Implementation of Sustainable Finance Regulation for Financial Institutions in Indonesia

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Abstract:

The interaction between people and the environment are very vital because functioning ecosystem services are important resources for people. Economy is a subsystem of human society, which is also a subsystem of life on earth and its ecosystem. The issue of environmental change has shifted from a peripheral concern of scientists and environmentalists to being a central issue in global policymaking. To ensure global long-term financial stability and economic development, financial institutions need to significantly change their performance to promote more responsible and sustainable business practices. The Financial Services Authority of Indonesia has unveiled a roadmap, which sets forth the end goal of sustainable finance in Indonesia by the financial services industry and determines the benchmark for improvements in sustainable finance. This paper explains the reasoning and implementation of sustainable financing policies under the term of Environment, Social, and Governance concepts. This paper explains the complementarities of the Islamic worldview and sustainable financing policies by opening up the topic of the scientific nature of heterodox Islamic economics in particular. The term sustainable financing conveys the fact that society and economics, finance, environment, governance, polity, institutions, etc. cannot be independent of a unique and common set of moral and ethical values. The ESG concept is completely in line with the *Maslahah* concept under *shariah* law. It embeds moral and ethical values in the body of heterodox Islamic economic thought aligned with the *shariah* ruling.

Keywords: Ecosystem Services, Economic Development, Sustainable Finance, ESG Concepts, Islamic Economics.

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Introduction

The world has experienced tremendous economic progress. The side effects of the development process have also been enormous – loss of biodiversity, climate change, environmental damage, etc. which brought about social issues such as poverty alleviation. On the other hand, economy is an important tool in developing social policies and the protection and management of environment and natural resources. Economy is also a tool to provide information about options, costs and benefits of various actions to be decided along with the measurement results (Cato, 2009).

However, at the heart of the efforts of environmental protection is the need to resolve an essential intellectual problem. The problem is that the body of economics, science, and social knowledge that we have developed over the centuries has been based on a clear differentiation between humans and nature - between natural and social conditions (Schumacher, undated). This differentiation has allowed us to parcel social problems into small pieces and place these under analytical and empirical scrutiny (Choucri, 1995).

This is but one of many indications that our economy is in fundamental conflict with our ecological systems. For this reason, we need a new paradigm of economy, which is more concerned with the quality of human life. Choudhury (1993a) introduces the idea that sustainable socioeconomic development comprehends relationships between economy and society from the perspective of an integrated study between polity and the market system. Development is the theory, process, and realization of certain major social and economic objectives simultaneously. In this light, no separate preference is placed on one over the other: the social (distributive equity) and economic goals (economic efficiency) both need to be attained (the equity-efficiency principle).

Theoritical Framework and Hypothesis Development

Orthodox and Mainstream Economics

In the modern context, the permanent idea of economic wellbeing is premised on scarcity of resources and thus competition and the axiom of marginal rates of substitution between everything, good and bad.

Consequently, welfare can be defined as maximization of output by marginal substitution between labor and capital inputs. Ecological welfare is defined by tradeoffs between environment and economic growth. Social welfare is defined in terms of tradeoffs between distributive equity and economic efficiency. Such tradeoffs remain true even in the case of time-dependent dynamics between the substituting variables.

Complements are possible only in the local sense and that too, by holding all other factors constant (ceteris paribus). Mainstream socio-scientific theory has no methodology to integrate morality and ethics in its epistemology as endogenous reality. In other words, morality and ethics remain either as neutral elements or are exogenous matters of mainstream socio-scientific thought, application and verification.

Resource scarcity, competition and substitution have proven to be the cause of much of deprivation in the human world. These assumptions are the groundwork of the sciences of nature and society upon which modernism rests. The world may be richer in terms of material wealth, conventionally measured, but a rising tide of operational renunciation of moral and ethical principles seems to have accompanied the increase in material wealth.

The cost of this material wealth has been an unstoppable increase in carbon dioxide emission in the world and, with it, a likely increase in global surface temperature change. Clearly, the status quo is not acceptable. The received socio-scientific-philosophical paradigms have to change.

The existing ethical theory of Islamic economics, especially on the environmental side of sustainable finance has not been fully considered. The objective of this paper is to explain the complementarities of Islamic worldview and sustainable financing policies by opening up the topic of the scientific nature of heterodox economics in general and heterodox Islamic economics in particular.

