

SUSTAINABILITY RISKS FOR SOUTHEAST ASIAN BANKS

IMPLICATIONS FOR POLICY MAKERS

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FOREWORD



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The forces driving climate change and ecosystem destruction, including the unsustainable production of forest risk commodities (FRC), are deeply intertwined with our financial system. Both the Paris Agreement and the 2030 Sustainable Development Agenda address the need for re-aligning the capital allocation towards the ambitious global agendas; therefore, the effective engagement with financial institutions is critical.

For companies in FRC supply chains in Southeast Asia, bank lending is the most important form of financing – making up 66% of their total financing from 2010 to 2018. Lending to companies in the FRC supply chains in Southeast Asia is also very concentrated; just 24 banks accounted for over 72% of lending from 2010–2019¹.

Financial institutions have significant potential to catalyze sustainable business practices in Southeast Asia through their lending policies, as well as by engaging with the companies they lend to, invest in and insure. In 2019, CDP started developing the world’s first reporting framework for financial institutions covering both climate change and forest metrics. The framework aims to help banks assess and improve management of forest related risks within their lending portfolios through the establishment of annual reporting. It was piloted in Southeast Asia, as it is a critical region for animal and marine species².

This policy brief analyzes the actions disclosed by Southeast Asian and Global banks through CDP’s pilot 2020 climate and forest questionnaire. It is aimed at financial regulators to deepen their understanding on how bank lending activities shape and impact climate and deforestation that, in turn, present financial risk to themselves. It concludes with recommendations for policymakers to increase and strengthen Southeast Asian banks’ policies and action towards halting deforestation and biodiversity loss.

A handwritten signature in black ink, consisting of the letters 'P' and 'B' in a stylized, cursive font.

Pietro Bertazzi
Global Director, Policy Engagement

KEY FINDINGS

- 1 Regulatory and reputational risks are the top drivers of risk identified by banks in their climate and forest-related assessments.
- 2 There are low rates of portfolio impact analysis on forest-related risks for global and Southeast Asian banks.
- 3 Both global and Southeast Asian banks scored poorly on scope 3 portfolio emissions disclosure, due to lack of capacity and clear guidance.
- 4 Southeast Asian banks have limited engagement with clients and their suppliers in forest risk commodity value chains.

For this analysis, we define "Southeast Asian" banks as banks that are headquartered in this region, whilst "Global banks" refers to banks outside the Southeast Asia region. This report will highlight the alignment of the key analysis with the existing platform such as Task Force on Climate-related Financial Disclosure (TCFD); Regulation of Indonesia Financial Authority (OJK) No.51/2017 (P.OJK No.51/2017); Principles for Responsible Banking; Value-based Intermediation Financing and Investment Impact Assessment Framework (VBIAF) by Bank Negara Malaysia (BNM); Guidelines on Environmental Risk Management by Monetary Authority of Singapore (MAS); and Sustainable Banking Assessment.

