KPMG

Sustainable Finance in Indonesia

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KPMG Siddharta Advisory
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Foreword

KPMG Indonesia is excited to present our first publication which focuses on the importance of incorporating sustainability to long-term business strategies.

Financial institutions and investors have become more environmentally conscious and savvy.

Regulators and standard setters are continuously enhancing frameworks, introducing principles, standards and guidelines to foster and drive sustainability and comparability. Media and Non Governmental Organization (NGO)s are increasingly scrutinizing and exercising pressure on companies behavior and code of conduct through negative publications and case studies. For example, around companies in Indonesia being associated with unsustainable practices.

Hence, it is deemed as crucial for businesses in Indonesia to start taking into consideration the environmental, social and governance aspects into their business activities, in order to avoid risks of reputational damage and loss of business.

The importance of sustainability is acknowledged through the regulation set forth by Indonesia's Financial Services Authority, *Otoritas Jasa Keuangan* (OJK), in 2017 related to the application of sustainable finance. This has further highlighted the commitment from the Indonesian Government and the regulators towards sustainable development goals (SDGs).

Financial institutions and investors are committing and innovating their approach towards financing and investing into sustainable businesses by increasingly promoting green finance products and solutions. For Indonesia, green bonds are gaining traction. The green bond market continues to grow by a sizable proportion over the last few years, with investors continue to be showing interests in sustainable investment options.

These are exciting times for Indonesia businesses, regulator and financial institutions, to embark on the new success in the road to be more sustainable.

Indonesia – A snapshot into the sustainability roadmap

According to the Voluntary National Review (VNR) 2019, Indonesia has been successful in reducing inequality, complemented by sustained and inclusive economic growth and accountable governance[1] in line with its SDGs ambitions.

The government, the regulator and corporates are continuously embracing sustainability in terms of environmental, social and governance (ESG) frameworks as a practice to follow for the benefit of future growth and as a guidance to disclose, report, monitor and manage good and responsible conduct going forward.

This is particularly of relevance for Indonesia's key sectors, like the financial services, mining and palm oil industries increasingly being required to comply with international ESG disclosure standards.

In fact, going forward, the ability to accurately and transparently disclose relevant information to private and public stakeholders will help foster innovative financial solutions that are able to sustain a resilient economic growth.

OJK is well-aware of this necessity. This is also clear by reading the latest World Wildlife Fund (WWF) report "Sustainable Banking Regulations in ASEAN – Raising the bar"[2]. OJK has introduced a set of regulations in line with the country's sustainable roadmap requiring banks to disclose ESG information and practices in their first sustainability reports expected to be published this year, covering the 2019 reporting period.

We expect Indonesia and OJK to increasingly align its sustainability and sustainable finance roadmap and regulations to international principles and frameworks like PRI[3] and TCFD[4].

From awareness to actions

Investors, stakeholders and consumers are taking actions to ensure that proper ESG-practices are followed, made transparent and comparable. Larry Fink's in his latest letter to Chief Executive Officer (CEO)[5] makes it very clear that standard disclosure – in line with the Sustainable Accounting Standards Boards (SASB) and TCFD frameworks - should be a means not only to achieve a more sustainable and inclusive capitalism but also to hold companies and senior management accountable for their actions and behaviors.

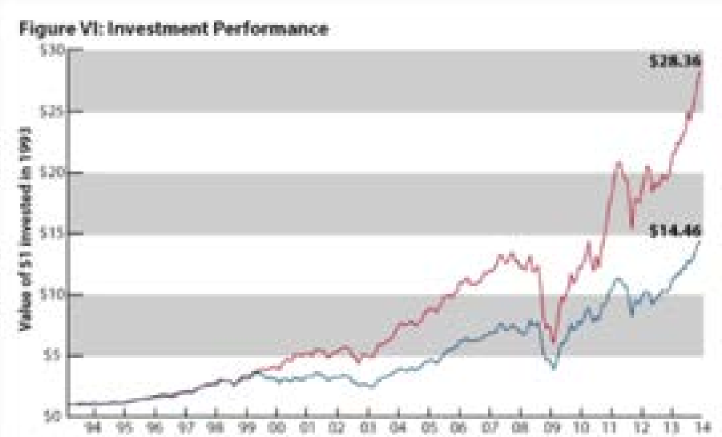
Sustainability can therefore be a key success factor in the long-term business strategy.

