



Towards a Sustainable Financial System in Indonesia

The UNEP Inquiry Into the Design of a Sustainable
Financial System

In partnership with

The Association for Sustainable and Responsible
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About this report

This report has been developed by the UNEP Inquiry, in partnership with the IFC and AsRIA. Its aim is to support both domestic policy making and international understanding and knowledge. The research was carried out through a desk review of literature and data and a series of interviews carried out in Jakarta between October 2014 and January 2015. An earlier version was presented at a workshop in Jakarta in February 2015.

It is part of a wider set of regional and country reports being produced as part of the UNEP Inquiry (including Bangladesh, Brazil, China, Colombia, India, Indonesia, Kenya, South Africa, Uganda, the UK and the US; the Colombia and Kenya reports are also being developed with the IFC).

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Summary

Placing Indonesia's economy onto a green and sustainable development pathway, as envisaged in the National Long Term Development Plan, will require a large mobilization of investment. Estimates of the annual investment needed are in the order of US\$300-530 billion, with a large portion of this investment needed in critical infrastructure, as well as environmentally sensitive areas such as agriculture, forestry, energy, mining and waste. In addition, financing for SMEs and industry is critical for creating jobs and boosting productivity.

Funds for this investment will need to come from both the private and public sectors, including both domestic and international sources. Addressing 'real economy' barriers, such as fossil fuel subsidies and gaps in enforcement of environmental regulation, is critical to mobilising green investment. However, such policies are not the only tools for influencing investment. Policy makers around the world are increasingly recognizing that weaknesses and failures within the financial system may be constraining its ability to respond to risks and opportunities for viable, resilient investments.

Indonesia's financial system is dominated by banking, which accounts for 79.8% of total assets, compared to 10.5% of assets held by insurers, 2.6% by pension funds and 6.4% by finance companies. There are already some flows of private green investment—for example, a review by Bank Indonesia of green financing by banks found that green investment in May 2013 was about US\$1 billion, which is already equivalent to a significant portion of the public budgets allocated to green relevant line ministries. According to the 2014 *Asia Sustainability Investment Review*, sustainable investments in Indonesia's capital markets reached US\$1.14 billion at the end of 2013.

Today, the majority of banks, as well as non-bank-financial institutions do not consider environmental, social and governance factors in their lending or investment process as a main consideration. While climate change is seen as a threat to Indonesia's long-term economic development, lending and investment horizons remain short-term. However, Indonesia's financial markets have seen a number of important design innovations over the past years aimed at encouraging green lending and investment, such as the development of sustainability ratings in its rapidly growing stock market, the SRI-KEHATI index and the recent launch of the SRI KEHATI-ETF. While these are innovations that mirror developments in OECD countries, they are almost unique for a developing country.

Furthermore, the Indonesian Government has begun to take steps to green some aspects of the financial system. In December 2014, OJK, the financial services regulator, launched a *Roadmap for Sustainable Finance in Indonesia*, which lays down a comprehensive work plan for promoting sustainable finance for the period 2015-2019. The *Roadmap* will constitute an integral part of OJK's Master Plan for Indonesia's Financial Sector. Despite being at an early stage, the *Roadmap* is unique internationally as a systematic plan grown out of a decade of development of sustainable finance in Indonesia.

As part of this *Roadmap* OJK might develop a binding regulatory framework for green finance which, among others, could include the establishment of compulsory environmental and social management systems and associated reporting in both banking and capital markets.

Given that Indonesia is the country with the world's largest Muslim population, the development potential for Islamic finance is vast. OJK might therefore foster the development of Islamic finance as a means of aligning the Indonesian financial system with sustainable development.

1 Introduction

To place the economy onto a sustainable development pathway requires an unprecedented shift in investment; away from greenhouse gas (GHG), fossil fuel and natural resource intensive industries and toward more resource efficient technologies and business models. These shifts must be part of an even larger mobilization of the finance needed to enable broad and equitable economic growth, through resilient energy systems, cities, agriculture, transport, water, healthcare and education.

This is true both globally and in Indonesia. Funds for this investment will need to come from both the private and public sectors, including both domestic and international sources.

Weak and uncertain ‘real economy’ policies are often identified as barriers holding back sustainable investment. Countries with more transparent, coordinated long-term and credible policies capture more investment and build new industries, technologies and jobs while reducing emissions faster and more efficiently than countries with weak and disjointed policies (Deutsche Bank 2010). In particular, a lack of strong carbon prices, fossil fuel subsidies and weakly enforced environmental regulations are often highlighted as the cause of underinvestment in the green economy. This is true also in Indonesia, where real-economy reforms to electricity and fuel subsidies, fiscal and regulatory policies to promote green industries, and strengthened environmental protection have been identified as key priorities for transforming the economy toward green prosperity, in support of national medium and long-term development plans (UNEP 2011). More generally, improvements to the overall investment climate, including factors such as ease of doing business and the enforcement of property rights, will be also key to fostering investment.

