

Green bonds in Indonesia: Prospects and challenges

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On December 21, 2017, the Financial Services Authority (OJK) issued Peraturan OJK No.60/POJK.04/2017 (POJK 60) to regulate the issuance and terms of green bonds. We view the enactment of this regulation positively, as it helps the development of green bonds in Indonesia. It should also support the government's objectives to develop the capital market and preserve the environment through the harmonization of economic, social and environmental aspects.

Green bonds are debt securities whose proceeds are used to finance or refinance, in part or fully, activities with specific environmental sustainability purposes and, apart from this, are the same as conventional bonds. The regulation requires a minimum 70% of proceeds from issuance to finance agreed green projects. The issuer must adhere to capital market laws and regulations that govern the registration statement and debt security public offering.

The regulation specifies activities eligible to be financed through the issuance of green bonds to include:

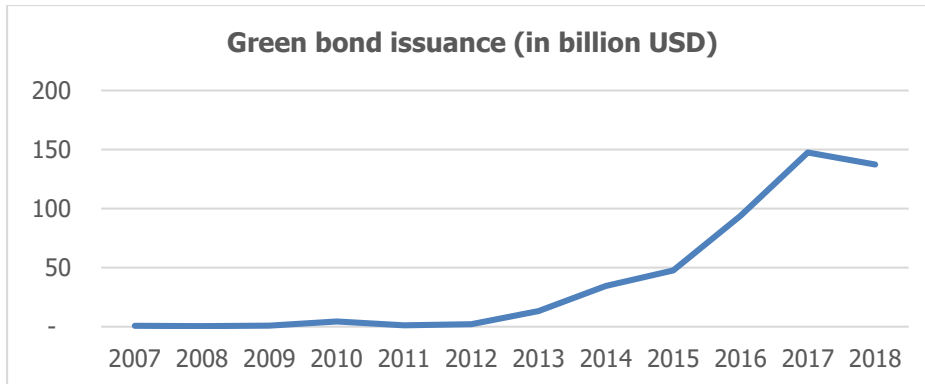
1. Renewable energy
2. Energy efficiency
3. Pollution prevention and control
4. Natural resource management and sustainable land use
5. Biodiversity conservation
6. Environmentally friendly transportation
7. Sustainable water and waste water management
8. Climate change adaptation
9. Eco-efficient products
10. Environmentally friendly buildings that meet national, regional, or international standards or certification
11. Other activities that are environmentally friendly or have environmental benefits.

The regulation encourages transparency to verify the allocation of the proceeds. The issuer must prepare a separate account or disclose a specific note in the notes to their financial statement. It is obliged to regularly submit the performance of green projects – reviewed by an independent third party – to the regulator. Should the projects no longer meet the green requirements, the issuer must define the action plan and will be given one year for improvement. In the event of failure to restore green criteria, the bondholders may request the issuer repurchase the bond or increase the coupon rate.

Green bonds in the global market

The first green bond was issued in 2007 by the European Investment Bank for USD807.8 million, and the proceeds used to finance renewable energy and energy efficiency projects. Green bond issuance has shown a phenomenal growth rate ever since, reaching USD147.5 billion as of December 2017. Growth in 2018 was slower – with total issuance of USD138 billion – due to rising interest rates that weighed on debt issuance in the global market. At December 2018, the three largest green bond issuers were European Investment Bank, Industrial Bank Co Ltd, and Kreditanstalt fuer Wiederaufbau.

Strong market growth, in our view, is attributable to growing demand for and supply of green financial instruments, as both investors and issuers are in need of investment diversification, and seek investment innovation that pursues environmental and social outcomes. Green bonds are attractive as they create opportunities for environmental change investment, delivering environmental and financial returns. Given such an overwhelming response, we project the global green bond market will continue to grow in the medium term.



Source: Bloomberg

Green bond issuance in Indonesia

State-owned infrastructure financing company, PT Sarana Multi Infrastruktur (Persero) (SMI), was the first company in Indonesia to issue green bonds, with 100% of the proceeds to be used to finance eligible projects, exceeding the minimum 70% regulatory requirement. It issued the bonds under the shelf-registration issuance scheme for a maximum of IDR3 trillion. It only realized IDR500 billion in the first phase of issuance, against an initial target of IDR1 trillion. SMI offered a three-year interest rate at 7.55% and five-year at 7.8%. In comparison, Lembaga Pembiayaan Ekspor Indonesia offered 7.5% and 7.7% for three-year and five-year conventional bond tenors, respectively. We view the higher pricing as a constraint for the issuer. It must also bear additional expenditure for defining the green criteria, and monitoring and reporting the bond's performance.

There are strong potential supply growth prospects for green bond issuance in Indonesia. Infrastructure companies may issue them to finance projects that meet the green criteria. PLN may use the proceeds to finance renewable energy power plants. Banks may propose them with the proceeds distributed to loan activities that are environmentally friendly or have environmental benefits. We view strong market potential from the issuer side, considering Indonesian state-owned construction companies, PLN and banks have a dominant position in the nation's debt issuance market.

As a new investment product in the domestic market – with limited track record of repayment and investment return – investors tend to avoid the placement of green bonds. POJK 60 also requires a buyback should the green criteria not be maintained – raising additional concerns about the prepayment risk. There is also no regulatory push that requires a certain percentage of green investment.

The green bond market in Indonesia has strong potential to grow further, but low penetration indicates it needs to be further developed, and faces challenges to reach a comparable scale with conventional investment. The regulator is also challenged to seize the opportunity by building market education of stakeholders and society to increase awareness of green investment, which may, in turn, stimulate supply and demand in the green bond market in the medium term.

Challenges associated with green bonds

Taking into account the green bond market is still in the early stages of development, we expect the green criteria will likely evolve in the medium term. Defining this criteria is also a challenge, in our view, as it may not meet every investor's definitions and needs. To date, there is also no common and broadly accepted standard for determining what is categorized as green.

Another challenge is to maintain the environmental benefits of the investment by ensuring the proceeds are used for designated projects and are properly managed throughout the lifecycle of the bonds. This raises the need for assessment or review from an independent third party. Thus, we expect the issuer to bear additional costs and expenses, while providing returns similar to conventional debt instruments. In our opinion, promoting integrity through providing such reliable and transparent information should gain

trust among investors and facilitate a credible green bond market. We envision the regulator promoting the development of the market in Indonesia in the medium term, including providing incentives or directing investors to allocate a minimum investment portion in green products – as in the minimum requirement of government bonds through Peraturan OJK No.1/POJK.05/2016.

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