



Evaluation of Environmental and Social Safeguards Performance Assessment Method using Corrective Action Plan Compliance Rate in Financing and Investment

Retno Dwirestiani, S.T.¹, Yunieta Anny Nainggolan, S.E, M.Com., Ph.D.², Gan Gan Dirgantara Ph.D.³

¹School of Business and Management, Institut Teknologi Bandung and PT Sarana Multi Infrastruktur (Persero), Jakarta, Indonesia

²School of Business and Management, Institut Teknologi Bandung, Bandung, Indonesia

³PT Sarana Multi Infrastruktur (Persero), Jakarta, Indonesia

ABSTRACT: This study evaluates the environmental and social safeguards (ESS) performance assessment method of PT Sarana Multi Infrastruktur (Persero) (PT SMI), focusing on the corrective action plan (CAP) compliance rate in financing and investment. Despite the utility of the compliance rate in monitoring adherence to financing agreements, it often inaccurately reflect actual environmental and social performance due to its inherent ambiguities. This research employed a qualitative method, employing observations of 146 active financing facilities and equity investment, surveys, and discussions with PT SMI's ESS personnel. The study reveals that projects with higher CAP compliance rates may still have unresolved issues, while projects with fewer CAPs can be unfairly categorized as underperforming. To address these limitations, the study proposes a new, comprehensive framework that incorporates multiple variables to better capture ESS performance. This approach aligns with sustainable practices, enhances legitimacy, and meets stakeholder expectations more effectively. In addition, the proposed framework offers opportunities for incentives or disincentives based on ESS performance. Future research should focus on developing and validating this new framework to ensure accurate assessments of ESS performance in financing and investment activities.

KEYWORDS: Corrective action plan, Compliance rate, Environmental and social safeguards, Financing and investment, Performance assessment method.

INTRODUCTION

PT Sarana Multi Infrastruktur (Persero), hereinafter referred to as PT SMI, is a state-owned enterprise with shares solely owned by the Ministry of Finance of Indonesia, concentrating on infrastructure financing and investment in Indonesia. PT SMI has three main business pillars, including commercial financing, public financing, as well as advisory and project development. Not only channel funding for private and state-owned enterprises but also public service entities and subnational governments. Besides, PT SMI undertakes equity investment, holding shares in infrastructure-related companies. PT SMI has been implementing sustainable finance, one of them by mainstreaming environmental and social safeguards, focusing on financing and investment business pillars. PT SMI has also cooperated quite closely with development financial institutions, donors and philanthropists, and partners, who have applied stringent ESS standards, to accelerate infrastructure development in Indonesia.

PT SMI has ten standards environmental and social safeguards (ESS) and conducts environmental and social due diligence (ESDD) on every financing and investment proposal as explained in the internal procedures of PT SMI. If there are gaps in mitigation measures according to ESDD results, corrective action plan (CAP) will be entailed in the agreement or other equivalent documents, such as side letters, to be fulfilled by the borrowers/investees. When financing facilities or investment have been effective, each CAP submitted by borrowers/investees shall be assessed for adequacy by PT SMI, and then recorded in a database when it is substantially adequate. CAP compliance rate of all borrowers is maintained at a minimum of 70% as defined in the Risk Appetite Statement (RAS) of PT SMI as parts of credit risk and would be monitored monthly. The objective of this study is to review current performance assessment method of borrowers/investees using CAP compliance rate.



THEORETICAL FOUNDATION

The idea of sustainable development refers to economic growth that does not cause pollution and enhances living standards without depleting the net resources of the earth (Steiner & Steiner, 2012). In recent years, climate change has also driven many nations to find solutions, culminated in COP26 Summit in Glasgow where countries committed to reduce GHG emissions and deforestation, including pledges from Indonesia (Mohamad et al., 2022). The Government of Indonesia also shows commitment in sustainable finance by launching “*Taksonomi untuk Keuangan Berkelanjutan Indonesia*” or hereinafter TKBI, a classification of economic activities involving economic, environmental, and social dimensions. TKBI consists of Environmental Objective, or hereinafter EO, and Essential Criteria, or hereinafter EC. EO is a priority to achieve environmental performance target and EC is the requirement to undertake activities under EO classification.

Pertaining to this study, according to legitimacy theory, many firms proactively addressed environmental and social concerns to protect their reputation in relation to risk-events that could damage their legitimacy (Azevedo et al., 2018). Considering ESG risks is becoming an important element (challenge) for the stability of the financial system, but the state of implementation of risk assessment methodology involving ESG risks by financial institutions remains at different levels of advancement (Ziolo et al., 2019).

METHODS

This study employed a qualitative method. Observations of 146 active facilities of financing and equity investment as of early July 2024 have been undertaken as well as survey and roundtable discussions with all personnel of PT SMI with the function of environmental and social safeguards, including levels of Division Head, Team Leaders, and staff/analysts.

