PRAKARSA Policy Brief

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Sustainable Finance to Foster Green Recovery Post Covid-19 Pandemic

Key Points:

- The implementation of sustainable finance by financial institutions (FIs) in Indonesia is still in its infancy. The management of ESG risk on lending activities is implemented by using a negative screening approach towards companies/industries that potentially harm the environment and society.
- Financial institutions have started to finance new and renewable energy sector but yet to have an explicit target or commitment to phase out financing of fossil fuels and a measurable target to increase financing of renewable energy generation.
- Financial institutions have yet to establish a measurable reduction target for the greenhouse gas emissions connected with its finance consistent with the Paris Agreement.
- Sustainable finance is key to support transition and green recovery post Covid-19 pandemic towards a climate resilient economy by mobilizing financial resources for climate adaptation and mitigation. To facilitate a conducive sustainable financial ecosystem, cross-sectoral policy coherence is needed.

Financial institutions can be a catalyst for accelerating development towards more sustainable pathways and tackling climate change by allocating financial resources to green and environmentally friendly sector. The involvement of financial institutions is key to drive business transformation by means of sustainability due diligence and ESG risk management. At the moment, financial institutions have begun to show their ambition by announcing pledges to achieve net zero emission (NZE) by 2050. However, one of the remaining challenges is to ensure that the financing activities of financial institutions are aligned with their own commitments.

Without intervention from the banking sector to encourage businesses to act responsibly, climate change that drives global warming will continue to disrupt the ecosystem and supply chain , and further threaten financial stability. As a country who ratified the Paris Agreement, Indonesia is obliged to achieve collective goals on limiting global warming to well below 1.5 degree Celcius compared to pre-industrial levels and reduce emission by 29% (with own efforts) and 41% (with international support) from the BAU levels in 2030.

To achieve the target set out in Nationally Determined Contribution (NDC), a massive amount of financing is needed to support climate change mitigation and adaptation. This is in line with Article 2.1 of the Paris Agreement which stated "*making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*". CPI in FFA (2020) stated that in ASEAN, Indonesia requires the largest volume of green finance, an estimated USD 247 billion by 2030 to meet its NDC of reducing greenhouse gas emission by 29%. However, only about USD 13,2 billion has been tracked between 2015-2018, highlighting the need for Indonesia to immediately mobilize finance to achieve its NDC.

Based on that ground, Indonesia needs to develop coherent policies to optimize efforts and resources, including those from financial institutions. In line with the momentum, the world is currently moving from conventional to sustainable finance. This trend arises due to growing awareness among investors to combine short-term profitability objective with environmental and social interests. Unfortunately, commitment to transition has not been followed by ambition and commitment to phase out financing of climate change driving industries. Globally, sustainable finance assets has grown by 15 percent over the last two years, reaching USD 35,3 trillion in 2020 (GSIA, 2020). On the other hand, the "*Banking on Climate Chaos 2021*" report reveals that 60 largest banks in the world have channelled more than USD 3,8 trillion to fossil fuels industry since the ratification of Paris Agreement in 2015. An increase in sustainable finance amid the absence of commitment to phase out raises doubt on the credibility and commitments of financial institutions in supporting climate actions.

Ignorance towards climate risks and failure to adapt will expose financial institutions at significant risk of credit default. According to the IMF, climate-related risks can be classified in two categories: (1) physical risk due to extreme weathers and catastrophic impact of climate change and (2) transition risk driven by changes in climate policies, technology and market sentiment during the transition process towards low carbon economy. Such climate-related transition process can lead to the risk of stranded assets where assets will be devalued and no longer of use, bringing about financial losses and further threatening financial stability (IESR, 2021). Therefore, portfolio management that incorporates climate objectives is proven to enhance financial services sector resiliency and competitiveness in the long term.

In Indonesia, sustainable finance is still in the early stage. Based on OJK's data, Indonesia's credit and investment to the green sector has reached Rp809,75 trillion between 2015 to 2019. In 2019, OJK issued the Palm Oil Financing Handbook which serves as a guidance for financial institutions on sustainable palm oil practice. In addition, OJK also launched the Sustainable Finance Roadmap 2021-2025 which focuses on the development of taxonomy as a green classification system and the innovation of sustainable financing instruments. Despite Indonesia's growing sustainable financial market , there is still a huge gap to meeting the target.

