PRAKARSA Policy Brief

September 2019

LONG ROAD TO SUSTAINABLE FINANCE IN INDONESIA

Key Points:

- A recent study conducted by Responsibank Indonesia in 2018 shows that Financial Services Institution (FSIs) do not have specific sector policy for high risk business and industries that are exposed to environmental and social conflict issues.
- The national bank's policy are yet to explicitly present commitment in moving away from fossil-fuel investment to renewable energy investment in accordance with the government commitment to encourage climate change adaptation by setting specific targets in carbon emissions reduction.
- The Regulation of the Financial Services Authority (OJK) Number 51/POJK.03/2017 regarding the Implementation of Sustainable Finance for Financial Services Institutions, Issuer Companies and Public Companies encourages more responsible FSIs practices by addressing environmental, social and governance (ESG) issues to support sustainable economy. Hence, further enforcement of this policy is required to effectively change FSIs practices.
- OJK needs to evaluate the implementation of Sustainable Finance Road-map 2015-2019 and ensuring that Sustainable Finance Road-map 2020-2024 have clearer and more measurable targets, timeline, incentives and sanctions.

Source: www.retreadingbusiness.com

Financial Service Institutions (FSIs) practice in Indonesia have not yet effectively addressed ESG criteria into their core business activities as a part of their risk management strategies. Regulation regarding sustainable finance is still deemed superficial and has yet to touch the substance. The existing regulation have not been able to clearly measure the financing risks of FSIs on ESG issues.

Furthermore, as a critical intermediary, FSIs serve a central role in driving capital to sustainable and green investment thus FSIs directly support inclusive and sustainable economic development and growth, one of which through responsible investment. The transformation process of harmonizing economic interests with environmental, human rights and inequality issues aims not only to accelerate the achievement of sustainable development goals (SDGs) but also to increase the resilience and competitiveness of FSIs.

As a heavily regulated sector, the compliance of FSIs in Indonesia is highly dependable on the mandate set by the government as a regulator. Meaning, a comprehensive regulation facilitates and optimizes the role of financial sector in promoting sustainable ecosystem so that the principles of sustainable finance become an integral part of FSIs practices.

Gap on Sustainable Finance Policy

At a global level, the financial architectures are transitioning from conventional financial system that tends to be profit-oriented towards socially and environmentally conscious financial system that puts forward sustainability principles. The Global Sustainable Investment Alliance (GSIA) data suggest that the total sustainable investment have reached US$ 30.7 trillion in 2018, a growth rate of 34 percent over the past two years. In addition, the ratio of green portfolio to the total amount of credit continue to increase. One of the factors behind considering ESG criteria includes an increase in the probability of credit default if FSIs feign ignorance towards social and environmental issues (Hadad & Maftuchah, 2015). In other words, sustainable finance directly contributes to long-term financial stability and economic growth.

The implementation of sustainable finance in Indonesia is considered to be progressive. Sustainable finance practice in Indonesia was formalized through the released Sustainable Finance Road-map in 2014 followed by the issuance of an "umbrella policy" which is the Regulation of the Financial Services Authority (OJK) Number 51/POJK.03/2017 regarding the implementation of sustainable finance for financial services institutions, issuer companies and public companies that requires FSIs to publish Sustainability Report and Sustainable Finance Action Plan (RAKB). Furthermore, in correspondence with one of the strategic activities stated in the Road-map that is to increase the supply of sustainable financing, OJK released the Regulation of the Financial Services Authority Number 61/POJK.04/2017 on the issuance and the terms of green bond. The Technical Guidelines for the Implementation of Sustainable Finance in 2018 serve as a guideline for FSIs to identify environmentally friendly business activities (KUBL). However, the existing regulations are ineffective in giving direct impact on the private sector that receives investment from FSIs. In fact, the released Technical Guidelines have not been able to identify clear and measurable performance targets and indicators.

Another cause that is hindering the implementation of sustainable finance practice is due to a regulatory gap which can be avoided if the revision process of Banking Law Number 7 of 1992 runs as smoothly. Currently, the revision process of Banking Law hits dead end at the legislative level.

One of the main problems in FSIs practice is the ignorance of environmental impact analysis (AMDAL) compliance as a prerequisite in granting credit especially for large-scale projects. Although the provision of AMDAL have already exist in the Banking Law, still the majority of banks do not conduct an adequate environmental feasibility analysis to ensure that their business activities do not harm the environment

The current benchmarks for national banks in assessing the environmental impact of a proposed business are Indonesia's Program for Pollution Control, Evaluation, and Rating (PROPER) by the Ministry of Environment and Forestry and Indonesia Sustainable Palm Oil (ISPO). Meanwhile, none of the national and state-owned banks adopts the global standards and initiatives in regards to sustainable finance such as the Equator Principles, IFC Performance Standards, UN Global Compact, UN Principles for Responsible Investment.