Firms implementing and living up to sustainability frameworks have been shown to outperform their counterparts in the long-term. Companies are finding that the integration of sustainable development into the activities of an organization can improve its brand values, competitiveness and attractiveness.

Incorporating sustainability can increase the efficiency and resilience of a company's supply chain. This is particularly important for food manufacturing companies with long and often unclear supply chains.

Furthermore, as energy prices are expected to rise in the long-term, companies are driven to reduce energy consumption also to improve financial performance. Hence, benefits of sustainability are not limited to only specific segments in the economy, but it is believed that all industries in the economy will to a certain extent gain benefits from incorporating sustainability into their business activities.

Earlier research has indicated that customers have demonstrated a shift in their purchasing behaviors. A third of consumers are choosing to buy from brands that they believe are doing social or environmental good. That being said, 66% of consumers say that they are willing to pay more for products and services that come from companies who are committed to positive and social environmental impact (Unilever Press Release, 2017). It is then rather unsurprising that companies with high sustainability performance show a significantly better financial performance compared to companies with low sustainability performance, as illustrated in the graph below.



The figure shows the evolution of $1 invested in a portfolio of firms with high performance on the material sustainability issues versus competitor firms with low performance on material sustainability issues. Materiality of sustainability issues is industry-specific and it is defined by the Sustainability Accounting Standards Board. Source: Mo Khan, George Serafeim and Aaron Yoon. Corporate Sustainability: First Evidence on Materiality. HBS working paper, 2014.

In addition to changes in customers buying behaviours, the global financial crisis that took place a decade ago and various high-profile scandals have led to investors, governments and communities calling for an increased transparency, accountability and responsibility from businesses.

Companies are expected and now under heightened scrutiny for their roles in incorporating sustainability aspects in their business practices.

[1] https://sustainabledevelopment.un.org/content/documents/2380320190708_Final_VNR_2019_Indonesia_Rev3.pdf
[2] https://d2ouvy59p0dg6k.cloudfront.net/downloads/wwf_sustainable_banking_regulations_in_asean___raising_the_bar__dec_2019_.pdf
[3] PRI stands for Principles for Responsible Investments along defining strategies and practices to incorporate ESG factors in investment decisions and active ownership.
[4] The Task Force on Climate-related Financial Disclosures (TCFD) develop voluntary, consistent climate-related financial risk disclosures.
[5] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