However, such ‘real economy’ policies are not the only tools that policy makers have for influencing investment flows. Policy makers around the world are increasingly recognizing that weaknesses and failures within the financial system itself may be constraining its ability to respond to risks and opportunities for viable, resilient investments (see box on page 2). Central banks and financial regulators from Bangladesh to Brazil and from China to South Africa are experimenting with ways of explicitly incorporating sustainability considerations into rules governing financial markets (UNEP Inquiry 2014a, 2014b). Financial market standard-setters, including credit rating agencies such as S&P, are advancing standards that increasingly factor in environmental risk (S&P 2014).

1.1 This Study

To date, there is still limited understanding of the broad landscape of private green finance in Indonesia. While some research has been conducted on sustainable financing in the banking sector, there has been relatively little systematic research into the specific features and flows of green finance from private capital markets, even though Indonesia has reasonably sophisticated financial institutions and markets.¹

This study is therefore intended to contribute to the exploration of the state of green investment in Indonesia within the wider economic and financial sector context. Its aims are:

- ⊙ To examine how and to what extent different types of investors and lenders currently finance green investments in Indonesia in order to better understand the drivers and subsequent impacts on capital flows.
- ⊙ To identify and analyse gaps in financing, regulatory barriers and potential financial policy innovations in order to increase green finance in Indonesia.
- ⊙ To enhance the dialogue on increasing the flow of green finance to steer the transition to a low carbon economy in Indonesia and coordinate closely with related initiatives.
- ⊙ To contribute to growing international experience on aligning financial systems to sustainable development.

¹ In 2012, PWC and IFC (2012) carried out a survey in the Indonesian financial sector as part of a larger study on environmental and social risk management in the East Asia and Pacific region. In 2013, Bank Indonesia and the German Development Institute conducted a green finance survey in the Indonesian banking system (Volz et al. 2015).

International Experience

Around the world, investment flows are failing to enable balanced growth, spark full employment and allocate capital for the development of resilient infrastructure. Resources are still being over-invested in inefficient, environmentally damaging activities and under-allocated to build green, efficient and inclusive economies. Many countries have started to take measures to promote green finance and to address the problem of shortsighted investment horizons. The Asia-Pacific region is one of the most active in innovating towards a sustainable financial system. There is widespread adoption of new green disclosure requirements across banking and capital markets. Green credit guidelines are being introduced by banking regulators. Sustainability indexes and benchmarks are becoming common in securities markets, and credit rating agencies are incorporating climate risk into their solvency analysis. Innovations in micro-finance including mobile-money are seeking to close the gaps in access to finance.

The Central Bank of Brazil and the China Banking Regulatory Commission both require commercial banks to establish systems for environmental and social risk management. The EU has set requirements for large companies to disclose information on their environmental and social policies. The Bank of England is assessing the vulnerability of insurance companies to climate related risks. Norway's sovereign wealth fund will give more consideration to climate change related risks in its investments. The Central Bank of Bangladesh requires 5% of bank lending to be for clean energy, pollution control and enhancement of energy efficiency. In South Africa, regulatory rules require that enterprises disclose their finance and sustainability policies, while the Securities Commission Malaysia issued rules for institutional investors making an explicit requirement that they include corporate governance and sustainable development into the investment decisions. The Australian Securities Exchange has also issued the new requirements for governance of listed companies, requiring that the listed companies shall disclose whether they are facing substantive economic, environmental and social sustainability risk exposure and how to manage these risks.

Market players and private standard setters have also taken a number of positive steps, including leading credit rating agencies,² stock markets and institutional investors. US\$45 trillion in assets now support the UN-backed Principles for Responsible Investment, and US\$24 trillion supporting the 2014 Global Investor Statement on climate change.³ The green bond market is developing rapidly with an estimated US\$500 billion+ of bonds already linked to green economy and climate investment themes.

While these policy and market innovations indicate potential, they have not yet reached scale. Industry initiatives may be held back by institutional inertia and require policy support to reach a critical mass. Country-level innovations may also require changes to international policy frameworks—such as the Basel rules (Alexander 2014). Many policymakers are rightly cautious about intervening in the financial system to achieve real economy goals, and knowledge about what could work is still at an early stage.

Sources: UNEP Inquiry (2014). *Aligning Finance to Sustainable Development: Insights from Practice*. Geneva: UNEP and UNEP Inquiry (2015). *Aligning the Financial Systems in the Asia Pacific Region to Sustainable Development*. Geneva: UNEP.

² See, for example discussion in S&P (2014).

³ www.iigcc.org/publications/publication/2014-global-investor-statement-on-climate-change

2 Financing for Sustainable Development in Indonesia

Indonesia’s *National Long-Term Development Plan* for the period 2005 to 2025 (Rencana Pembangunan Jangka Panjang Nasional, RPJPN 2005-2025) envisages a “green and ever-lasting Indonesia”. One of the RPJPN’s eight national development missions is the realization of “a greener and sustainable Indonesia”. It recognizes that “the long term sustainability of development will face the challenges of climate change and global warming which affect activities and livelihood” and requires the Government of Indonesia pursues its economic growth targets in accordance with socially balanced, resource-efficient and environmentally friendly management. This is part of a vision to establish a country that is developed and self-reliant, just and democratic, and peaceful and united. Economic development is aimed at achieving efficient and modern mining and agricultural sectors, a globally competitive manufacturing sector and productive service sector. Social objectives include reaching a level of income per capita in 2025 of approximately US\$6,000, with a relatively good level of equity and less than 5% of people in poverty.

