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Sustainable Finance in Indonesia: How the Financial Services Industry Contributes to Environmental, Social and Governance Issues

The Roadmap for Sustainable Finance in Indonesia

Indonesia, a G20 member and an archipelago comprising more than 17,000 islands with 270 million inhabitants, has the potential to become an ideal example of how economic growth can be accomplished responsibly and sustainably. In 2014 Indonesia's Financial Services Authority (Otoritas Jasa Keuangan, OJK) together with the support of a number of prominent contributors established the first phase of a strategic roadmap of sustainable finance for the years 2015-2019. Based on the 3-P Principles, Profit, People and Planet, the roadmap was designed to strategically and systemically guide Indonesia's financial services industry (FSI) to play an active role and contribute positively in the process of sustainable development (OJK, 2014).

The roadmap acts as a guideline to support Indonesia's effort in achieving the United Nations Sustainable Development Goals (UNSDGs) 2015-2030 and also in fulfilling the Paris Agreement on Climate Change for 2015-2030, among other objectives. The ultimate goal is to combat climate change and to intensify actions needed for a sustainable low-carbon future. Although the first phase of the roadmap covers 2015-2019, the roadmap is a medium to long term initiative of 10 years and is meant to be part of the global initiative established by a number of institutions worldwide to supporting sustainable development.

Such global initiatives include the RIO+ Agreement, which commits developed countries to reduce greenhouse gas emissions globally and to help developing countries undertake environmentally friendly economic development programs (RIO+, 2016), and The Equator Principles (EP), observed by 70 financial institutions committed reject loans to projects worth USD10 million or more if the prospective debtor does not comply with prevailing social and environmental regulations and follow procedures established by the EP (Equator Principles, 2017).

Under the roadmap (Table 1), strategic activities to implement sustainable finance in Indonesia comprise of three focus areas which are:

1) Increase supply of environmentally friendly financing;

2) Increase demand for environmentally friendly financing products; and

3) Increase oversight and coordination of sustainable finance implementation.

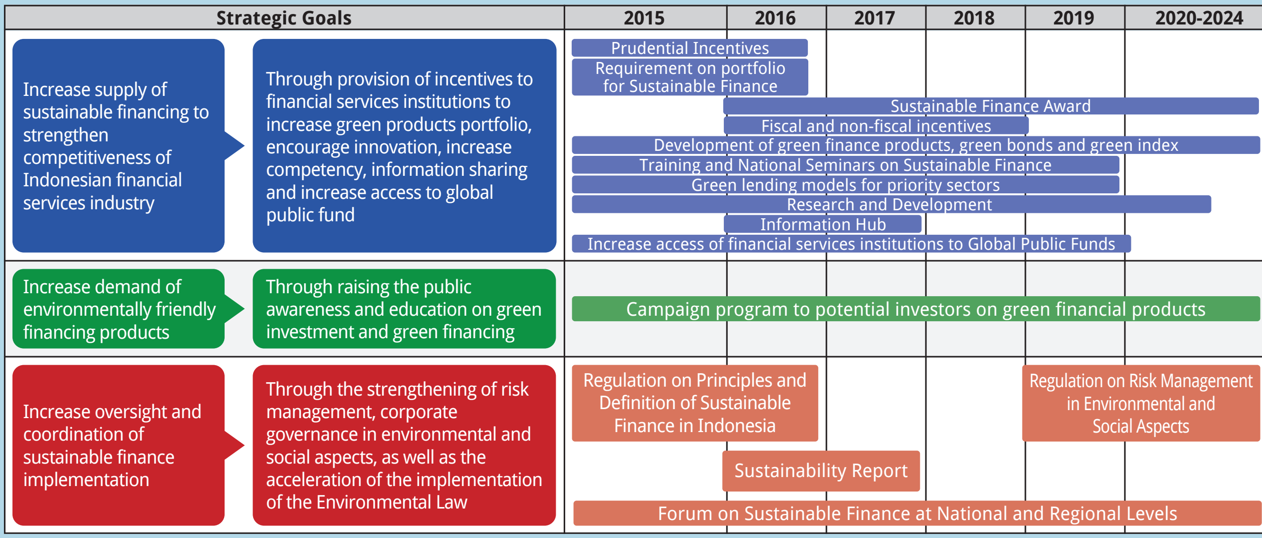
These strategic activities will be implemented gradually in the medium and long term. Firstly, activities in the medium term, from 2015 to 2019, focus on the basic regulatory framework and reporting system, increase understanding, knowledge and competence of the human resources in the FSI, and provide incentives and coordination with related agencies. Secondly, the longer term from 2020 to 2024 will focus on integrated risk management, corporate governance, bank rating, and the development of an integrated sustainable finance information system.