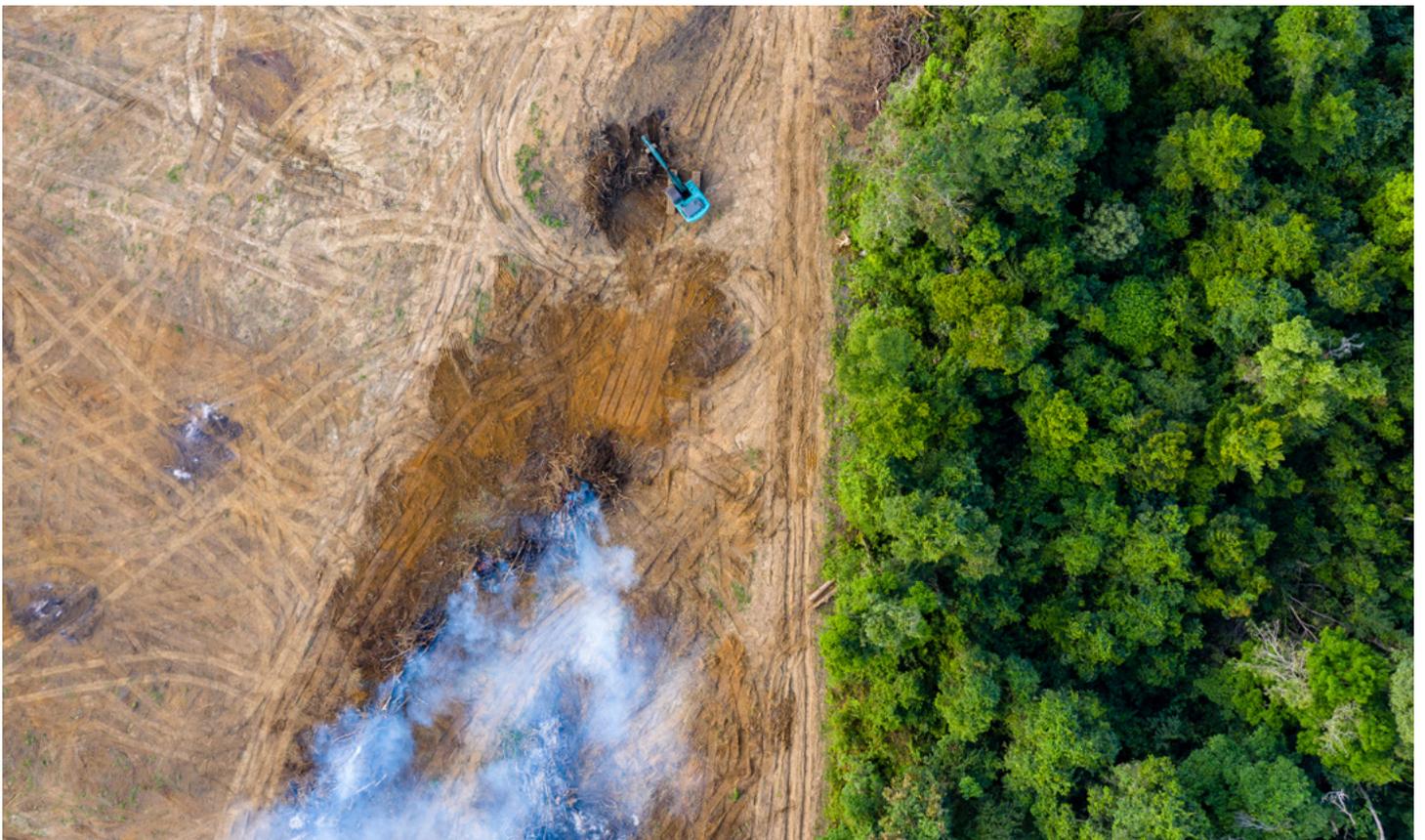
INTRODUCTION

Climate change is set to dominate the economies of the future. Since the 2015 Paris Agreement, conversations around the risks and opportunities it will bring have moved squarely into the world's most influential boardrooms and circles of government³. Limiting global temperature rises to well below 1.5°C will require both deep de-carbonization and, crucially, a halt to deforestation. The case is clear as even with all other anthropogenic emissions phased out, continuing 'business-as-usual' deforestation rates will drive global warming above 1.5°C by 2100⁴.

Southeast Asia is home to some of the world's richest biodiversity, encompassing around 20% of global plant, animal and marine species. The region's forests contain one of the three global major biodiversity landscapes, along with the South American Amazon and African Congo regions. Yet they are under serious threat, with some parts of the region projected to lose up to 98% of their remaining forests in the next nine years. Agricultural production of FRCs is the largest culprit for biodiversity decline, deforestation and forest-degradation in the region, which accounts for a large portion of the Gross Domestic Product (GDP) for most countries in Southeast Asia.

Southeast Asia is also one of the fastest growing markets in the world, with estimates predicting that by 2025, more than half of the world's consuming class will live within a five-hour flight of Myanmar. Alongside rapid population growth comes an increased demand for FRCs and the need for capital to finance this growth and demand. Worryingly, Southeast Asia is also home to one of the most challenging and non-transparent financial systems in the world.

The absence of public reporting by the financial services sector across Southeast Asia has reduced the ability of the region to adopt and scale interventions to tackle deforestation. Without a clear picture of who is involved, what is working and what is clearly not working, the sector remains unable to benefit from best practices and makes it virtually impossible for financial regulators and civil society organizations to adequately hold financial institutions to account.



SUSTAINABLE FINANCE LANDSCAPE

This brief focuses on Indonesia, Malaysia and Singapore in order to drive new and improved sustainable finance regulation in the region. These countries are at the core of Southeast Asian palm oil⁷ production and expansion, with Malaysia and Indonesia producing around 85% of the world's palm oil. In 2018, palm oil was Indonesia's second largest export and Malaysia's seventh biggest export.