At the 2009 G20 Summit in Pittsburgh, President Yudhoyono proclaimed the goal of reducing Indonesia’s GHG emissions by 26% with national efforts and 41% with international financial assistance in relation to a business-as-usual (BAU) baseline by 2020. In order to meet the government’s ambitious climate goals, a *National Action Plan for Green House Gas Reduction* (Rencana Aksi Nasional Penurunan Emisi Gas Rumah Kaca, RAN-GRK) was developed by the National Development Planning Agency (BAPPENAS) and approved by President Yudhoyono in September 2011.⁴ RAN-GRK has the objective of “the implementation of various activities both directly and indirectly to reduce greenhouse gas emissions in accordance with the national development targets” (President of the Republic of Indonesia 2011). It defines five priority sectors for climate change mitigation to reach the 26% target (Table 1).

Table 1: RAN-GRK priority sectors and envisaged action

Action plan→ Implementing ministries	Forestry	Environment	Public works	Agriculture	Transport	Energy and Mineral Resources	Industry
Forestry and peat land: Fire control, network system management, water management, land rehabilitation, plantations, community forest, illegal logging eradication, deforestation prevention, community empowerment.							
Agriculture: Introduction of low-emission paddy varieties, irrigation water efficiency, organic fertilizer use.							
Energy and transport: Bio-fuel use, fuel efficiency standard, Transportation Demand Management, public transport and roads, demand side management, energy efficiency, renewable energy.							
Industry: Energy efficiency, use of renewable energy, etc.							
Waste: Use of final landfill, waste management and urban integrated wastewater management.							

Source: BAPPENAS (2011: 8).

⁴ In the course of 2015, the RAN-GRK estimates of finance needs will be expanded to 2030 as part of developing Indonesia’s Intended Nationally Determined Contribution for the UNFCCC process.

1.1 Investment Needs

Under the *National Medium Term Development Plan* for the period 2015-2019 (Rencana Pembangunan Jangka Menengah Nasional, RPJMN 2015-2019) annual total investments needs were put at IDR3,945 trillion (about US\$300 billion) for 2015 and are set to increase to IDR6,947 trillion (about US\$530 billion) by 2019 in order to raise economic growth from a target of 5.8% in 2015 to 8.0% in 2019 (President of the Republic of Indonesia 2015).⁵ The RPJMN 2015-2019 sets forth a sustainable development strategy that balances social, economic and environmental development. It seeks to mainstream sustainable development principles across all development sectors to maintain the sustainability of communities' social life, economic welfare and environmental quality. The RPJMN 2015-2019 demands that "development activities must not degrade the carrying capacity of environment and the balance of the ecosystem".

Taking the RPJMN 2015-2019 estimates as a yardstick for Indonesia's future investment needs, annual financing in the order of US\$300-530 billion will be needed. A large share of this will need to go into critical infrastructure, as well as environmentally sensitive areas such as agriculture, forestry, energy, mining and waste. In addition, financing for micro, small and medium sized enterprises (MSMEs) and industry is critical for creating jobs and boosting productivity. All of this investment will need to be sensitive to environmental and associated policy risks. Funds for this investment will need to come from both the private and public sectors, including both domestic and international sources.

Looking at climate change specifically, differing estimates of the investments needed to reach the national GHG reduction goals were released by BAPPENAS (2010, 2011) and UNFCCC (2009). UNFCCC (2009) and BAPPENAS (2011), in its RAN-GRK implementation guide, use the same BAU-scenarios in which they predict 2.95 Gigatonne (Gt) CO₂ emissions until 2020, leading to estimated mitigation cost in the order of US\$8.9 billion (Table 2).⁶ Based on these estimates, the Indonesian government committed itself to allocate US\$8.9 billion from different sources for the 26% goal and estimated a need for an additional US\$17.96 billion of international funding in order to reach the 41% target (UNFCCC 2009). For the Indonesian Climate Change Sectoral Roadmap (ICCSR), BAPPENAS (2010) assumed a much higher BAU-scenario with 18.72 GtCO₂, which subsequently yields a much higher estimated mitigation cost of approximately US\$69 billion.

In Indonesia's *First Mitigation Fiscal Framework* (MFF), the Indonesian Ministry of Finance estimated that the annual cost of actions in forestry and peat lands, energy and transportation sectors required to reach the 26% emission reduction target by 2020 would be between IDR100 trillion and IDR140 trillion (US\$10.7 billion and US\$15 billion at the time) (cf. Table 3; MOF 2012). The Ministry assumed that between one and two thirds of the cost of new initiatives would be financed publicly, including fiscal incentives to stimulate private investment. Mitigation cost for agriculture, industry, and wastewater were not considered in the first MFF.

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