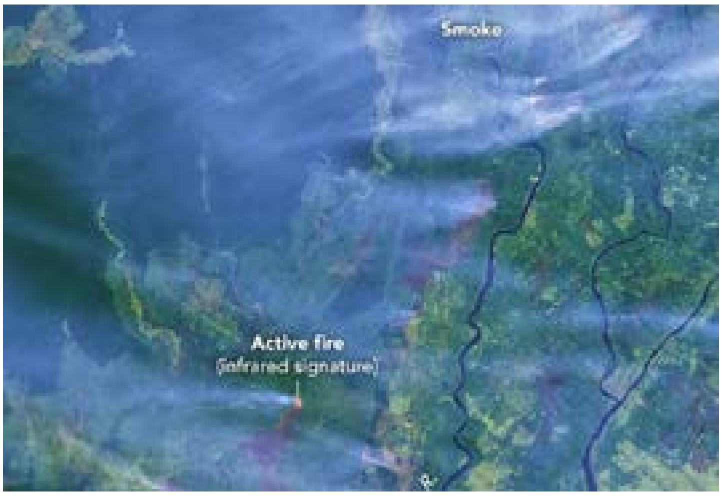
Media attention and NGOs

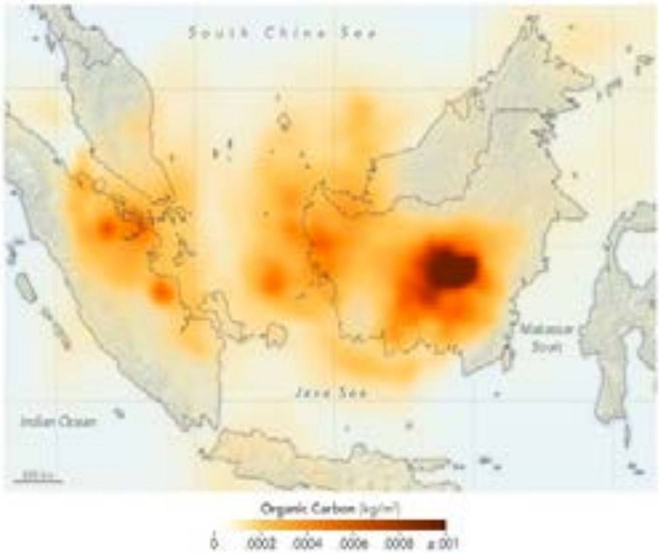
In fact, there has been heightened attention from media and NGOs on ESG related impacts of investment decisions. NGOs through their high profile case studies, have been putting more pressures on financial institutions into being more sustainably conscious in funding their clients.

One of the most renowned issues often highlighted by media is regarding the deforestation by palm oil.

Palm oil is understood to be one of the world's most consumed oils. With its useful properties such as high stability, cheap production, it is used in wide variety of food, cosmetic and hygiene products. It is also used a source of bio-fuel or bio-diesel. Global palm oil production is dominated by Indonesia and Malaysia, and altogether they account around 80-90% of global palm oil production. Indonesia stands as a largest producer and exporter of palm oil globally. Indonesian palm oil industry has shown robust growth in past 20 years. The majority palm oil produced in Indonesia is exported to countries including China, Pakistan, India, Malaysia and Netherlands (European biggest importer of palm oil).

Indonesia's palm oil plantation and processing industry is key industry to country's economy. Almost 70% of palm oil plantation are located in Sumatra and 30% is in Kalimantan island. According to Indonesia's Statistics Agency (BPS), the total area of palm oil plantations in Indonesia is currently around 11.9 million hectares and is expected to increase to 13 million hectares by 2020. Palm oil refining capacity in Indonesia is understood to have jumped to (an annual) 45 million tons by the start of 2015, up from 30.7 million in 2013, and more than double the 21.3 million in 2012. Indonesia palm oil exported US$ 22.9 billion worth of palm oil in 2017, up from US$18.6 billion in 2016, contributing between 1.5%—2.5% of Indonesia's Gross Domestic Product (GDP.) However, the continuous growth of this sector also poses environmental, social and ethical risks such as deforestation, soil depletion, land disputes and below standards working conditions.





Source: Kompas.com 20 September 2019

British Broadcasting Corporation (BBC) - 2019 mentions that "Part of the blame for the haze lies with big corporations and small-scale farmers, which take advantage of the dry conditions to clear vegetation for palm oil, pulp and paper plantations using the slash-and-burn method. National Aeronautics and Space Administration (NASA) have also released satellite imagery of billowing of smokes from fires in Kalimantan, with Robert Field, NASA's scientist, concluded that the crisis was reaching proportions not seen since 2015.

Therefore, any bad publication from the media or non-profit organizations are believed to be able to impact the investment decisions and further damage the reputation of a particular financial institutions funding the business.