RESULTS AND DISCUSSIONS

CAP, generated at the initiation stage, is expected to reduce the potential environmental and social risks in underlying projects during financing tenure or investment period. At the financing and investment monitoring stage, an environmental and social monitoring report (ESMR) is also prepared which evaluates the implementation of environmental and social management. Data for ESMR are obtained from the CAP documents received as well as site visits and interviews with borrowers/investees. However, complexity and ambiguity occur in assessing ESS performance based on CAP compliance rates. Projects could have high number of CAP due to several conditions such as:

1. The project is categorized as green field in which the holding companies established new SPVs. Therefore, a number of pertaining documents have not been provided or personnel have not been deployed during the due diligence period; or
2. The project scale is large or considered high risk according to regulation and internal assessment that triggered all or almost all ESS standards, thus requiring robust mitigation measures that are partially unavailable or have not been prepared yet.

On the other hand, based on the ESDD that has been carried out thus far, the number of CAP could be small, as represented by Project D, due to some factors, for instance:

1. The project has been operational, systems and personnel are available, but there are still minimal mitigation measures that have not been fulfilled or need updating; or
2. There are risks that are shared with other parties, for instance in a vast majority of public-private partnership projects, the risks of permitting and land acquisition is the responsibility of the government; or
3. Borrowers/investees who act as contractors or leasers, the risks would be limited to the period the works are carried out and the project operations are no longer their responsibilities.

CAP fulfilment ratio according to RAS is measured using the equation shown in **Equation 1**.

Equation 1. CAP compliance metric according to RAS

$$\frac{\text{Number of facilities that have a good compliance rate (minimum 70\%)}}{\text{Number of facilities that have gone through an ESDD process}}$$

Borrowers/investees which have CAP compliance rate between 70% and below 75% are considered as potentially exceed acceptable limits or designated as ‘Alert’, while below 70% would be marked as ‘Breach’ (**Table 1**).



Table 1. Risk appetite boundaries and evaluation

No.	Risk appetite boundaries	Evaluation
1	CAP fulfilment $\geq 75\%$	Within Compliance Limit
2	$70\% \leq \text{CAP fulfilment} < 75\%$	Alert
3	CAP fulfilment $< 70\%$	Breach

(Source: PT SMI internal memo, 2023)

CAP compliance rate has been a useful tool to control the fulfilment of financing/investment agreement requirements. However its potentially leads to misinterpretations of actual environmental and social performance in the projects during financing/investment monitoring phase. Simulation of assessment is illustrated in **Figure 1**.

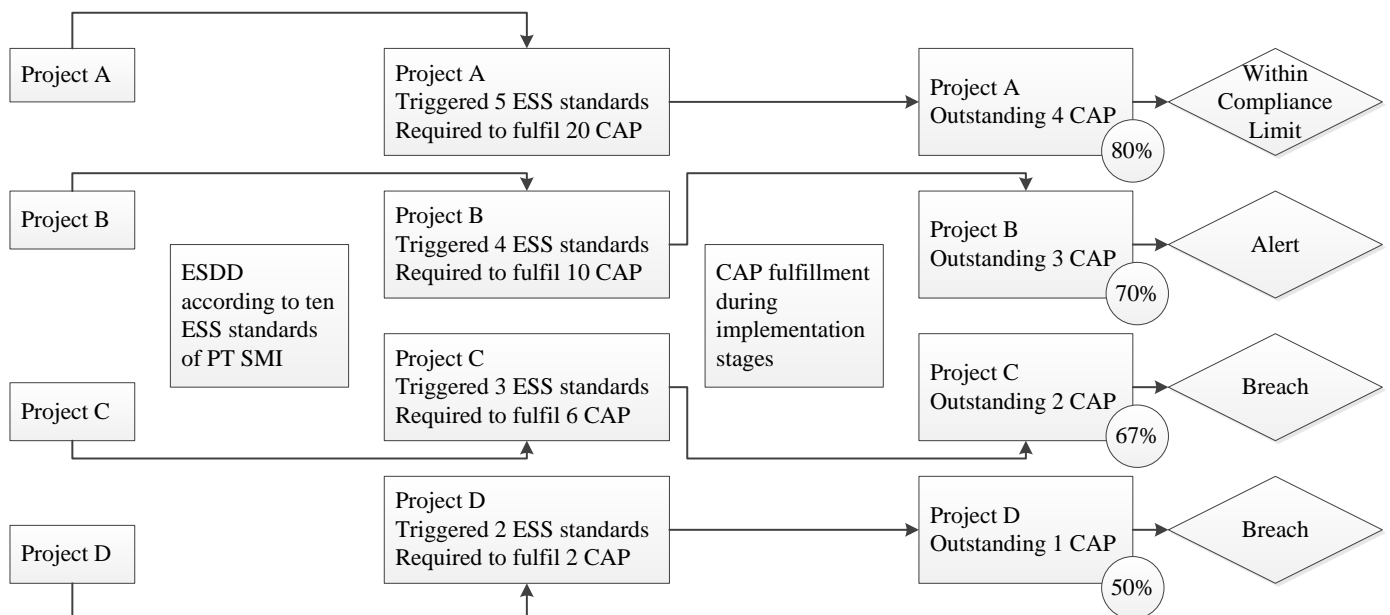


Figure 1. Simulation of ESS performance using CAP compliance rates according to RAS method

The diagram illustrates borrowers/investees who are entailed to fulfil more CAP obtain a high CAP compliance rate at monitoring stage, even though there are several outstanding CAP that missed the due date, as represented by Project A. Therefore, Project A is in the 'Within Compliance Limit' category. Meanwhile, CAP stipulated in Project D is only two, much less than those required in Project A. However, the CAP compliance rate of Project D is only 50% because Project D meets one of total two CAP. Project D falls into 'Breach' category accordingly. To improve methods that can reflect ESS performance and translate the assessment results more accurately, it is necessary to develop a framework that considers a number of variables (**Figure 2**).