Research Method

The paper delves into Indonesia's strategy for sustainable financing, emphasizing the United Nations' sustainable development framework. It discusses the role of financial institutions in supporting Indonesia's economic growth and analyses the roadmap unveiled by the Financial Services Authority of Indonesia (OJK). The study outlines three main areas of sustainable finance implementation and explores the role of financial services in achieving long-term financial stability.

Result, Discussion, and Managerial Implication

The United Nations (United Nations, 2014) in cooperation with various governments, civil society, and other economic players have developed a sustainable development framework that is expected to bring both economic and environmental sustainability interests together, provide economic transformation, and expand access to alleviate poverty from the poor and enforce justice.

This also takes into account that the social and environmental issues, which have not been included in the economic calculations, have become important elements that need to be considered. The balance between the importance to make profits does not legitimize a lower attention and commitment to protecting the environment and a better social life.

The two most common aspects of sustainable finance (i) the sustainability factor, and (ii) the interrelationship between ESG issues and financial issues. Thus, sustainable finance looks at how investing, lending, and financing interact with environmental, social, and governance issues over a given period. Sustainable finance is not merely focused on how to make a profit while investing with a "green" conscience, but how green investments lead to profit and benefits for environmental, social, and governance issues (Krauss et al., 2016).

The systemic nature of environmental issues and the globalization of the economy that gives rise to them are making international interdependence an inescapable reality. Climate change remains the top concern of global leaders per last year’s World

Economic Forum survey. As the fourth largest nation in the world, Indonesia will play its part in meeting this global challenge (Indrawati, 2017).

Indonesia's social issues, such as environmental damage and poverty alleviation, become more important as the country has progressed economically because the people who are most affected by the changes to the natural environment are those who live in the poorest areas and who have usually contributed the least to the environmental problems. Their problems arise because they often rely on agriculture and natural resources that are threatened by rising temperatures and extreme climate change. They are also amongst those most vulnerable to natural disasters and lack the mechanisms to cope with their effects.

Hadad and Maftuchah (2015) revealed that the Indonesian Ministry of National Development Planning create an Indonesia development plan which utilized two financing sources, approximately 20% from the government and 80% from the private sector. Government funding sources include taxes and non-taxes, domestic and foreign grants, domestic and overseas loans, while the private sectors (non-state budget) are financed through banks and non-banks, business entities (domestic/international), and various sources. The combination of development funding is a collaboration between the government and the private sector / public-private partnership in the form of social responsibility through corporate social responsibility (CSR) as well as religious social funds.

Given that 80% of the development financing is supported by the private sector, the role of the financial services industry is substantial to support Indonesia's economic growth. Therefore, financial institutions need to understand that negative ESG outcomes caused by their financing, client relationships and advisory decisions can affect them and may cause reputational and brand damage (WWF, 2014).

The Financial Services Authority of Indonesia (OJK) unveiled a roadmap that sets forth the benchmark and the end goal of sustainable finance in Indonesia for the financial services industry under the supervision of OJK (Indonesia Financial Services Authority, 2014). The implementation of strategic activities of sustainable finance in Indonesia is comprised of three main areas:

1. Increase the supply of environmentally friendly financing.
2. Increase demand for environmentally friendly financing products.
3. Increase oversight and coordination of sustainable finance implementation.

Setijawan (2017) described that sustainable finance was not just about financing renewable energy companies; it was also about working with clients and portfolio companies to help advance them along the sustainability through proper ESG risk management policies, processes and protocols in place. In the long term, the distribution of sustainable financing to strategic sector industries is expected to encourage sustainable economic growth, which in turn will provide a larger market for Financial Services Institutions (FSI).