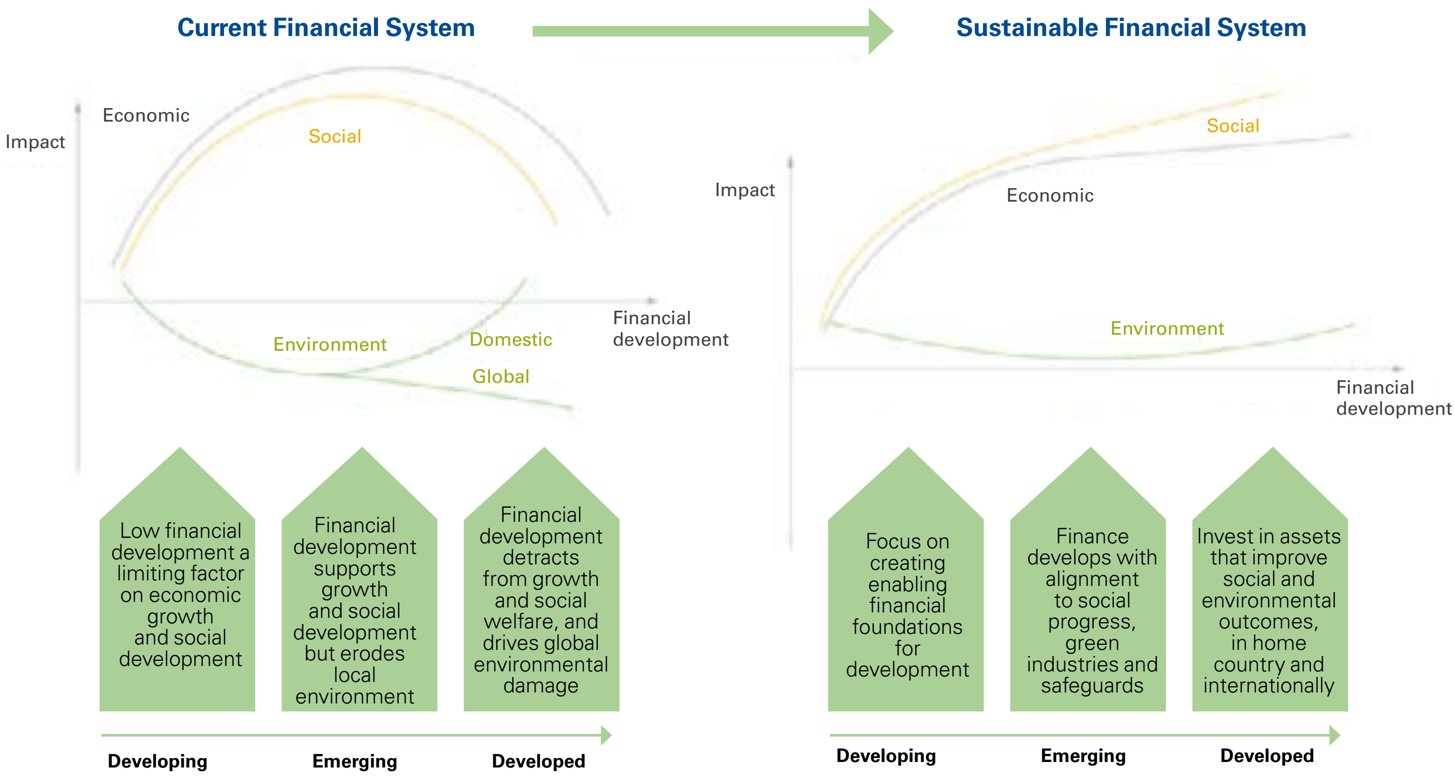
The importance of sustainability lies in the consequences that may arise should companies fail to consider the ESG aspects in their businesses. Ignoring these elements expose companies to not only financial losses, but also reputational, social and legal costs. There have been many occasions where banks were fined for financing projects in areas that were illegally deforested. Providing loans for projects that are environmentally damaging also increases financial pressure for financial institutions, as clients of these projects are susceptible to lawsuits and fines, which then lower their ability to repay loans, and consequently the collateral value of the asset. In addition, customers and investors are perceived to be more environmentally conscious. Hence, any exposure that may suggest companies are connected to any unsustainable activities may result in businesses experiencing reputational damage and eventually lost of clients.