Singapore's strategic location and status as a financial hub in Southeast Asia has resulted in numerous palm oil growers and multinational consumer goods corporations being based out of the city-state. Out of the 30 largest global palm oil trading companies, eight are headquartered in Singapore; three of⁸ which control 75% of globally shipped palm oil volumes⁹.

All three countries have ratified the Paris Agreement and set Nationally Determined Contributions (NDC) in line with their commitments¹⁰. As part of leveraging the financial sector to support the implementation of the Paris Agreement goals, their financial regulators have joined the Network for Greening the Financial System (NGFS)¹¹. Further information is detailed below:

Indonesia

- ▶ In 2014, the Financial Services Authority 'Otoritas Jasa Keuangan' (OJK) launched its Sustainable Finance Roadmap Phase I (2014-2019). The Roadmap was designed to support Indonesia's 4P development principles outlined in its National Medium-Term Development Plan; a pathway that is pro-growth, pro-jobs, pro-poor and pro-environment^{12,13}.
- ▶ OJK's Roadmap Phase II (2020-2024) includes an increased focus on financial risk management, corporate governance, bank financial ratings and the development of an integrated sustainable financing information system¹⁴.
- ▶ There is no formal engagement yet on the Task Force on Climate-related Financial Disclosures (TCFD) in Indonesia, however OJK actively provides feedback to TCFD.
- ▶ In 2017, OJK issued regulation P.OJK No.51/2017 for financial service institutions, issuers and public companies to require banks to implement sustainable finance strategies. A key component of this regulation is the requirement of publishing annual bank sustainability reports, beginning in 2020¹⁵.
- ▶ In the same year, the No.60/POJK.04/2017 on Guidance for Green Bond Issuance required a minimum of 70% of proceeds from issuance to finance green projects. This regulation encourages transparency to verify green bond issuance, with the issuer being required to submit independently verified performance reviews¹⁶.
- ▶ OJK has developed technical guidelines on lending practices for clean energy and the palm oil sector. The Green Taxonomy is expected to be ready in 2022¹⁷.

Malaysia

- ▶ In 2014, The Securities Commission Malaysia (SCM) expanded its Sukuk Guidelines¹⁸ to include the Sustainable and Responsible Investment (SRI) Sukuk framework, facilitating the creation of a sustainable finance ecosystem for SRI investors and issuers. This framework was introduced to further promote Malaysia's position as a center for Islamic finance; it includes disclosure requirements, appointment of independent party monitoring and reporting requirements¹⁹.
- ▶ In 2019, Bank Negara Malaysia (BNM) established a Joint Committee on Climate Change (JC3) to pursue collaborative actions for building climate resilience within the Malaysian financial sector²⁰. The JC3 comprises four sub-committees focusing on risk management, governance and disclosure, product and innovation, and engagement and capacity building. The governance and disclosure sub-committee will develop disclosure-related best practices and is exploring the potential adoption of existing standards, including the TCFD recommendations²¹.
- ▶ In 2019, BNM developed a discussion paper on "Climate Change and Principle based Taxonomy" to guide lending towards sectors that support a low carbon economy. It has two key objectives:
 - (1) identify and classify economic activities that contribute to climate change targets and;
 - (2) build capacity in managing the financial risks from climate change. A revised version of the taxonomy is planned for publication in early 2021²².

- ▼ In 2019, BNM also published the Value-Based Intermediation Financing and Investment Impact Assessment Framework-Guidance (VBIAF). The VBIAF enables the implementation of an impact-based risk management system to assess the financing and investment activities of Islamic financial institutions, incorporating environmental, social and governance (ESG) considerations in their risk management systems²³. Following the VBIAF guidelines, in late 2020 a public consultation for the VBIAF sectoral guidelines on palm oil, renewable energy, and energy efficiency was held²⁴.

Singapore

- ▼ With the primary aim of improving disclosure and corporate transparency, in 2016, the Singapore Exchange Limited (SGX) issued rules and guidance requiring companies to disclose and publish an annual sustainability report²⁵.
- ▼ In 2019, The Monetary Authority of Singapore (MAS) published its Green Finance Action Plan, which focuses on building resilience, developing markets, leveraging technology and building capability in sustainable finance²⁶.
- ▼ To support the issuance of green bonds, MAS has developed a sustainable bond grant scheme. Within this scheme, external parties are able to review expenses of proposed green bonds²⁷.
- ▼ In December 2020, MAS issued its Environmental Risk Management Guidelines for banks²⁸, asset managers²⁹ and insurers³⁰, which sets out sound practices in relation to FIs' governance, risk management and disclosure of environmental risk, co-created with the industry as part of MAS' Green Finance Action Plan. This environmental risk framework is aligned to the recommendations of the TCFD, recognizing physical and transition risks associated with climate change, with MAS electing to encompass a wider range of issues than climate change alone, including biodiversity loss, pollution and land use change³¹.