Since the roadmap was enacted, its implementation has been progressing positively through a number of financial products, regulations, and initiatives.

Promoting Sustainable Finance through Issuance of Green Bonds

Due to sustainability and development challenges faced by Indonesia as well as the investment opportunities offered by clean development, OJK has issued a series of sustainable finance policies to encourage the shift in the Indonesian economy towards sustainable and low-carbon economic growth.

Table 1: Strategic Activities to Implement Sustainable Finance



Source: Otoritas Jasa Keuangan

On 21 December 2017, OJK issued a regulation on green bonds that was geared towards raising capital for green projects. OJK Regulation Number 60/POJK.04/2017 (POJK 60) set out the standard for green bonds issuance in Indonesia (OJK, 2017b). This standard is an amalgamation of globally accepted green bond standards, such as the Green Bonds Principles, the Association of Southeast Asian Nations (ASEAN) Green Bonds Standards and the Climate Bonds Initiatives, with adaptation specific for the Indonesian capital market.

As with any other type of bond, issuers of green bonds must adhere to Indonesia's capital market regulations on debt securities. According to POJK 60, there are four additional characteristics of a green bond. First, green bonds can only be issued to finance eligible green projects, 11 types of which are specified by regulation including renewable energy, energy efficiency, biodiversity conservation, clean transportation, climate change adaptation, and sustainable waste management (OJK, 2017b).

Secondly, the regulation stipulates a minimum of 70% of proceeds from green bond sales shall be used to finance the agreed green projects. Third, issuers of green bonds have to manage the proceeds and report on the use of proceeds, and issuers should create a separate account to manage the proceeds or disclose the use of the proceeds in a specific note in the financial statement.

And lastly, the environmental benefit of the projects should be clearly defined and verified by an independent third party. The review should cover the performance of the green bond and projects by an independent third party and the result shall be reported annually to OJK. In the case that the underlying projects no longer meet the green project criteria, the issuer shall define an action plan for remediation and will be given one year to execute the action plan. In the case that the action plan fails to restore the green eligibility criteria of the project, the bond holders may demand the issuer to buy back the green bond or to increase the coupon rate.

OJK's effort to promote sustainable finance with green bonds through the enactment of POJK 60 was also based on consideration of the growth of green bonds globally. Since the first green bond was issued in 2007 by the European Investment Bank for USD807.8 million, green bond issuance has experienced phenomenal growth, reaching USD147.5 billion as of December 2017, although growth slowed in 2018 with total issuance of USD138 billion due to rising interest rates that weighed on debt issuance in the global market (Pefindo, 2019).

We view that strong market growth is attributable to growing demand for green financial instruments. This is because both investors and issuers are in need of investment diversification and seek innovative investments that pursue desirable environmental and social outcomes. Green bonds are attractive as they create opportunities for investment in environmental change, delivering environmental and financial returns. Therefore OJK predicts green bond markets in Indonesia and around the world will continue to grow.

Government green bond issuance

Indonesia's government has also been complimented for efforts in promoting sustainable finance. Through the Indonesian Ministry of Finance Climate Budget Tagging mechanism, it has identified more than IDR78 trillion (USD5.7 billion) in the national budget for fiscal year 2017 that was related to climate change impacts. This amounted to a 32% increase over the amount in the fiscal 2016 budget (Badan Kebijakan Fiskal Kementerian Keuangan Republik Indonesia, 2018).

This finding has encouraged relevant ministries and wider partners to also engage in environmentally responsible investment. As a result of active participation in the green bond market Indonesia made history as the first Asian country to sell a sovereign green sukuk (Islamic bond). The issuance successfully raised USD1.25 billion in February 2018 to fund a number of environmentally friendly projects such as renewable energy, green tourism, and waste management projects.