The implementation of Sustainable finance in Indonesia still faces many challenges. These include business as usual mindset and behaviour, limited human resources capacity in the field of ESG, lack of green classification system which results in different perceptions about activities deemed to be sustainable. Moreover, sectoral policy incoherence is admittedly a challenge of its own especially in supporting the development of a comprehensive sustainable financial ecosystem in Indonesia. However, at the same time, sustainable finance provides new investment opportunities for financial institutions to support the financing of ESG-linked sector.

Since 2014, Responsibank Indonesia, a civil society network that seeks to push banks to be responsible, conducted a study on state-owned banks, private banks, and foreign banks within the BUKU III and BUKU IV category operating in Indonesia to assess their credit and investment policies based on ESG standard. As part of the Fair Finance Guide International (FFGI) global network, Responsibank adopts the FFGI methodology that has also been used in other countries such as the Netherlands, Belgium, Brazil, Denmark, India, Japan, Germany, Norway, France, Sweden and Thailand.

In 2020, Responsibank conducted a study on 11 banks operating in Indonesia, namely HSBC, DBS, BNI, BCA, BRI, Maybank, BJB, Mandiri Bank, CIMB Niaga, Danamon Bank and Permata Bank based on their Annual Reports, Sustainability Reports, Good Corporate Governance Implementation Report, sectoral policy documents, and other publications.The assessment is conducted based on 18 themes which are divided into three main categories: cross cutting, sectoral, and operational themes. Cross cutting themes include climate change, corruption, gender equality, human rights, labor rights, nature and taxation. Sectoral themes include arms, food, forestry, manufacturing industry, mining, oil and gas, and power generation. Meanwhile, the operational theme focuses on bank's internal policy which includes consumer protection, financial inclusion, remuneration, as well as transparency and accountability. This study was limited due to the approach it used in the assessment where scoring is given based on the financial institutions' policy documents, thus it cannot truly reflect whether financial institutions really implementing their own commitments set out in their policies.

Some important findings from Responsibank Indonesia (2020) are:

- **National banks have started to incorporate ESG within their lending framework.**

The implementation of sustainable finance by Indonesian financial institutions (FIs) is still in its infancy. Sustainable finance is implemented by applying a negative screening approach towards businesses/industries that could potentially harm the environment and society. This practice is undertaken by developing lists of activities/businesses that are prohibited to be financed (exclusion list). BJB, CIMB Niaga, Mandiri and Maybank have disclosed such policy in their sustainability report (Figure 1). Furthermore, some national banks claim to have sectoral policies and yet they remain undisclosed, hence it is not known which standards/criteria are used to screen debtors. Those banks are CIMB Niaga and Mandiri. In general, environmental impact analysis (AMDAL) and company performance rating program (PROPER) are used as a benchmark for national banks in assessing the risk of debtors towards environmental and social aspects.

Table 1. Forms of Violations of Palm Workers' Rights

BJB	CIMB Niaga	Maybank	Mandiri
• Production, shipment and trade of illegal weapons • Pornography or similar businesses • the Activities of political parties and organizations including their businesses • Companies that could endanger the environment based on the AMDAL principles set by the Government • Betting and gambling including money laundering and credit for speculative purposes	• Illegal activities • Arms and munitions • Casinos and gaming (related to gambling), bribery • Breaches of national labour laws and human trafficking laws • Illegal logging or uncontrolled fire • Activities impacting World Heritage Sites • Terrorism and smuggling	• I Production or trade in products or activities that are considered illegal according to the law in the country where the bank operates, international regulations/ conventions/agreements, or international prohibitions • Money laundering and/or terrorism activities • Production or activities that involve dangerous forms of forced labour or exploitation or child labour • Production or trade in pornography, prostitutions, and related services • Production or trade in firearms and other dangerous weapons • Production or trade in radioactive materials, including nuclear power plants and related services • Activities that could damage World/National/UNESCO heritage sites	• businesses, gambling, pornography, narcotics • Loan to debtors with problems and/or has a bad loan on other banks or creditors • Loans for companies whose managers/ owners are listed in the blacklist, SLIK bad loan and banned list • Loan for political parties, political organizations and for political activities • diplomatic Loan to individuals with diplomatic immunity • Production, trade, shipment and import of weapons outside an official business entity/ institution that has a special permit/legality from the government • .Projects/ businesses that harm the environment