ACTION BY SOUTHEAST ASIAN BANKS ON CLIMATE AND FOREST RISKS

This section presents the anonymized, aggregated results from CDP's pilot 2020 climate change and forests questionnaire.

Out of 42 target group banks invited, 24% responded, resulting in a sample of 10 banks disclosing (three were global banks; seven were in Southeast Asia, while no banks from Singapore responded). The participating banks are significant financial players, collectively holding loans of more than \$2.5 trillion, and accounting for over 19% of all lending to the FRC sectors in Southeast Asia between 2010-2018. The response rate is encouraging considering the global COVID-19 pandemic, which has brought much of the region to a standstill.



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Target group banks invited

3 Global banks
7 Southeast Asian banks

24% responded in a sample of 10 banks disclosing

19% of participating banks are significant financial players

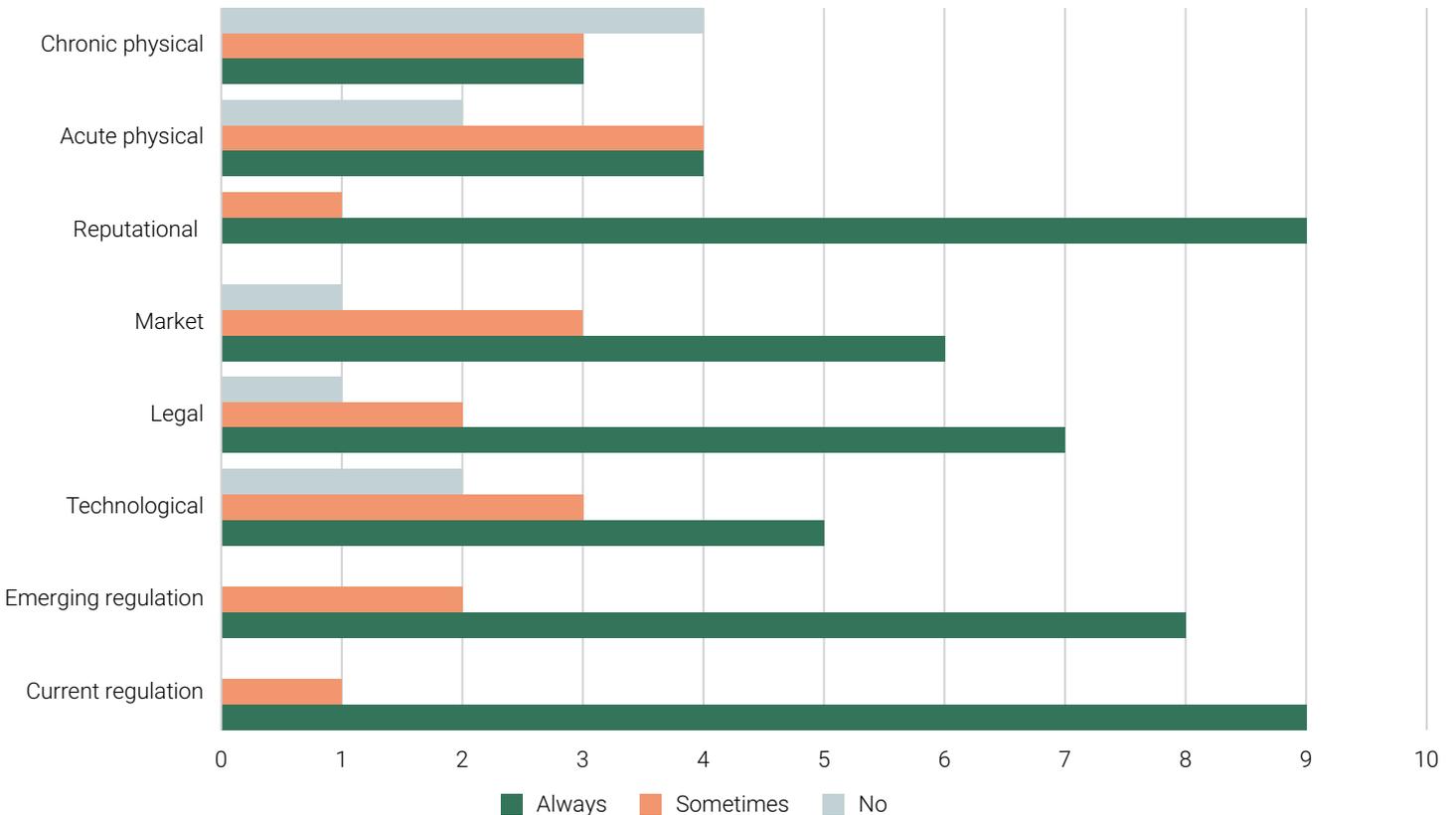
US\$2.5 trillion in loans collectively held



