PRAKARSA Policy Brief

November 2023

Bank Sustainability Information and Risk Disclosure: Transparency on Sustainability

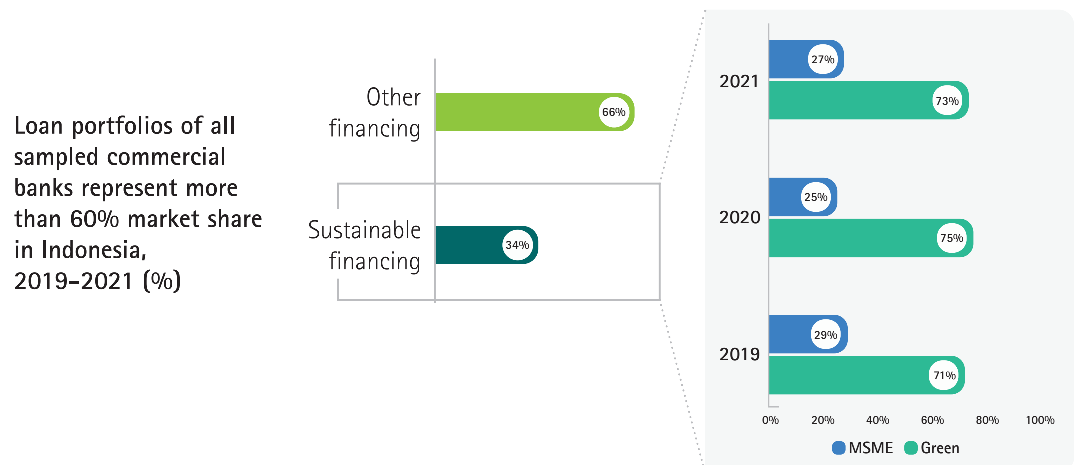
Key Points:

- The technical guidelines of POJK 51/2017 need to detailed regulations regarding reporting standards, disclosure of financing impacts, and examples of complaints handling mechanisms from communities.
- The Bank must disclosure of Environmental, Social, and Governance (ESG) information to consider a double materiality approach and financing impact based on clear targets supported by evidence and data.
- The Financial Services Authority (OJK) must efficiently create derivative technical regulations under the Sustainable Finance Law, governing sustainable finance, ESG information disclosure, and connecting banking financing portfolio reporting with green taxonomy.

Financing for Green Activities is Not Optimal

OJK has recently released the 2022 report on implementing of Indonesia's Green Taxonomy, but financing for green classifications still needs to be higher. The green classification is still dominantly focused on financing for SMEs rather than funding for green activities. The implementation of credit or financing based on green taxonomy classification reached IDR1.521 trillion in June 2022. According to the Climate Policy Initiative's research (2022), between 2019-2021, the Sustainable and Responsible Financing (LST) portfolio of banks in Indonesia reached 34% of the total portfolio, or USD3.6 trillion, mainly directed towards "social" financing or SMEs. However, more than 70% of LST financing is used for SME activities, while less than 30% is allocated to green activities (CPI, 2022). This indicates that financing for green activities is still far from optimal as environmental financing remains low, especially considering that not all SME activities are green.

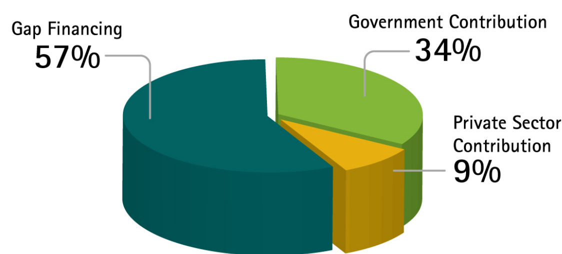
Figure 1. Trend of the increase in ESG portfolio after the issuance of OJK Regulation 51 on Finance



Source: CPI, 2022

The proportion of green financing in private banks is still higher than in state-owned enterprises (BUMN). Out of their total ESG portfolio, private banks allocated 41% to green activities, whereas state-owned enterprises allocated 23% (CPI, 2022).

