will reduce smallholders' income risk, which will improve the credit risk for banks.
- **Financial institutions** should be given support with the development of investment cases to allow financing to smallholder farmers at larger scale. This includes better information about smallholder financing needs and credit risk scores. This will allow the identification, through use of financial technology, of potentially bankable (pools of) farmers, which would reduce lending costs for banks.
- **Smallholder organizations**, such as cooperatives, should be given support through targeted interventions that enable them to improve their management practices and trace palm oil within their supply chain. This will enable them to act as aggregators for data collection from, and loan distribution to, smallholder farmers, due to the reduced costs and risk for loan providers.

Future research could focus on: 1) identifying the specific requirements and lending constraints of individual banks, microfinance institutions and other investors; 2) further analysis of specific farmer intervention needs, especially during the replanting period; and 3) measuring the sustainable impact of smallholder finance models which are currently being implemented, as well as examining how they could be scaled up to reach large groups of farmers seeking long-term financing.

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