Indonesia has been playing an active role in addressing the challenges of climate change and making progress towards the SDGs. This includes the development of a national level sustainable finance program mandated in Law No.32 Year 2009 regarding Environmental Protection and Management. In addition to that, OJK launched a Sustainable Finance Roadmap in December 2014. OJK has further introduced OJK Regulation No.51/POJK.03/2017 on 27 July 2017 regarding the application of sustainable finance in Indonesia.

Sustainable Finance system

Sustainable finance system refers to financial services and products integrating ESG criteria into the business or investment decisions that contribute to sustainable development and value creation in the short- and long-term.

Sustainable finance puts forth an impetus to encourage comprehensive support from the financial services sector to create sustainable economic growth by harmonizing economic, social and environmental interests. It is believed that there is a financial system misalignment with sustainable development as illustrated in the figure below.



We have witnessed a similar transformation process in Europe, where the European commission - as part of the European Union (EU) Action Plan on Sustainable Finance - established a Technical Expert Group on Sustainable Finance (EU TEG) to develop a proposal on how to integrate the sustainability agenda into the regulatory and financial framework to transform into a sustainable finance system.

The proposal to launch an EU-taxonomy for sustainable activities[6] was approved by the Council, and adopted in April 2020 as a regulation setting out an EU-wide classification system.

On the back of standard setters and global sustainable principles and reporting initiatives - providing framework, guidelines and standards about how "good sustainability" looks like - regulators, financial institutions, corporates, NGOs and media play a critical role in the transformation of Indonesia into a more sustainable finance system supporting the development of innovative sustainable finance solutions contributing to the country's sustainable roadmap.

[6]https://www.consilium.europa.eu/en/press/press-releases/2020/04/15/sustainable-finance-council-adopts-a-unified-eu-classification-system/

Standard Setters

There has been widespread acceptance of global principles such as The United Nations (UN) PRI, UN Guiding Principles on Business and Human Rights, and the UN Global Compact.

Key global sustainable financial initiatives are:

- **The Principles for Responsible Investment:** It works to understand the investment implications of ESG factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. *Nearly 1600 signatories from 30 countries, representing over 50% or over USD 68tn of global assets under management.*
- **The Principles for Sustainable Insurance:** It serves as a global framework for the insurance industry to address ESG risks and opportunities. *It is adopted by insurers representing over 20% of the global insurance market by premium volume and USD14tn in assets under management.*
- **The Equator Principles:** is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making. It applies to 1) Project Finance Advisory Services 2) Project Finance 3) Project-Related Corporate Loans and 4) Bridge Loans. *It has commitment from 92 financial institutions in 37 countries covering the majority of international project finance in developed and emerging markets.*
- **UN Environment Programme – Finance Initiative (UNEP FI):** It is a partnership between UN Environment and the global financial sector with a mission to promote sustainable finance. *More than 200 financial institutions, including banks, insurers, and investors, work with UN Environment to understand today's ESG challenges, why they matter to finance, and how to actively participate in addressing them.*
- **The Financial Stability Board (FSB) TCFD:** It is a voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to stakeholders.

The work of standard setters has contributed to create more transparency, accountability and comparability between countries, thereby an enhanced focus and integrating sustainable practices into regulatory guidelines, financial products and generally code of conduct of businesses.

Regulators & Financial institutions

In recent years, regulators have increased focus on sustainability for sustainable financing. This is evident in the regulation stipulated by OJK in 2017 regarding the application of sustainable finance for financial services institutions, issuer companies, and public companies. OJK issued this new regulation with the objective to increase awareness and commitment to implement sustainability principles and develop sustainable finance products. This new regulation can be perceived as a further commitment towards achieving sustainable growth and development of a low carbon economy. Detailed roadmap for sustainable finance in Indonesia as designed by OJK is shown below

Goal of Sustainable finance in Indonesia

- Improve ***Financial Services Institution (FSI) resilience and competitiveness*** to enable them to grow and develop in a sustainable manner
- ***Providing financial resources*** required by the public by using pro-growth, pro-job, pro-poor and pro-environment long-term development plan (*Rencana Pembangunan Jangka Panjang*/RPJP) and middle-term development plan (*Rencana Pembangunan Jangka Menengah*/RPJM) as point of reference.
- ***Contributes to the national commitment*** to address the global warming challenge by carrying out climate change mitigation and adaptation in business activities towards competitive low carbon economy.