Risk Management

As recommended by the Task Force on Climate-related Financial Disclosure (TCFD), P.OJK No.51/2017, VBIAF by BNM and Environmental Risk Management Guidelines by MAS, companies need to identify and manage environmental risk. CDP data show that banks consider the risk drivers of current regulation, emerging regulation, and reputation more than any other forest-related risks in their risk assessment. This suggests regulators wield considerable influence and have a vital role in creating the enabling policy conditions to manage and minimize climate and forest-related risk.

Figure 1 - Risk types are considered by bank's on climate and forest-related risk assessment





Portfolio Analysis

There is a large gap in the transparency between global and Southeast Asian banks, with all global banks disclosing their portfolio impacts on climate, compared to only 14% of Southeast Asian banks. For comparison, only 14% of Southeast Asian banks and 33% of global banks analyze their portfolio's exposure to forests-related risks.

In addition, banks are more likely to assess climate and forests-related risks to their own portfolios, rather than assess their portfolio's impact on climate and forests. This difference is especially marked for forests and suggests banks are focussing on one side of the 'double-materiality'³² equation.

The TCFD, Sustainable Banking Assessment, P.OJK no.51/2017, VBIAF by BNM, Environmental Risk Management Guidelines by MAS and the Principles for Responsible Banking highlighted the importance of the financial sector in considering the potential impacts of environment-related risks in the context of their financing activities and the impact on their financing portfolios including lending portfolios for banks.

'Double materiality' is an approach where an issue is considered material if it can influence the development, performance and position of the company in a material way, or if the company's activities have a material impact either environmentally or socially

(European Commission, 2019). The concept of double materiality is implicitly recognized in CDP's Financial Services Climate Change and Forests Pilot Questionnaire in that it asks both if banks assess their portfolio exposure to risks and their portfolio impacts.

Figure 2 - Conduct assessment on portfolio's exposure to climate and forest-related risk