		• Production or trade in endangered animal species • Production or trade in unbonded asbestos fibers • Gambling, games and similar business entitities	

Source : Summarized from sustainability reports of each banks published on 2019

Figure 1. Average Score on Power Generation Theme

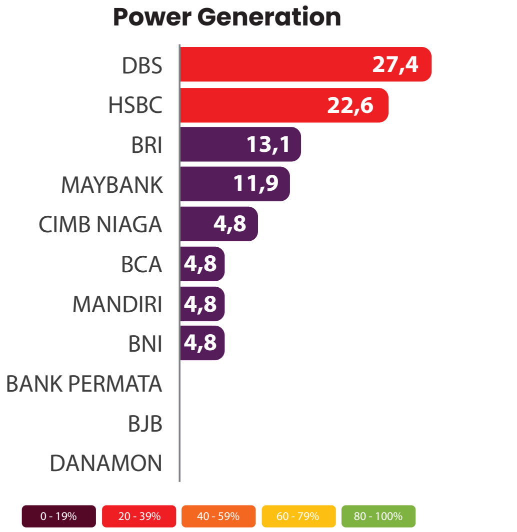
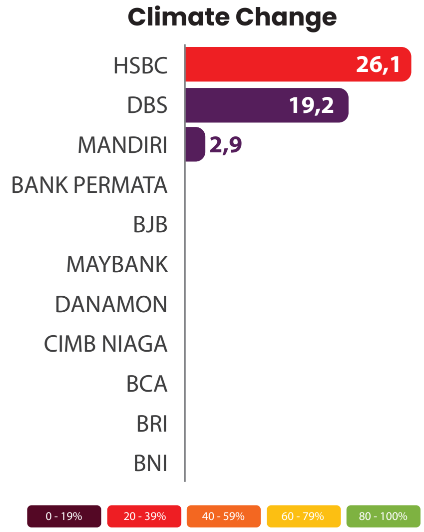


Figure 2. Average Score on Climate Change Theme



• National banks have started financing new and renewable energy sector but yet to have an explicit target or commitment to phase out financing of fossil fuels and a measurable target to increase financing of renewable energy generation.

Of all banks, only DBS has a measurable target to increase the financing of new and renewable energy sector to 10 billion dollar Singapore by 2024. Figure 1 shows that DBS and HSBC are more progressive than national banks since they already have sectoral policies to restrict its lending to fossil-fuel-based power plants including coal, oil and gas. To identify and manage environmental and social risks associated with its project financing, the two banks adopt the IFC Performance Standard. Meanwhile, HSBC adopt the OECD Guidelines for Multinational Enterprise to guide its project financing and corporate lending.

However, the commitments made by DBS and HSBC are still lenient towards the coal industry where lending prohibition is limited to only new coal-fired power plants rather than all existing plants. In addition, HSBC excludes Indonesia, Bangladesh and Vietnam from its lending prohibition. DBS will no longer finance new coal-fired power plants regardless of the efficiency technology it used. Meanwhile, HSBC will continue to finance new coal-fired power plants if it uses *Carbon Capture Storage*/ CCS technology. The use of such technology raises many controversies because it is considered as an expensive form of subsidy and increases dependence over fossil fuels (Stephens, 2015).

Last year, CIMB Niaga just stated its commitment to stop financing new coal-fired power plants and coal mining in 2020 and remove coal from its portfolio in 2040[1]. Similarly, Maybank stated its commitment, yet there are no clear and measurable targets.