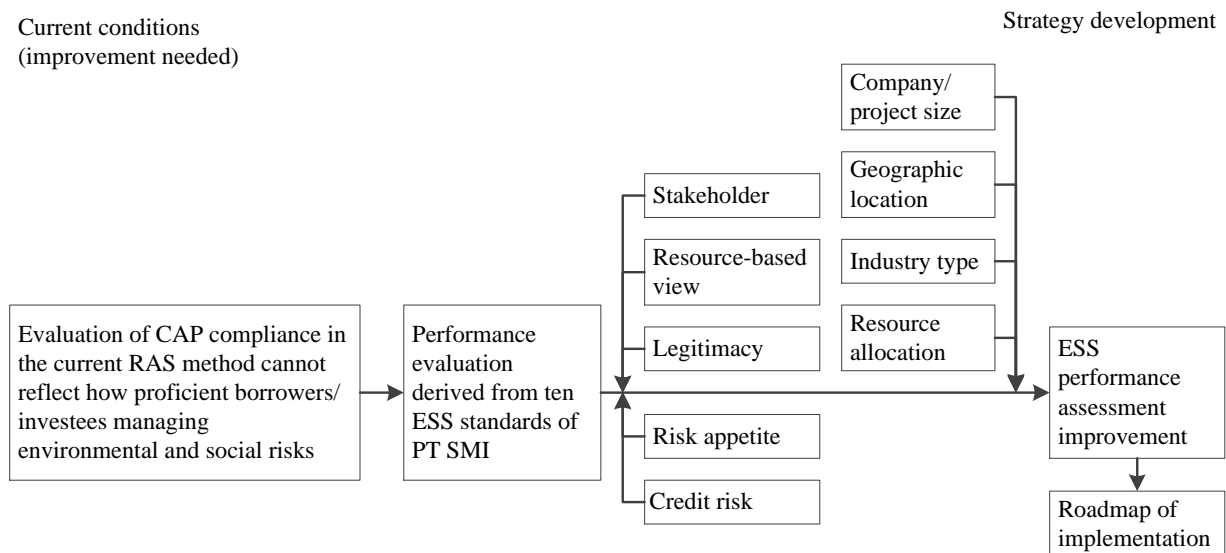


Figure 2. Proposed framework for improving current ESS performance assessment method of PT SMI

Current research on sustained competitive advantage focuses on four key variables: technological innovation, knowledge management, dynamic capability, and organizational agility (Satar et al., 2024). Improvement of ESS performance assessment method can be seen as a dynamic capability that helps PT SMI to systematically identify and evaluate environmental and social risk management in its business pillars, especially financing and investment. Enhancement of ESS performance assessment method also enables PT SMI to align sustainable practices with stakeholder expectations. This alignment increases legitimacy and social acceptance, which is pivotal in mitigating reputational risk (Azevedo et al., 2018). In addition, PT SMI should foster relationships and create maximum value for stakeholders without compromise or trade-offs, balance the interests of different stakeholders as explained in stakeholder theory, by conveying a framework for examining ESG issues from the perspective of the organization (Wai-Khuen et al., 2023). Adjustment of ESS performance assessment method will provide a more structured approach to evaluate how well potential and current borrowers/investees manage their environmental and social risks, which have raised concerns to various stakeholders, including affected communities. Therefore, PT SMI can address stakeholder needs and concerns and attain long-term sustainability. Company size, geographic location, industry type, and resource allocation, are also considered to ensure that the proposed model is adaptable to different contexts and can accurately reflect ESS performance under varied conditions. Risk appetite and credit risk are crucial to translate the proposed framework into practical outcomes, influencing the overall risk profile and continuity of projects. This framework is also a potential opportunity for PT SMI in the decision-making process to provide incentives (or disincentives), both financial and non-financial aspects, including a technical assistance or an appropriate recognition.

CONCLUSION

The study argued ESS performance assessment method using CAP compliance rate could be ambiguous in reflecting the actual situations. The limitations of the CAP compliance rate as a sole metric underscore the need for a more comprehensive and nuanced framework. The framework should incorporate multiple variables that better capture the complexity and multifaceted nature of ESS performance, to enable a more accurate assessment. Current reliance on CAP compliance rate must be reconsidered and future research should focus on developing new methodologies that can reflect a more precise ESS performance. In conclusion, while the CAP compliance rate has been a useful tool to encourage fulfilment of requirements in financing and investment, its inherent ambiguities necessitate the exploration and implementation of a new, more robust framework to determine ESS performance of borrowers/investees during financing tenure or investment period.



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