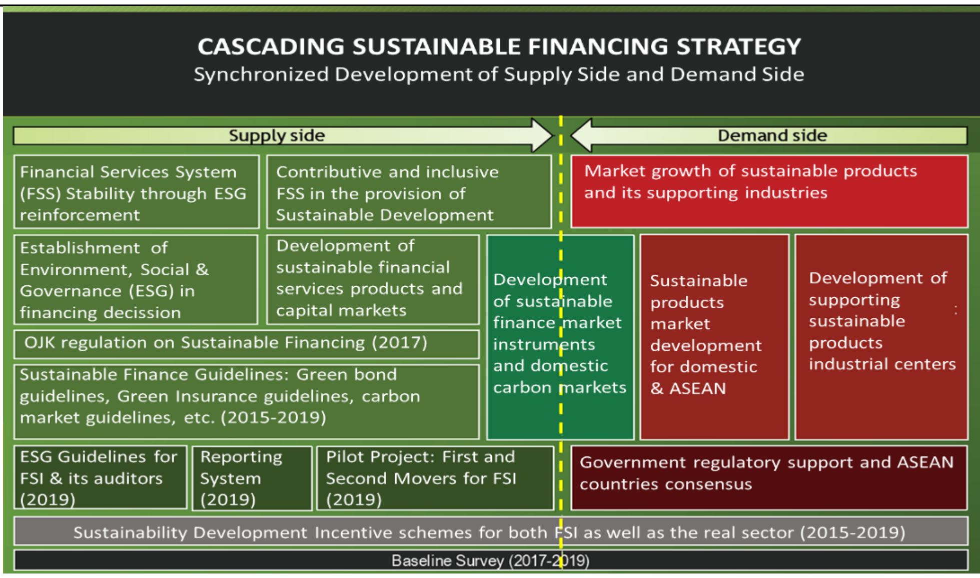

Figure 1. Sustainable Financing Strategy (by Setijawan, 2017)

The creation of a larger market along with its generated economic growth will have a positive impact on the sustainability of FSI in particular and is also expected to reduce Indonesia's balance of payments deficit. To support the implementation of Sustainable Finance stipulated in Indonesian law Number 32/2009 regarding Environmental Protection and Management, in July 2017 OJK issued a regulation on Sustainable Finance, namely POJK Number 51/POJK.03/2017 regarding the Application of Sustainable Finance for FSI, Issuer, and Public Companies.

Figure 1 presents the role and position of OJK regulation in the overall sustainable financing strategy. In broad-spectrum, the Sustainable Financing Strategy in Indonesia can be broken up into Supply Side and Demand Side for financing. OJK is accountable to regulate the development of the supply side, while the government is accountable for the development of the demand side.

At the supply side, it is necessary to shape a contributive financial services system to achieve financial system stability by strengthening ESG. This means that sustainable financial programs not only seek to grow the financing but also to improve the resilience and competitiveness of FSI. The development for resiliency and competitiveness is based on the rationale that sustainable finance is a new challenge coupled with a new opportunity where the FSI is able to grow and reach financial stability by integrating ESG.

On the other hand, Financial Services System (FSS) should be more prudent in its investment decision to sustain its financial integrity through more selective investments, whether in the form of credit, debt, or other options by incorporating ESG as the instrument to filter the investment. Financial integrity can be interpreted that in the management of credit / finance of the financial services industry, it is necessary to examine the various risks to avoid the materialization of problems that are not desirable during the process and after credit / financing take place.

Nonetheless, if the focus of financing is only on the integrity aspect, it will result in an economic contraction as FSS will only focus its attention to environmental issues which will result in many financing projects being rejected. Therefore, it has to be balanced with financing expansion that FSS should be both contributive and inclusive in the provision of sustainable development financing.

Financial inclusion means that the financing is able to protect and manage the problems that may arise due to environmental and social issues. FSS has to be more selective, but at the same time; has to drive cooperation among related sectors to achieve government commitment to Sustainable Development Goals, one of which is related to the environmental aspects.

For example, by stimulating investment in renewable energy, energy efficiency, green building, eco-tourism, recycling industry, etc. So this policy is not contractive but also expansive financing and is expected to expand the Indonesian economy through financing sustainable business sectors.

The implementation of this strategy mix will be achieved through:

1. Establishment of Environmental, Social, and Governance (ESG) in the financing decision. Provide understanding and strengthen FSS on ESG risks and rewards.
2. Development of sustainable financial services products and capital markets.

   Encourage green innovation or sustainable finance products. For example, in the capital market, initially, the market uses the term green bond. However, before it was implemented in Indonesia, the sustainable bond or social bond emerges in the market. There will be 3 types of bonds, i.e. (i) green bond emphasizes the aspect of the environment, (ii) Social bond focus on social, (iii) Sustainable bond focus on both environmental and social aspects.
3. Strengthening Financial markets through the development of domestic carbon markets and other sustainable financial market instruments. This section is broken down into two with the dotted line in the middle. This shows that the development of this section requires the involvement of non-OJK parties, namely the government. The government determines who is green and what is green, as OJK has no competencies to do so. The development of the carbon market mechanism should involve cross-sectoral ministries and agencies, including the ministry of finance, the ministry of environment and forestry, etc.

