Adopting Sustainable Finance Regulation for Islamic Financial Institutions in Indonesia

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Abstract: The interaction between people and environment are very vital because functioning ecosystem services are important resources for the people. The economy is a subsystem of human society, which is also a subsystem of the 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 the global policy-making. 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 complementarities of Islamic worldview and sustainable financing policies. Under the term Environment, Social and Governance, the ethical theory of Islamic economics focuses only on the social and governance, the environment under sustainable finance have not been fully considered. Therefore, the adoption of sustainable financing concept in Islamic financial services institutions will enrich Islamic economics to attain Islam *rahmatan lil 'alamin* (Islam is a blessing and mercy to the entire universe).

1 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, the economy is an important tool in developing social policies and the protection and management of the 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, scientific, 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 in small pieces and to 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 in the perspective of an integrated study of policy 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).

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

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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 interacts 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 the 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.

The objective of this paper is to explain the complementarities of Islamic worldview and sustainable financing policies. the ethical theory of Islamic economics focuses only on the social and governance, the environment under sustainable finance has not been fully considered, especially on the term of Environment, Social and Governance.

2 INDONESIA STRATEGY ON SUSTAINABLE FINANCING

Hadad and Maftuchah (2015) revealed that the Indonesian Ministry of National Development Planning creates Indonesia development plan which utilized two financing sources, approximately 20% from government and 80% from private sectors. Government funding sources include taxes and non-taxes, domestic and foreign grants, domestic & overseas loans, while the private sectors (non-state budget) are financed through bank 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 which 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). 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 advancing 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). 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

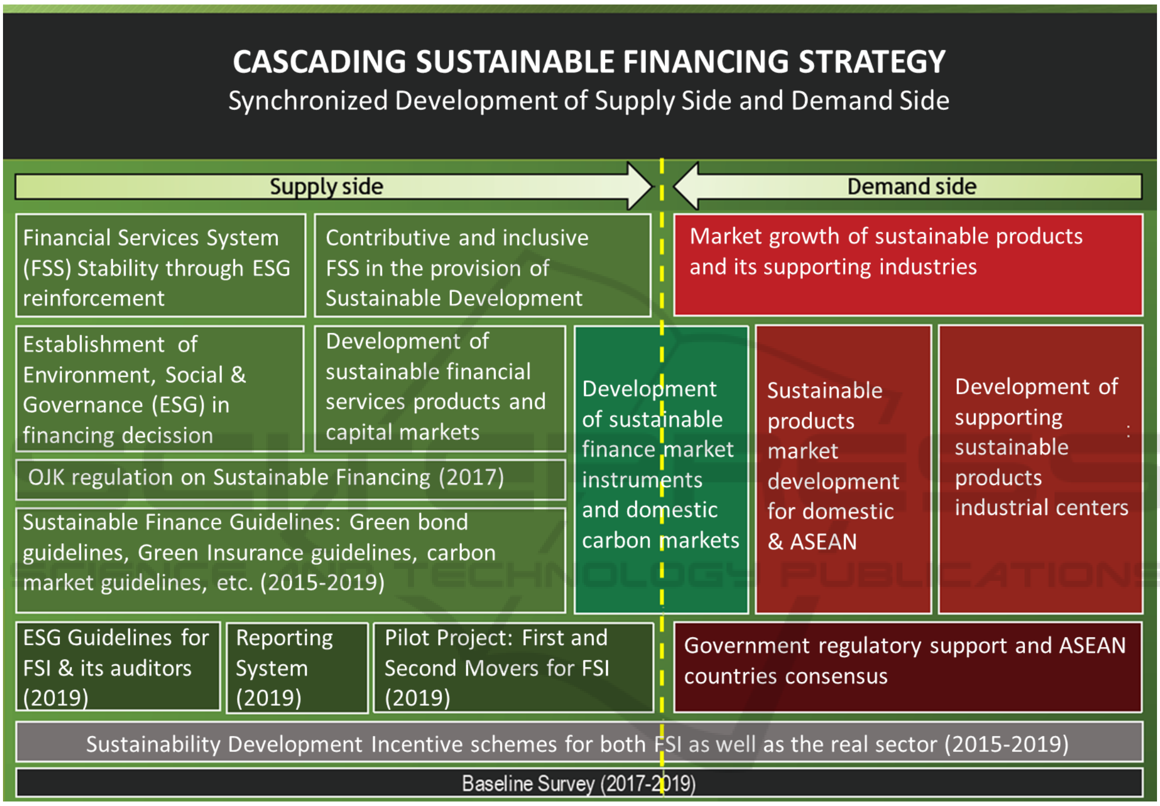

Figure 1: Sustainable Financing Strategy (by Setijawan, 2017).

to protect and manage the problems that may arise due to the environmental and social issues.

FSS has to be more selective, but at the same time; has to drive the cooperation among related sectors to achieve government commitment in Sustainable Development Goals, one of which is related to environmental aspect. For example, by stimulating the 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 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 strengthening 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 environmental, (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 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 the scope of OJK authority, so good coordination with 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 green industry or sustainable industry. OJK 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 Indonesian Agency for Technology Assessment and Application (BPPT), Ministry of Industries, and 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:

- ESG Guidelines for FSI and FSI auditors.

- Reporting System. Standard reporting enables OJK to categorize whether a financing is classified as sustainable or not as it relates to incentive and disincentives scheme.
- Pilot Project: First and Second Movers for Sustainable Finance Institution.

In order to implement this sustainable fiscal 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 has already covered 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.

3 ISLAMIC ECONOMICS THOUGHTS OF ESG

Humans are the guardians of the earth and are entrusted to protect it for the 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.

In the development of Islamic economics, the 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 *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 are 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 Islamic contract (*Aqd*), prohibition of *riba* (usury and unearned income), *maisir* (gambling), *gharar* (uncertainty) and *maksiat* (breaking of a religious law). These are the center of Islamic economic in defining whether a transaction is lawful or not (Khan, 2002).

Islam commands 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 emphasize 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).

4 CONCLUSIONS

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 complimentary actions from both financial services industry at supply side and industries at 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 term sustainable financing conveys the fact that society and economics, finance, 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 encompassing economic, environmental and social in the body of economics aligned with the *shariah* ruling. However, the theory and practice of Islamic economics and finance have not brought sound environment and social justice to improve human well-being, balancing the social justice and economic goals. Hence, Islamic economic institutions should adopt the OJK regulation as it corresponds with the concept of *maslahah*.

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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)*