Environmental, Social and Governance Responsibility by Financial Sector

The concept of ESG criteria in investment stems from the publication of the report "Who Cares Wins" by the UN Global Compact in July 2004. The report starts with the hypothesis that better investment leads to an improvement in welfare. This idea eventually become the foundation of responsible investment principles. The term ESG criteria continues to evolve and helps to define social goals and business values whereby, long-term profits must be in harmony with sustainable economic growth, poverty reduction and climate change risk mitigation.

Since 2014, Responsibank Indonesia, as a national civil society network that seeks to strengthen the commitment of banks to responsible investment , conducted a study on state-owned banks, private banks, and foreign banks within BUKU III and BUKU IV category which classify banks in Indonesia based on the amount of their core capital (tier 1), to assess their credit and investment policies from ESG perspective. As part of the Fair Finance Guide International (FFGI) global network, Responsibank adopts the FFGI methodology that has been applied in several countries such as the Netherlands, Belgium, Brazil, Denmark, India, Japan, Germany, Norway, France, Sweden and Thailand. In 2018, Responsibank conducted a study of 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. In particular, the assessment of cross cutting and sectoral themes is carried out based on the disclosure of internal policies and the disclosure of credit and investment policies for business activities that are financed by banks. 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 the bank's internal policies which consist of consumer protection, financial inclusion, remuneration, as well as transparency and accountability. The assesment was limited to written policies published by banks and does not reflect the implementation of sustainable finance practice.

Several important findings from Responsibank Assessment (2018) are :

- **The majority of national banks do not have specific sector policy for credit and investment catered for high risk and sensitive industry especially for sectors that are exposed to environmental damage and social conflict.** The study suggests that amongst the assessed banks, only foreign banks that have sectoral policies and those policies are agriculture, mining, fisheries, forestry, oil and gas, and coal policies. Figure 1 explains the average score of each bank based on sectoral themes.

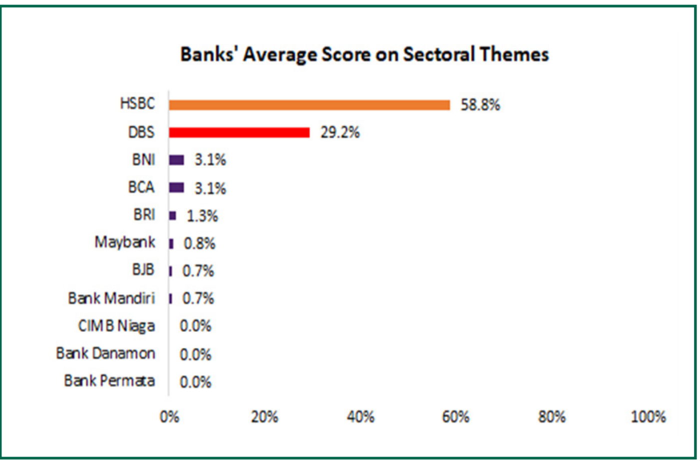

Figure 1. Bank's Average Score on Sectoral Themes

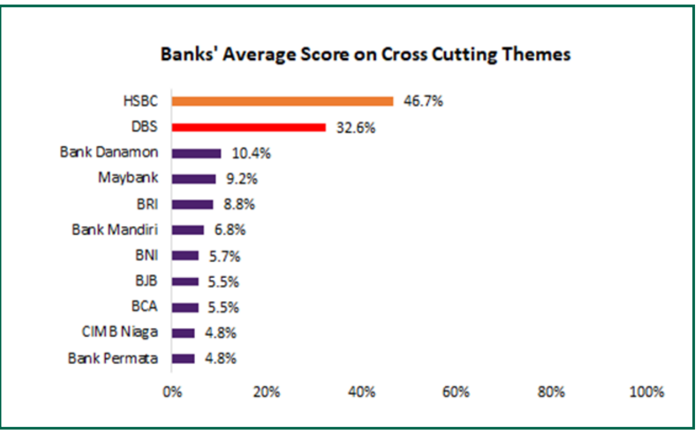

Figure 2. Bank's Average Score on Cross Cutting Themes

- **National banks do not explicitly have a commitment in shifting away from fossil fuel investment to renewable energy investment.** All foreign banks obtain score in climate change theme because they already have policies to mitigate climate change risks by setting specific target on reducing carbon emissions. On the other hand, only one national bank obtains score in climate change due to clear disclosure of investment portfolio towards efficiency and conservation of energy.