Due to this success, issuance of a second sovereign green sukuk with the total amount of USD2 billion was done in February 2019. A global sukuk was issued in the amount of USD750 million with a return of 3.9% annually and 5.5 years maturity (the "Wakala Sukuk") and a USD1.25

billion Trust Certificates issue with a yield of 4.45% per year and 10 years maturity will be listed on the Singapore Exchange and Nasdaq Dubai. This transaction took advantage of a window within a period of heightened volatility in the global capital markets and successfully priced the global sukuk with an oversubscription of close to 3.8 times (Direktorat Jenderal Pengelolaan Pembiayaan dan Risiko, 2019).

Public green bond issuance

After POJK 60 was issued, the state-owned infrastructure financing company, PT Sarana Multi Infrastruktur (Persero) (SMI), was the first company in Indonesia to issue green bonds. With 100% of the proceeds to be used to finance eligible projects, it exceeded the minimum 70% regulatory requirement. SMI issued the bonds under the shelf registration issuance scheme for a maximum of IDR3 trillion. It realised IDR500 billion in the first phase of issuance, against an initial target of IDR1 trillion. SMI offered a three-year interest rate of 7.55% and five-year rate of 7.8% (Pefindo, 2019).

Closely behind SMI's green bond issue, PT. Bank OCBC NISP Tbk. became the first commercial bank to successfully issue a green bond in 2018 with a value of USD150 million. On their first emission, International Finance Company (IFC) became the sole investor in the green bond.

Indonesia's FSI expanded beyond issuing green bonds in 2019 when one of the biggest banks in Indonesia, PT. Bank Rakyat Indonesia Tbk. (Bank BRI) became the first Indonesian company to issue a global sustainable bond. With the total value of the bonds offered at USD500 million, the bond issuance is viewed as a success, having been oversubscribed by more than 8 times or USD4.1 billion.

Aside from being in such high demand, the bond is also seen as a success due to the relatively low coupon which is 3.95% with 5 years maturity. With the coupon, the spread is only 168 bps or 35 bps higher than United States Treasuries and the Government of Indonesia's global bond respectively. This is a tantalising spread that has been achieved by a public company in Indonesia.

The low spread also reflects the low risk of default. Naturally, this is also due to Bank BRI's investment grade rating from Fitch Rating and Moody's. A few weeks after the bond issuance, the rating agency Standard and Poor's (S&P) also raised the rating of Bank BRI to investment grade.

There are strong prospects for growth in the supply of green bonds in Indonesia. In the future we hope other companies besides financial services will also issue them to finance projects that meet the green criteria. Potential enterprises such as the National Electricity Company (PLN) may use the proceeds to finance renewable energy power plants, and banks may propose them with the proceeds distributed to loan activities that are environmentally friendly or have environmental benefits.

Challenges in developing green bonds

Even though it has considerable potential, there are also challenges in developing green bond as a new investment product in the domestic market. One challenge is because there is still a limited track record of repayment and investment return for investors. Also, POJK 60 requires a buyback should the green criteria not be maintained which in return raises additional concerns about the prepayment risk.

The green bond market in Indonesia has strong potential to grow further. Current moderate penetration indicates it needs to be further developed as it faces challenges to reach a comparable scale with conventional investment. Therefore, to seize the opportunity, OJK needs to actively educate stakeholders and society to increase awareness of green investment, which may stimulate supply and demand in the green bond market in the medium term.

Also in the same period, taking into account the green bond market is still in the early stages of development, we expect the green criteria will likely evolve and find its most accurate criteria. Defining these criteria is also a challenge, as they may not meet every investor's definitions and needs. To date, there is also no common and broadly accepted standard for determining what is categorised as green.

Another challenge is to maintain the environmental benefits of the investment by ensuring the proceeds are used for designated projects and are properly managed throughout the lifecycle of the bond. This raises the need for assessment or review by an independent third party. In our opinion, promoting integrity through providing such reliable and transparent information should gain trust among investors and facilitate a credible green bond market. We envision to promote the development of the market in Indonesia in the medium term, including providing incentives or directing investors to allocate a minimum investment portion in green products as in the minimum requirement of government bonds.

Enhancing Corporate Governance of Listed Companies

Through sustainable finance, Indonesia's financial services institutions are naturally encouraged to improve governance. This is reflected in the roadmap as in the Long Term (2020-2024) when financial services institutions are expected to have integrated environmental and social aspects in their risk management and corporate governance practices, while also providing regular progress reports on sustainable finance implementation to the public (OJK, 2014).