Principles of Sustainable finance in Indonesia

- ***Risk Management Principle*** which integrates Environment and Social (E&S) protection in FSI's risk management.
- ***Sustainable Priority Economic Sector Development Principle*** that is inclusive by increasing financing activities primarily in industry, energy, agriculture & Micro, Small and Medium Enterprise (MSME) sectors balancing E&S aspects and provides financial services to community
- ***Environmental & Social Governance and Reporting Principle*** by implementing ESG practices in FSI and their clients
- ***Capacity Enhancement and Collaborative Partnership Principle*** by developing Human Resources (HR), Information and Technology (IT) and operational capacity of each FSI in implementing sustainable finance, establish cooperation between FSIs, regulators government.

2015
- Policy of Sustainable Finance (SF) principles
- Policy on increase of SF portfolio
- Policy of SF supervision

2016
- Prudential Incentives
- Information hub
- SF Award
- Policy on SF Reporting

2017-18
- Fiscal and Non-fiscal Incentives in collaboration with relevant institutions

2019-24
- Strengthening of risk management and corporate governance in environmental and social aspects

Roadmap to Sustainable Finance

2015-19: Campaigns, Environmental Analyst Training/Development of Green Product, Green Bond and Green Index/FSIs access to Global Public Funds/Coordination of SF Policy

In the WWF report mentioned earlier (see footnote 2), by the end of 2019, seven out of 10 ASEAN countries[7] representing more than 95% of the region's GDP, have issued new or revised sustainable banking regulations or guidelines for the financial sector to include sustainability practices as an integral part of their strategies and policies going forward.

For Indonesia's key sectors (infrastructure, mining and agriculture) this translate into requirements to disclose and mitigate exposures to climate risk and environmental degradation (such as deforestation and biodiversity loss) along continuously addressing social aspects in terms of poverty and livelihoods.

The enhanced focus on sustainable practices and standards is fueling the innovation of financial tools and products supporting the growth and development of Indonesia's economy.

Financial institutions in Indonesia are reported to have started developing initiatives around sustainable financing in the form of green finance products:

- Green and Sukuk[8] bonds are taking off as investment and lending vehicle of choice for the private and public sectors to finance projects with environmental benefits, such as clean power, low-carbon transport and energy efficient buildings.
- Sustainability-linked loans are also gaining traction as lending products to finance the transition to more carbon neutral businesses. The satisfactory performance on relevant sustainability metrics and targets, is positively correlated to the interest rate for the loan.

Green finance products have proved attractive to the growing number of investors with an interest in sustainable investment options and as for the case of green bonds generally oversubscribed.

No wonder the labelled green bond market grew by almost 80 percent between 2016 and 2017, with a record-breaking US$155 billion worth of bonds issued in 2017 alone.

While most green and Sukuk bonds are issued by government and banks in Indonesia, it is increasingly common for corporations to issue their own bonds. Big brands in the technology, utilities, automotive and consumer products sectors are among those that have done so.

Along with the advantages, there are also challenges and uncertainties for green bond issuers as the market is still new (the first green bond was issued in 2007). Many organizations can benefit from expert advice to navigate the pitfalls or from independent assurance to maximize the credibility and appeal of their bonds.

Green finance products can provide access to broader range of investors e.g. ESG investors along mitigating risks for lenders to benefit of borrowers - mainly in terms of lower interest rates.