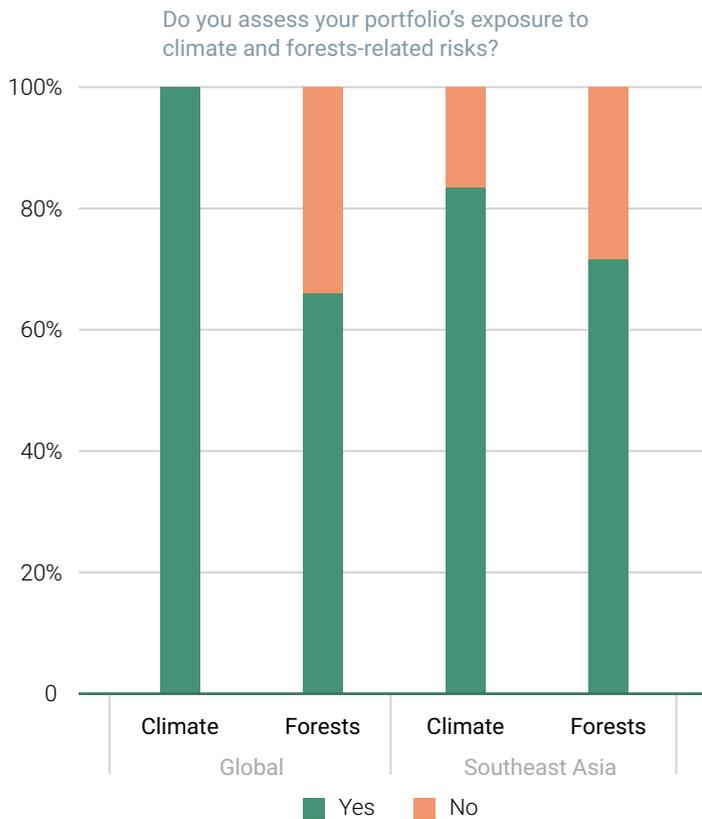
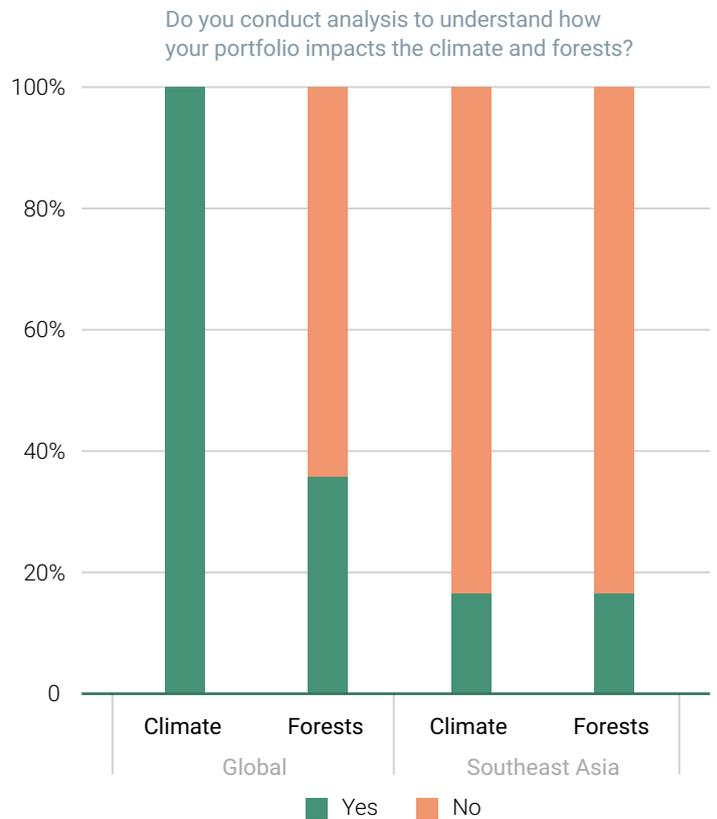


Figure 3 - Conduct analysis to understand portfolio Impact on the climate and forest





Scope 3 Portfolio Emissions

Scope 3 emissions are a result of activities from assets not owned or controlled by the reporting organization, but rather indirect emissions in its value chain^{33,34}. The importance of this data is articulated by TCFD metrics and targets, Principles for Responsible Banking on impact target setting, P.OJK No.51/2017 on environment performance by financial institutions, VBIAF by BNM on impact based risk measurement and Environmental Risk Management Guidelines by MAS on risk identification-assessment and risk management-monitoring.

Despite this importance, scope 3 portfolio emissions disclosure was poor with only one global bank able to disclose their portfolio emissions. The reasons for non-disclosure for Southeast Asian banks appear to be a capacity issue, where banks do not yet have the tools to conduct analysis on how their portfolios impact the climate. Whilst global banks have more capacity, they cited uncertainties about the carbon emissions methodologies as the reason for non-disclosure.