Once the Supply side formed the sources of financing, it has to be balanced with the formation of demand for sustainable financing, as the demand side. The demand for this type of financing will inevitably be many, but the demand must meet the financial services system requirements. The development of the demand side is not within the scope of OJK authority, so good coordination with the government is critical to the success of the program.

For this reason, OJK has intensively discussed the plan with the Ministry of Energy and Natural Resources and other ministries, especially for the development of New and Renewable Energy. This financing will be related to the incentives and disincentives by the government for the green industry or sustainable industry. OJK's two long-term development targets through this policy are:

1. Sustainable products market development for domestic & ASEAN.
2. Development of supporting sustainable products industrial centers.

The development of the domestic market for sustainable products will grow demand for these products, such as hydroelectric power plants that require turbines and solar cells. In addition, there are also increasing interest in green lifestyle, where people tend to choose green products, such as organic rice or the use of environmentally friendly products. This will also foster demand.

However, the development of the domestic market needs to be coupled with the development of the industry supporting sustainable products, as most of the technology, machines or solar cells, are still imported. Fail to do so, Indonesia will only be a consumer and will not get any benefit from this policy.

Therefore, it is important to work in cooperation with the Indonesian Agency for Technology Assessment and Application (BPPT), the Ministry of Industries, and the Ministry of Trades, so that domestic sustainable industries can be developed domestically to meet the increase in demand. In order for the domestic products to be competitive with imported products, the design of the strategy embraces ASEAN countries. Through this strategy, the potential consumers will increase to 600 million from 250 million if the coverage is only in Indonesia.

This large number of potential consumers is expected to assist the industry to reach the economies of scale so that the products can compete head-to-head with non-ASEAN products.

Again, this demand-side development is not OJK capacity; therefore, OJK requires the support of government regulation and agreement from ASEAN countries. With the enactment of the POJK regulation on Sustainable Financing, several basic Sustainable Finance Guidelines will be developed and available by 2019 (International Finance Corporation, 2017).

The guidelines include green bond guidelines, Green Insurance guidelines, carbon market guidelines, etc. These guidelines will cover:

1. ESG Guidelines for FSI and FSI auditors.
2. Reporting System. Standard reporting enables OJK to categorize whether financing is classified as sustainable or not as it relates to incentive and disincentives schemes.
3. Pilot Project: First and Second Movers for Sustainable Finance Institution.

In order to implement this sustainable financial policy, FSI participation is required in the form of a pilot project. Since 2016, OJK has received commitments from 8 banks of this program, namely BRI, BNI, Mandiri, BCA, Artha Graha, Bank Jabar Banten, BRI Syariah, and Muamalat with total assets of 46% of total banking portfolio in Indonesia (Yudawinata, 2016). If this pilot project goes well, it will already cover half of the banking industry. Lastly, in order to measure the effectiveness of the implementation of this policy in the future, a Baseline Survey has been initiated in 2017.

Ethico-Economics in Heterodox Economic Thought of ESG

Humans are the guardians of the earth and are entrusted to protect it for future generations. Despite that, currently millions of people are suffering as a result of the damage to the environment. The people who are most affected by the changes to the natural environment are those who live in the world's poorest countries and who have usually contributed the least to the world's environmental problems.

Contrary to the viewpoint of orthodox and mainstream economics, social well-being in the sense of human sustainability is viewed in postmodernism to rest on ideas and structural changes that liberate resources. Consequently, the assumptions of scarcity, competition, and substitution are rejected for a restructured way of organizing social relations.

Choudhury & Bhatti (2016) opened up the topic of the scientific nature of heterodox economics in general and heterodox Islamic economics in particular. They filter of heterodox economic thought by encompassing socio-scientific heterodoxy through the monotheistic methodology of consilience. The epistemic foundation of the heterodox worldview in meta-science is to extend the nature, domain, and inferences premised on the existing scope of scientific inquiry to that of the monotheistic worldview.

Economic heterodoxy is the area comprising the emergence of non-neoclassical economic and mainstream economic ideas. Neoclassicism is orthodoxy as the science of rational choice. Mainstream economics is the sociology of economics. Heterodox Islamic economics, founded on the principle of the monotheistic law of knowledge ontologically, epistemologically, and phenomenologically, may, in time, put back God and His words where they functionally belong—and that is everywhere that the human mind can comprehend. Practically, this civilizational change has to happen in Indonesia, having, as it does, the Belief in the One God as the very first and foremost of five principles of her Constitution. The monotheistic methodology of unity of knowledge needs to be applied to the functional interpretations of the other four for consistent applications in the multiverse field of human experience.