• National banks have yet to establish a measurable reduction target for the greenhouse gas emissions connected with its lending and investment consistent with the Paris Agreement.

To establish such target, banks need to measure and disclose its indirect emissions generated from its financing activities (scope 3). This enables banks to measure their baseline emissions which is fundamental to determining the target (PCAF, 2020). For DBS, the emission calculations is still limited to specific industries it finances by conducting pilot assessment of 368 debtors in agriculture; chemical; energy; mining and metals; real estate and transportation sectors[2]. This is similar to that of HSBC, whose emission calculations is still limited to specific industries it finances[3]. This early movement of DBS and HSBC in measuring and disclosing such emissions drives score in climate change theme (Figure 2).

Of all banks, only HSBC has announced its target to reach net zero emission (NZE) by 2050 and explain how that target is going to be achieved[4]. Although DBS has stated its commitment to support the low carbon development economy and efforts to decarbonize, DBS has yet to set a net zero emission target. Recently, Maybank has just announced its target to achieve net zero by 2050[5]. However, there has been debate over the need for a more ambitious goal by setting net zero target before 2050 or a decade earlier.

• Majority of banks have yet to disclose its climate-related financial risks according to the recommendation of Task Force on Climate-related Financial Disclosures/TFCD.

Of all banks, only HSBC and DBS has implemented key disclosures of TCFD standard, although such disclosures have yet to accommodate all TCFD's recommendations: (1) governance, (2) strategy, (3) risk management and (4) metrics and targets. For strategy, HSBC announces its commitment to provide 100 billion US dollar in sustainable financing and investment by 2025 where 52,4 billion US Dollar has been realized cumulatively since the target was initiated in 2016. Meanwhile, DBS set a target to provide about 10 billion Dollar Singapore by 2024 for green projects.

Recommendations

1. The government needs to push for more ambitious goal by setting NZE target in order to give clear signals to FIs, business sector and other stakeholders to immediately transition. This aims to encourage sectoral policy coherence that supports the ecosystem and implementation of sustainable finance in Indonesia.
2. OJK needs to develop green taxonomy in line with national climate goals and science-based target to avoid market fragmentation and greenwashing. Green taxonomy needs to accelerate just transition, meet sustainable development goals (SDGs) and Paris Agreement.
3. OJK needs to develop a financing handbook for sectors with high ESG risk exposure (e.g : extractive, manufacturing) to guide FIs in developing their policies, recognizing and managing ESG risks as well as encouraging sustainable business practice. For the handbook it developed, OJK needs to adopt a mandatory system.
4. OJK needs to push FIs to contribute to the greenhouse gas emission reduction target by ensuring that the business sector has a comprehensive analysis about how such target is going to be achieved, including requiring the business sector to have climate change experts within its human resource structure.
5. Financial institutions (FIs) must commit to align its portfolio with the greenhouse gas emission reduction target as mandated by the Paris Agreement (NDC) and develop sectoral policies by adopting minimum standards which refers to international standards, best practices and applicable laws.
6. Financial institutions (FIs) need to immediately shift from the financing of fossil fuels to new and renewable energy sector to support the transition efforts of achieving the 23% new and renewable energy mix target by 2025.
7. Financial institutions (FIs) need to develop a monitoring and evaluation system to regularly ensure that the companies it finances implement ESG practice. M&E system needs to be developed to support the monitoring and due diligence process of the financed business activities based on ESG criteria

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[1] CIMB Niaga stated its commitment in 2020 so that this progress was not included in the assessment results because the study was conducted based on the 2019 policy document

[2] Quoted from HSBC Holdings plc 2019 Sustainability Report

[3] Quoted from HSBC Report entitled 'Environmental, Social and Governance (ESG) Update 2019'

[4] https://www.hsbc.com/news-and-media/hsbc-news/hsbc-sets-out-net-zero-ambition

[5] Maybank stated its commitment in 2020 so that this progress was not included in the assessment results because the study was conducted based on the 2019 policy document

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PRAKARSA *Policy Brief* is an independent policy analysis and recommendation about various critial issues related to development and welfare.

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