Figure 1. Contribution of Financing to Achieve NDCs.



Source: CPI, 2022

Considering Indonesia's climate financing needs of USD 285 billion, government financing still dominates with a 34% proportion, the private sector contributes 9%, and there remains a financing gap of 57%. This gap can be reduced if bansks increase their financing share.

Why is ESG information disclosure necessary for banks?

Environmental, Social, and Governance (ESG) information disclosure benefits public companies, including banks. Some of the benefits include:

- Investment in ESG can help investors reduce risks in their portfolios. Companies prioritising ESG factors are better managed, have lower risks, and possess more sustainable business models. As a result, capital returns are more stable in the long term.
- ESG considerations aid investors in identifying opportunities for innovation and growth. Companies committed to sustainability will invest in more responsible technologies and practices, enhance worker safety and well-being, and promote ethical governance. This can create new market opportunities and revenue streams, and help companies remain progressive in catering to changing consumer preferences.
- Investing in ESG can enhance the reputation of the investors themselves. Banks can build trust with customers, regulators, and the public by demonstrating a commitment to sustainability and responsible investment. This can attract and retain clients and investors who value sustainability and differentiate the bank from competitors.
- There is growing evidence that ESG investments can provide long-term solid financial benefits. MSCI studies (2017) have shown that strong ESG characteristics have yielded positive stock performance (indicating causality). However, ESG momentum can be a valuable financial indicator in its own right, and investors can use it to build their portfolios.

Generally, public companies, including banks, have recognized the importance of disclosing Sustainable and Responsible Financing (LST). However, these companies, including banks, have not yet openly declared their policies related to LST accessible to the public.

Challenges for Banks in Disclosing ESG Information and Risks

The government has established policies regarding the obligation to disclose Sustainable and Responsible Financing (LST), but disclosure of ESG policies by public companies, including banks, still need to be improved. Several challenges, both internal and external to the company, influence this situation. In POJK 51/2017 on Sustainable Finance, Articles 8 and 10 stipulate the obligation to create sustainability reports, which can be produced separately or as part of the annual report and must be submitted to OJK within the specified deadline and reporting period. The format for sustainability reporting is detailed in Attachment 2 of POJK.

There are several good practices that banks can use as references in disclosing Sustainable and Responsible Financing (LST) information. PRAKARSA (2022) found that banks such as Bank Mandiri, BRI, CIMB Niaga, Maybank, and BJB have disclosed information related to their exclusion lists, which is communicated to the public and investors to refrain from financing business activities that may potentially violate ESG. Additionally, some other banks have exclusion lists at the sectoral level, such as not financing business activities related to terrorism funding, gambling, prostitution, money laundering, illegal weapons financing, supporting financing for land conversion through violence, or activities and businesses that can damage UNESCO World Heritage Sites. Furthermore, some international banks even disclose the names of companies on their exclusion lists. Several banks have explicitly stated in their documents that they have ceased financing coal-fired power plants (PLTU coal).

Based on various studies related to sustainability and sustainable finance in banking, particularly in Indonesia, some challenges from the perspective of banks in disclosing Sustainable and Responsible Financing (LST) (PRAKARSA, 2023) include:

Regulations need to be strengthened. In the technical guidelines of POJK 51/2017 on implementing sustainable finance, detailed regulations regarding globally acceptable reporting standards, disclosure of financing impacts, and examples of complaint-handling mechanisms from communities affected by bank financing have yet to be specified. The reporting format specified in the technical guidelines, especially regarding economic performance, is still general and does not explicitly regulate reporting related to sustainable business activities according those technical guidelines' definition of sustainable business.

Short-term perspective and limited involvement of top management. Banks in Indonesia generally have a short-term focus on profitability and growth, which can make it challenging for them to prioritize Sustainable and Responsible Financing (ESG) considerations that may yield little financial benefits. As a result, corporate leadership may need to see the value of integrating ESG factors into the decision-making process or incorporating ESG issues into their business strategies. Some stakeholders, such as investors, expect the board of directors to be involved and deeply understand all ESG-related risks, constraints and opportunities, and to plan appropriate risk control or mitigation systems.