- **Sustainability report does not present much of the banking core business which are credit and investment in the context of sustainable finance.** Sustainability reports tends to only present the highlights of philanthropic and Community Social Responsibility (CSR) activities. However, BNI as a state-owned bank who is also a member of UNEP-FI Initiative, have carried out a good practice in which their Sustainability Report clearly explains their sustainability strategies, sustainable finance policies and procedures, and the internalization of sustainability practices in their operations. Furthermore, the majority of banks have been consistent in publishing their Sustainability Report although Sustainabili*ty report as a mandatory requirement only began in 2018. Apart from that, Danamon is the only bank that last issued their Sustainability Report in 2015.*

- **National banks primarily obtain good score only from operational themes or good corporate governance.** Generally, banks already have an adequate internal policy to regulate their operations in line with the aspect of consumer protection and financial inclusion. Some banks already have clear consumer protection policies ranging from customer treatment, data protection, and complaint handling. All banks have contributed in accelerating financial inclusion through digitalization of banking services (branchless banking) as well as by providing micro credit program (KUR) and mortgage to low-income people. Some banks, such as BNI and BCA have integrated the need of disability group across a wide range of their operations by promoting access to infrastructure facilities which includes providing wheelchair access to their ATMs and facilities for the deaf. On the other hand, Mandiri bank contributes in promoting disability inclusion through the provision of internship programmes for disabled while other banks such as BTN, Permatabank, CIMB Niaga, and DBS Bank provide employment opportunities for disabled to become administrative officers, call centers, and help desks.

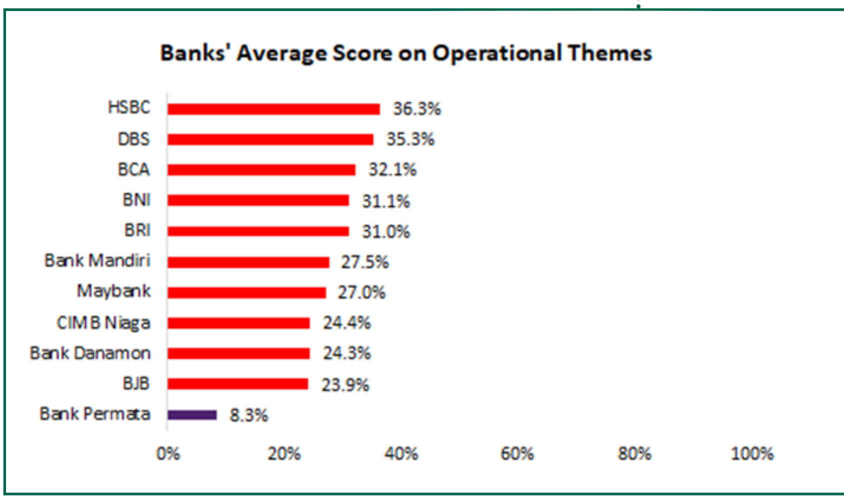

Figure 3. Bank's Average Score on Operational Themes

Policy Recommendation

Based on Responsibank Indonesia assessment, the following are policy recommendations to accelerate the implementation of sustainable finance practice:

1. **The Government and The House of Representative (DPR) need to immediately revise the Banking Law.** The Government and DPR need to incorporate inclusive, systematic and measurable sustainable finance principles by integrating environmental, social, consumer protection, financial inclusion as well as governance and transparency aspects in accordance with the international principles and standards.

2. **OJK needs to immediately publish Sustainable Finance Road-map 2020-2024 with clearer and more measurable targets, timelines, awards and sanctions.** The preparation for Sustainable Finance

Road-map 2020-2024 and the evaluation based on Sustainable Finance Road-map 2015-2019 must be carried out as soon as possible and should involve various stakeholders participation such as FSIs and civil society organization.

3. **FSIs need to be more transparent and accountable** by publicly presenting an Annual Report and Sustainability Report that contains financing policies and portfolios related to their credit and investment

4. **Banks need to establish specific sector policy for credit and investment especially for sensitive business and industry that have a high risk on ESG criteria.** The policy serves as a benchmark for banks when considering credit and investment decisions in order to comply with sustainable finance principles.

5. **OJK needs to establish a multi-stakeholder forum** which consists of government, FSIs, academics, and civil society organization to carry out sustainable finance planning, implementation, supervision, and evaluation.

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Disclaimer:

This Policy Brief aims to encourage better implementation of sustainable finance policy so that FSIs practice runs in accordance with ESG criteria to avoid the negative impact of financing. This Policy Brief is expected to be used as a material for discussion in regards to how financial industry can contribute to sustainable development. This Policy Brief was prepared with the support of SIDA and OXFAM Novib on behalf of Perkumpulan PRAKARSA.

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