The improvement of corporate governance aims to enhance the competitiveness of the FSI in the development of sustainable finance in Indonesia which eventually will increase the supply of sustainable financing. This increase in supply requires regulatory support and incentives to increase the volume of sustainable financing in priority economic sectors, namely sectors that have a high multiplier effect such as agriculture in the broadest sense, manufacturing, infrastructure, small and medium-sized enterprises (SMEs) and energy, to encourage innovation in developing environmentally friendly products, to improve the quality and provision of access to information and to improve access to the use of global public funds.

Incentives for implementing sustainable finance

In the long term, we have planned incentives linked to the implementation of the sustainable finance program to support the financial services institutions in enhancing their corporate governance especially in the priority economic sector. First is to develop incentives, both fiscal as well as non-fiscal, including conducting assessments on the establishment of incentive funds and instruments that address sustainable financing or investment needs in the priority economic sector. These incentives also aim to increase the efficiency of the funding process from financial services institutions to their clients. Second is to develop workshops and training to enhance the competencies of the industry to increase financing or investment activities in the sustainable finance priority economic sector (OJK, 2014).

Third is to develop financing or investment products and/or schemes with the aim to increase the sustainable finance portfolio including product assessment, development of the financing or investment guideline to support the financial services institutions' staffs in conducting analysis of the feasibility of implementing sustainable financing or investment in the priority economic sector. Fourth is to give out annual awards to financial services institutions deemed to have set the highest standard in implementing sustainable finance.

And lastly is the necessity to support sufficient infrastructure in the form of information technology system to facilitate the effective implementation of the sustainable finance program. The information technology system should focus on establishing interconnectivity of information between OJK and other relevant ministries.

Oversight of the sustainable finance program

Together with the incentives, the roadmap has also identified the need for proper oversight of the sustainable finance program to effectively improve corporate governance. The oversight will be done through the strengthening of risk management, corporate governance in environmental and social aspects, as well as the acceleration of the implementation of the Law No.32 of 2009 concerning Conservation and Management of the Environment.

The general policy shall comprise of first, establishing policies on sustainable finance principles that govern the obligations of financial services to observe the balance of the 4Ps (pro-growth, pro-jobs, pro-poor, and pro-environment), protection and management of natural resources, as well as participation by all parties in all financing activities in Indonesia (OJK, 2014).

Second, the general policy shall include policies governing the obligations of financial services to issue a sustainability report together with the annual report based on which the implementation of this policy will be adjusted to line up with each oversight division's level of readiness. And third, risk management policies governing the environmental and social aspects of financial services institutions financing activities shall be included.

The execution of the above mentioned policies requires an assessment that will result in specific policies or regulations to support the effective implementation of the sustainable finance program in each oversight division. The oversight especially needed in the banking and non-banking financial services industry such as risk management policy or regulation, target to increase the sustainable financing portfolio in the priority economic sectors, reporting as well as on the implementation of the sustainable finance program and evaluation on the level of soundness. With respect to capital market supervision, there is a requirement for specific policies and regulations governing the reporting mechanism on sustainable financing.

Collaboration among other institutions

As it involves multidimensional issues spanning environment, finance and also both domestic and international society, a number of the aforementioned incentives and oversight policies are carried out in collaboration with the relevant ministries and agencies including issuers in the capital market sector and the Indonesia Stock Exchange (IDX) as well as international agencies. This is to ensure effective integration and synergy among the ministries as well as between the national and sub-national governments. Seamless inter-agency coordination will help prevent the occurrence of bottlenecks that potentially come hand in hand with development activities.

Among others relevant to the sustainable finance program are the Ministries of Industry, Agriculture, Cooperatives and SMEs, Energy and Mineral Resources, Finance, National Development Planning (BAPPENAS), and Public Works and also such organizations as IDX and law enforcement agencies.

Some of the key issues that require coordination with respect to the implementation of sustainable finance in Indonesia are: first, solution to bottlenecks faced by each of the relevant ministries in implementing the sustainable finance program; second, determination of the sustainable financing or investment target for each priority economic sector on an annual basis; third, monitoring and evaluation of periodic achievements, including identifying the need to develop a supporting information technology system to supervise the implementation of sustainable finance; fourth, policy and regulatory coordination is expected to generate concrete action points to promulgate rules and policies that support the effective implementation of the sustainable finance program; and fifth, development of incentives, both fiscal as well as non-fiscal incentives, including conducting assessments on the establishment of incentive funds and instruments that address the sustainable financing and investment needs in the priority economic sector.