Limited capacity for ESG disclosure. The complexity of ESG disclosure results in banks needing to figure out where to start and feeling unprepared or continually postponing. The low awareness of sustainable finance is not unrelated to the lack of understanding among banking human resources

regarding sustainable finance principles and the integration of ESG as a cohesive element in the business process.

Relatively High Implementation Costs of ESG. Banks need to allocate costs for ESG disclosure. These costs include 1) ratings issued by various rating agencies such as MSCI, Sustainalytics, Bloomberg, Refinitiv, Moody's, S&P Global, and Fitch; 2) investments in enhancing the internal human resources capacity of the bank; 3) building a data management system; 4) reporting standards with ESG audits; and 5) emission measurements.

Lack of ESG data and metrics. Banks still face challenges in building a data management system, even though data is crucial for ESG disclosure. Without reliable data make decisions based on information about ESG integration is difficult. One example is the disclosure of GHG emissions, where banks need to disclose the calculations of emissions generated from their operational activities in sustainability reports. In calculating emissions, banks need to consider the emission scope, namely scope 1, 2, and a limited scope 3.

Double Materiality Approach to ESG Information and Risk Disclosure

ESG information disclosure needs to consider a double materiality approach. This approach is broader because it considers the financial and non-financial impacts of a company's activities. It recognizes that a company's actions can impact not only on its financial performance but also the environment, society, and other stakeholders. In this approach, a company's impact on the environment and society is considered equally important as its financial performance.

Banks should have accountable financial systems where they do not generate and retain profits from financing activities that harm the environment and society or are illegal. Banks should be responsive to and address complaints in ways that bring about positive changes within the affected communities or ecosystems. Banks also face significant consequences for financing activities considered harmful, which can manifest as legal risks.

As part of the sustainability policy, companies implementing of Sustainable and Responsible Financing (LST) aspects must strengthen grievance mechanisms for individuals or stakeholders regarding allegations of violations or issues. However, some public companies, including banks, still need grievance mechanisms. The UN Guiding Principles on Business and Human Rights emphasizes that businesses need to prevent, mitigate, and, if necessary, remedy human rights violations arising from their activities or contributions related to their operations, products, or services, even if their suppliers or business partners cause these impacts. Grievance mechanisms are regulated under Pillar 3 (Access to Remedy) in Principles 25 to 31 of the applicable guiding principles for the business sectors, including banks. Pillar 3 stipulates that if a right is violated, victims should have access to adequate, legitimate, accessible, predictable, equitable, transparent, and rights-based remedies.

Businesses can vary widely in scale, size, and types of activities Thus grievance mechanisms should ideally exist at the operational or project level. Grievance mechanisms can play a crucial role in fulfilling a company's responsibility to respect human rights, where: 1) They support the provision of redress from the company for the negative impacts caused. 2) Handling cases and identifying patterns of violations over time can provide direct input into broader human rights due diligence.

Indonesian banks lag in grievance mechanisms compared to other banks in Asia. This was highlighted by BankTrack (2022), even though the International Finance Corporation (IFC) (2009) documented several commonly encountered complaints during project implementation. For projects in general, issues often include inadequate consultation processes, excessive noise and pollution, damaged road conditions, project-related traffic congestion, restricted community access to natural resources and livelihoods, and the absence or lack of project benefits (such as no job opportunities for residents in the project/company). Meanwhile, more complex projects typically involve land access, land seizures, forced displacement of communities, a high number of project workers from outside the area, excessive use of security forces, and violations of the rights of indigenous communities. Such cases are widespread in Indonesia, especially in large-scale agricultural and extractive industries.