In Islam through revelation, the episteme arises from the most irreducible knowledge domain. This is known as Tawhid. Tawhid is reflected in the unity of the monotheistic law and the unity of the world-system to which the monotheistic law applies. These attributes are given by vectors (economic, political, social, etc) and each of these attributes is interactively unified together by means of the prime source of knowledge. According to the Tawhidi unification epistemology the divine law of oneness is seen to reveal itself in two important ways in Islamic socio-scientific inquiry. These are contrary to all other systems of thought. Unification through knowledge-induced interrela-tionships (i) means the principle of universal complementarity must become a logical part of this system and, (ii) it means that knowledge becomes endogenous in the evolutionary learning systems.

Choudhury asserts that the Tawhidi worldview, understood as the divine law of unity between all things (Signs of Allah) presents itself as continuous learning by reproduction of knowledge by linkages between the good things of life. Self, systemic, and institutional linkages in principle, and using the instruments derived from the discursive foundation of the Tawhidi worldview and world-system, form the basis of pervasive complementarities between such artifacts.

Unity of knowledge now forms the basis of human sustainability encompassing belief, behavior, formalism, application, and verification for its continuity over learning domains. Time now acts as the recorder of such structural changes based on complementarities. The principle of complementarities marks the sure sign of unity of knowledge. The evidences are shown in the signs of Allah inter-and intra-systems.

Tawhid thus presents the worldview of unity of everything premised on a regenerative dynamics (endogenous) of knowledge-flows derived from the divine origin, thus creating embedded and relational world-systems. This kind of worldview has been the project over time immemorial, as opposed to the differentiated methodology of modern science and society and everything. Tawhid presents the complete methodology of unity of knowledge, which science and society have always searched for since time immemorial.

Such is the significance of the Tawhidi methodological worldview in the study of science and society. It is unique and universal. It remains ever-new as the foundation of knowledge, process and reality. The study thus reflects four distinct areas.

First, the epistemological foundations of the learning world-systems are derived within the framework of a systems perspective relating to the epistemology of unity of knowledge in which the normative domain and positive domain, the a priori and the a posteriori or deductive and inductive methodologies, theory and practice, individual behavior and institutions, markets and ethics, all become circularly interrelated and unified.

Secondly, the developmental, institutional, cultural, ethical, and policy preferences of complementary and co-determined decision-making are made to induce the variables and parameters of the dynamic circular causation (inter-causal) system of complementary relations. In accordance with it, the real-world issues and problems of sustainable socioeconomic development in the problem of financing.

In the development of Islamic economics, scholars refer to the verses of the Qur'an and the relevant Hadith to establish the basic principles governing the rights and obligations of economic actors following the framework of *maslahah mursalah*. *Maslahah mursalah* is maslahah that there is no sharia (Islamic divine law) provision to make it happen and there is no sharia argument to consider it or ignore it.

Maslahah consists of "considerations that secure the benefits or prevent damage but, in accordance with the purpose (*maqashid*) of Sharia. Any action that keeps these values is included in the scope of *maslahah* and anything that violates is *mafsadah* (crime), and the act of preventing crime as well is *maslahah*". The purpose of sharia consists of five values of protection, namely: religion, life, mind, descent and wealth, which has a very wide spectrum and meaning (Dusuki and Abdullah, undated).

The basis of Islamic economics obliged that every transaction needs to obey the Islamic contract (*Aqd*), prohibition of *riba* (usury and unearned income), *maisir* (gambling), *gharar* (uncertainty) and *maksiat* (breaking of religious law). These are the center of Islamic economics in defining whether a transaction is lawful or not (Khan, 2002).

Islam commands us to eat from whatever is on earth that is lawful (*halal*) and good (*thayyib*) (Qur'an, 2: 168). The Islamic scholars divine that *thayyib* is what makes good physical, spiritual, intellect and morality of man (*akhlaq*). Consuming *halalan thayiban* is one manifestation of faith because it means following the command of God. However, the current Islamic economics only emphasizes its attention on to the transactions that are lawful (halal) and unlawful (haram) aspect, no elaboration on the aspect of *thayyib* (good transaction), especially the acknowledgment on ESG.