To facilitate the coordination and exchange of information relating to sustainable finance as well as to gauge feedback from the Financial services institution and other relevant stakeholders to refine the policy/regulation, it is necessary to establish a periodic sustainable finance forum. This sustainable finance coordination forum could be held at the national and regional levels. In addition, such a forum can also serve as a vehicle to monitor and evaluate the implementation of sustainable finance by the financial services sector.

Sustainability Disclosure by Financial Services Institutions

The third principle of the sustainable finance program in Indonesia is Environmental and Social Governance and Reporting Principle. This principle is carried out by implementing robust and transparent environmental and social governance practices in the financial services Institutions' operational activities. One form of transparency is by ensuring that the same practices are implemented by the financial services institutions and the progress of its implementation is periodically disclosed to the public.

Due to its significance, transparent practices also become one focus under the roadmap's medium term, for the years 2015 to 2019. During this period, the roadmap's strategic activities are focusing on the basic regulatory framework and reporting system (OJK, 2014).

It is expected that within this period, the basic regulatory framework and reporting system to be established and running well. A system to monitor the increase in financing volume of priority economic sectors that adopt sustainable finance principles is expected to be established, along with increased understanding, knowledge and competence regarding sustainable finance by human resources in the financial services sector. The provision of incentives and coordination with related agencies is also expected to be well executed and carried out regularly.

Reporting requirements

As already stated in the roadmap, to establish a reporting system the plan is to gradually enforce the issuance of a sustainability report as part of the integrated report for transparency to the wider public and for OJK supervision. Based on this, Indonesia has issued OJK Regulation Number 51/POJK.03/2017 (POJK 51).

POJK 51 on Application of Sustainable Finance to Financial Services Institutions, Issuers, and Public Companies acts as the Sustainable Finance Umbrella Policy to provide guidance to Indonesia's whole financial system. The rule requires the FSI to fulfill a set of criteria to implement sustainable finance in their operations (IFC, 2019). To implement sustainable finance, financial services institutions need to prepare and execute a Sustainable Financial Action Plan (OJK, 2017a).

The action plans are required to be submitted by each financial services institutions to OJK annually, carried out effectively by the financial services institutions and actively communicated to shareholders and all levels of organisation within the financial services institutions. Financial services institutions that implement sustainable finance effectively could be awarded with incentives by OJK.

To oversee and ensure effective implementation of sustainable finance, POJK 51 also requires financial services institutions to submit a sustainability report. As an integrated report, the sustainability report is announced to the public and contains economic, financial, social and environmental performance of financial services institutions, issuers, and public companies in carrying out a sustainable business (OJK, 2017a). The required report recognises and adheres to international reporting standards specifically related to sustainable finance reporting initiatives such as The Global Reporting Initiative (GRI).

GRI is one international sustainable finance initiative and its guidelines were adopted from the UN Environment Program, funded by the UN Development Fund. It serves as a guideline in developing sustainability reports, which it defines as a report made by a company in order to disclose or communicate to all stakeholders on its economic, environmental and social performance accountably (GRI, 2019).

Conclusion

Sustainable finance in Indonesia still holds untapped potential. This is apparent as the concept of sustainable finance is still in a relatively early stage of development. Despite the existence of a sustainable finance roadmap, rules, and financial products which have created positive traction in the development of sustainable finance domestically, the concept of sustainable finance still is not yet widely known both in society in general and in the business world. Therefore, to fully embrace the potential of sustainable finance, a detailed second phase of the roadmap which is for years 2020-2024 needs to be established with the right regulation and policies from the regulator, and also an active role of all parties involved to create an impactful sustainable finance in Indonesia.

As an integral part of the Republic of Indonesia, OJK consistently plays an active role in achieving the commitment of economically sustainable growth through its sustainable finance program. The program is carried out through the cooperation of various parties to create financial support to industries that practice sustainable finance principles. The sustainable finance program not only seeks to increase financing but also to increase the durability and competitiveness of financial services institutions, thus it can support a more resilient economy.

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