Fundamentally, companies should have clear grievance procedures to facilitate individuals with varying literacy levels and access to infrastructure. In its implementation, grievance mechanisms sometimes may not be sensitive enough to differences in opinions, as men, women, the elderly, and young people may have varying views and priorities anddifferent perspectives on the impacts of an activity or project. Companies should adopt a gender perspective, for example, by providing contact points for women in meetings specifically designed for women, especially in cultures where women may not typically attend general community meetings.

Furthermore, the main obstacle in Indonesia is the inadequacy of law enforcement, where even when cases of violations have been brought to the judicial process and communities win the cases, companies often continue to defy court decisions and carry on with activities that harm the communities around the project sites or companies (PRAKARSA, 2022).

From the perspective of affected communities or potentially affected by a bank's financing for a company's activities, several rights need to be fulfilled, namely, the right to know which bank is financing a company or project in their area and the right to remedy and redress - from the bank - in case of violations.

There are several best practices that banks can utilize as a reference in ESG information disclosure. PRAKARSA (2022) found that several national banks, such as Bank Mandiri, BRI, CIMB Niaga, Maybank, and BJB, have disclosed information related to exclusion lists provided to the public and investors to avoid financing business activities that may potentially violate ESG principles. In addition, some other banks have exclusion lists at the sectoral level, such not be financing activities related to terrorism funding, gambling, prostitution, money laundering, illegal weapons financing, supporting land displacement through violence, or activities and businesses that can harm UNESCO World Heritage Sites. Furthermore, some international banks even disclose the names of companies on their exclusion lists. Some other international bank practices that can serve as

references for ESG information disclosure include explicitly addressing climate goals by easing the finance of coal-fired power plants.

Policy Recommendations

1. OJK needs to revise the Indonesian Green Taxonomy document to make it more accountable. The determination of a company or activity's green category needs to be reassessed if 1) it does not report its beneficial ownership, 2) it does not openly report a list of complaints, including those related to serious risks in ESG, including human rights, inclusivity, and gender, and 3) it cannot prove that the entire cycle of its activities operates legally. If a company or business activity does not meet these minimum criteria, it is not categorized as 'green'.
2. OJK must revise the Technical Guidelines for Banks on implementing POJK No. 51/ POJK.03/2017, particularly regarding:
   - Provide ESG reporting standards that aligning with portfolio financing information and green taxonomy. Reporting standards should refer to international standards (TCFD) and be update by the International Sustainability Standards Board (ISSB) to facilitate compliance with specific requirements for broader stakeholders.
   - Ensuring the integration of ESG and Key Performance Indicators (KPIs) for Sustainable Finance
   - Developing guidelines for implementing sustainable finance in the capital market and non-bank financial institutions.
3. OJK needs to create derivative technical regulations under Law No. P2SK that governs sustainable finance and ESG information disclosure, and links portfolio reporting to the green taxonomy.
4. OJK should strengthen the monitoring and grievance mechanism in assessing financial institutions' compliance with POJK No. 51/POJK.03/2017, including expanding the complaint system for communities affected by the operational activities of companies that are bank customers. OJK should also provide information on complaints, complaint resolutions, and summaries of bank compliance with OJK regulations to motivate performance improvements and ensure public oversight.
5. OJK should establish a stakeholder forum for sustainable finance. The forum involves various parties, particularly environmental and human rights activists, updating the green taxonomy by participating in OJK's National Task Force on Sustainable Finance.
6. Banks are obliged to create an ESG report based on clear and evidence-based targets. This bank is required to establish measurable data management for the environmental and social aspects, including inclusivity, human rights, and gender.

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Managing Director :
Ah Maftuchan
The PRAKARSA Executive Director

Written by:
- Ricko Nurmansyah
- Eka Afrina Djamhari
- Dwi Rahayu Ningrum
- Victoria Fanggidae

Designed by:
Bambang Nurjaman

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

PRAKARSA
Welfare Initiative for Better Societies

Jl. Rawa Bambu I Blok A No.8-E
Pasar Minggu, Jakarta Selatan
Indonesia 12520

Phone +6221 781 1798
perkumpulan@theprakarsa.org

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