ESG issues are significantly relevant in Islamic teaching, which commands relationship with God, the relationship among man and the relationship with nature (*hablum minallah, hablum minannas and hablum minal alam*) (Al-Qaradhawi, 2001). Therefore, sustainable financing policy should be an integral part of the Islamic economics. Sustainable financing is a reflection that Islam as a religion of *rahmatan lil 'alamin* means Islam is a religion that brings grace and prosperity to the entire universe, including animals, plants and *jinns*, let alone fellow human beings (Qur'an, 21: 107).

The managerial implications of the research findings underscore the transformative role that financial institutions must play in aligning their strategies with sustainable finance principles. Integrating Environmental, Social, and Governance (ESG) considerations into the decision-making processes of financial institutions is crucial for fostering responsible and sustainable business practices. This involves a paradigm shift in managerial thinking, where the traditional focus solely on profit maximization gives way to a more holistic approach that considers the broader impact of financial activities on the environment, society, and governance structures.

Financial institutions need to recognize that their decisions, including financing, client relationships, and advisory services, can have far-reaching consequences on ESG outcomes. Negative outcomes in these areas can lead to reputational and brand damage, affecting the long-term viability and success of the institution. Therefore, a key managerial implication is the need for a thorough understanding and management of ESG risks and rewards. This entails incorporating ESG criteria into the evaluation of investment opportunities, lending practices, and overall business operations.

Furthermore, the paper emphasizes the encouragement of green innovation and the development of sustainable financial products and capital markets. Managers within financial institutions need to actively engage in the creation and promotion of financial products that align with sustainability objectives. This involves not only identifying environmentally friendly investment opportunities but also fostering innovation in financial instruments that contribute to sustainable economic development.

The role of Financial Services Institutions (FSI) is positioned as central to the implementation of sustainable finance strategies. Managers must navigate the dual responsibility of contributing to economic growth while mitigating environmental and social risks. Selective and inclusive financing becomes a key managerial strategy to strike a balance between maintaining financial integrity and supporting sustainable development. This requires careful consideration of various risks, including environmental, social, and governance factors, in the decision-making process.

In summary, the managerial implication of this research is a call for proactive engagement, strategic innovation, and a fundamental shift in mindset within financial institutions. Managers must lead the charge in integrating sustainability principles into the core of their operations, thereby contributing to both financial stability and the broader goals of sustainable development.

Conclusion, Suggestion, and Limitations

Indonesia Financial Services Authority has regulated sustainable development for the financial services industry embodied in the sustainable finance roadmap and Indonesia law Number 32/2009. The sustainable strategy was established based upon the interrelationship between demand and supply elements for sustainable finance products such that complementary actions from both the financial services industry at the supply side and industries at the demand side will achieve optimal and sustainable growth. Nevertheless, the supervision of sustainable financial implementation remains a priority, in line with efforts to create financial system stability.

The practical implications of the research are that it provides:

1. Understanding and strengthening Financial Services System on Environmental, Social and Governance (ESG) in the financing decision, particularly on risks and rewards.
2. Encourages green innovation or sustainable finance products along with the development of sustainable financial services products and capital markets,
3. Strengthens Financial markets through the development of domestic low-carbon markets and other sustainable financial market instruments.

The two social implications of sustainable finance are (i) the sustainability factor, and (ii) the interrelationship between Environmental, Social, and Governance (ESG) issues and financial issues. Thus, sustainable finance looks at how investing, lending, and financing interact with environmental, social, and governance issues over a given period. Sustainable finance is not merely focused on how to make a profit while investing with a "green" conscience, but on how green investments lead to profit and benefits for environmental, social, and governance issues.

The paper suggests ongoing efforts to strengthen Financial Services Systems (FSS) on

ESG and encourages the development of sustainable financial market instruments. It emphasizes the need for collaboration between the private sector and the government to achieve Sustainable Development Goals. The limitations include the challenge of balancing environmental concerns with economic growth and the necessity for ongoing research to measure the effectiveness of sustainable financial policies.

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Abbreviations

ASEAN : The Association of Southeast Asian Nations

ESG : Environment, Social and Governance

FSI : Financial Services Institutions

FSS : Financial Services System

OJK : The Financial Services Authority of Indonesia (Otoritas Jasa Keuangan)

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