However, some common key challenges in the green finance product space are notable. Those include:

- Lack of common definition of "green". For example, there is not yet a universally accepted definition of what makes a bond "green" or "not green".
- Still need to enhance the transparency on how proceeds are spent. Generally, we are witnessing a greater demand from investors and financial institutions to require independent assurances that proceeds have been monitored and managed appropriately.
- Complex regulatory landscape, including too many different guidelines and standards available, for green bonds, for example ranging from the Green Bond Principles to green bond indices and sector-specific standards. Navigating this landscape can be challenging and requires in-depth expertise.
- The risk of "greenwash" and the resulting reputational risks if the intended environmental benefits are not achieved or proceeds are used not in line with intended purpose.

Therefore, the reviews of the relevant green finance product framework (e.g. green bonds) and resulting assurances conducted by independent parties like KPMG are increasingly in demand. The aim is to provide confidence and transparency to the market place by ensuring consistency to standards and frameworks aligning the reporting of sustainable practices for relevant stakeholders in the market to Indonesia's SDGs.

Sustainability disclosures and reporting framework

The strategic value for Indonesia to embrace international standards, facilitate the disclosing and reporting of accurate information around corporates' ESG strategies and initiatives will be instrumental for being able to attract capital for future and sustainable economic growth.

A sustainability report is defined as the disclosure of non-financial information by a company communicated to stakeholders beyond economic aspects to include ESG aspects.

Sustainability reporting can bring values to the companies:

- **Regulatory compliance:** Sustainability reporting is a necessary requirement for listed companies to comply with the new regulations set forth by OJK regarding sustainable finance and sustainable reporting.
- **Transparency and accountability:** Through being transparent and accepting accountability for the impacts of the business, allows to build the reputation as a trusted business.
- **Shareholder confidence:** Considering the business holistically i.e. long-term risks and opportunities as well as short-term financial performance, is the hallmark or a well managed business, which instils further confidence in the company's ability to provide stable returns.

[7] Seven out of ten ASEAN countries were Vietnam, Thailand, Cambodia, Philippines, Malaysia, Singapore and Indonesia.
[8] A sukuk is an Islamic financial certificate that complies with Sharia law

- **License to operate:** Stakeholders such as investors and customers are becoming more sensitive to sustainability issues, particularly in the healthcare sector. Sustainability is increasingly necessary to avoid alienating certain investors and customers
- **Better management and monitoring:** A sustainability lens can highlight numerous opportunities for improvement, e.g. energy savings, new products or services

In doing the sustainability reporting, it is important for companies to select the right framework that caters to the business and its business needs. It is also crucial to consider the level of disclosure that the business wants to commit. More disclosures are not necessarily always better, but more strategic disclosures will enhance the report. Businesses should select a framework that provides better link between performance information and the drivers of business. A framework that could provide a clearer picture of management progress in implementing strategy and a better insight into the underlying health of the business are another factor that businesses must consider when choosing its sustainability reporting framework.

Conclusion and next steps

The aim of this report is to summarize the importance of sustainability for the development of Indonesia in line with the agreed roadmap and SDGs.

We are witnessing an increase pressure on corporates to disclose and report initiatives taking into considerations ESG factors in line with international principles, standards and frameworks. Whilst reputation can be at risk for not complying with those, the rewards for implementing frameworks and living up to principles can have multiple financial and non-financial aspects.

Regulators, financial institutions, NGOs, media and corporates are all responsible and accountable to drive the sustainability roadmap for Indonesia as a country.

OJK is increasingly aligning its regulations and guidelines to international standards and well-recognized frameworks like TCFD.

Peer countries and financial institutions, especially within ASEAN, are increasingly collaborating to implement standards so as to create transparency and comparability for investors.

NGO and media are educating and attentively watching out for misbehaviors and misconduct from a sustainability perspective.

Sustainability can be a key success factor in the long-term business strategy for Indonesia and its sectors. It requires a genuine, aligned and standardized approach from many different stakeholders, starting from accurately accounting, disclosing and reporting ESG-relevant activities and initiatives.

About KPMG Indonesia

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