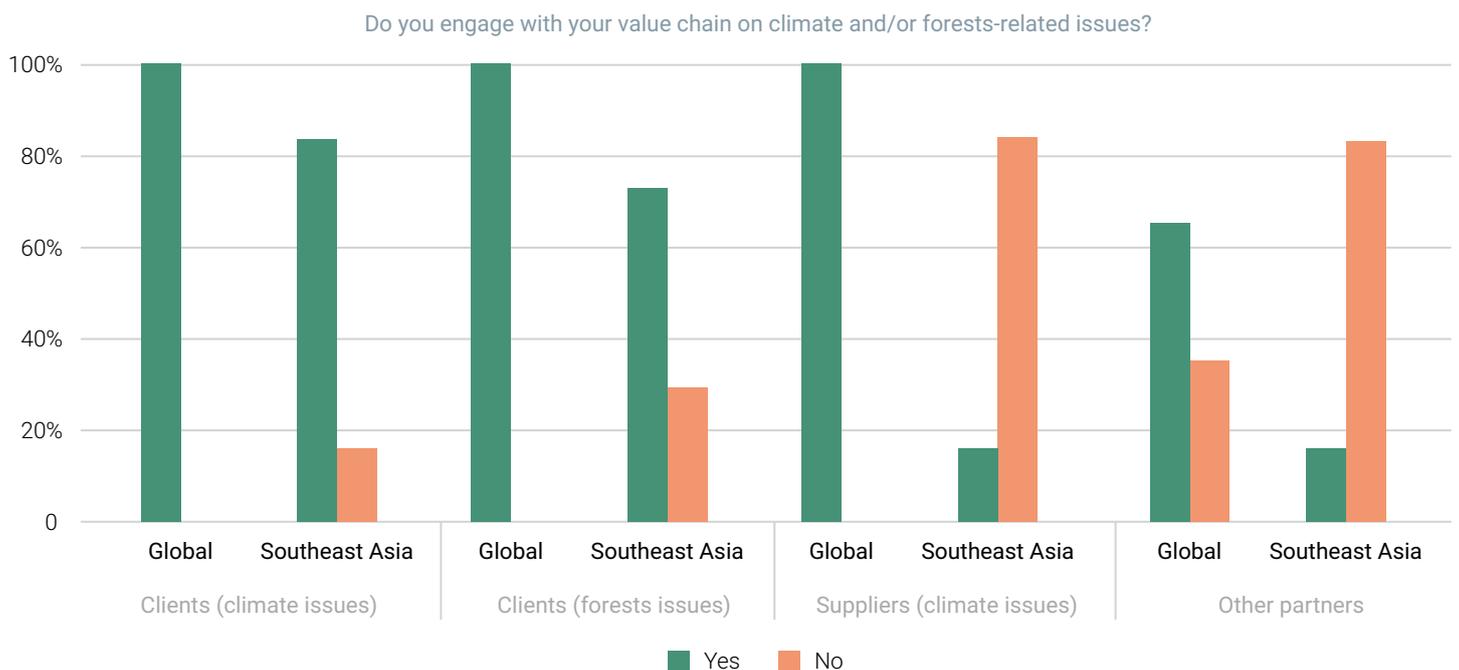


Engagement with Value Chain

Requirements to engage with FRC value chain stakeholders³⁵ is mandated by the Sustainable Banking Assessment, Principles for Responsible Banking, by P.OJK No.51/2017, VBIAF by BNM and Environmental Risk Management Guidelines by MAS.

All global banks engage with their suppliers and 67% engage with other partners in their value chains, compared to only 14% of Southeast Asian banks. In a similar distribution, all global banks are engaging with their clients on climate and forest-related issues, compared to 86% (climate) and 71% (forests) for Southeast Asian banks. This analysis suggests that Southeast Asian banks should step up engagement with partners in their FRC value chains and their suppliers. Increased capacity and understanding of portfolio-risk and impact is a key first step.

Figure 4 - Engagement within value chain on climate and/or forest related issues





ACTION BY SOUTHEAST ASIAN BANKS ON CLIMATE AND FOREST RISKS

Based on the analysis conducted, three top-tier policy recommendations emerge to drive new and improved sustainable finance regulations in the region. Recommendations are aimed at all Southeast Asian countries of focus (Indonesia, Malaysia, and Singapore); however, since more data was obtained from banks in Indonesia and Malaysia, additional specific recommendations have been made for policymakers and FIs in these two countries.

Policy Recommendations

1 Enhance adoption and implementation of climate considerations and forest safeguards in regulation, including through value chain engagement

Regulators wield considerable influence over banks. SEA regulators should integrate climate considerations and forest safeguards in market regulation, supervision and prudential regulation.

Indonesia	Malaysia
<ul style="list-style-type: none"> Indonesia should continue its journey with the Sustainable Finance Phase II roadmap and extend the provision to value chain engagement. 	<ul style="list-style-type: none"> Malaysia's JC3 should develop a roadmap and action plan outlining their actions towards a low-carbon economy. This plan needs to detail how financial institutions in Malaysia should engage with their FRC value chain clients to drive more ambitious sustainable actions and reporting.

2 Ensure mandatory disclosure requirements to enhance transparency of financial institutions and public companies' environmental impacts related to forest-risk commodities

To improve understanding and analysis of environmental risks and opportunities, good quality data and information are required to support informed investment decisions. Better data will also help investors engage with companies on the resilience of their strategies, which could help promote a smoother transition to a low-carbon economy³⁶. Quality disclosure is central to obtaining better data; the TCFD recommendations provide a standardized framework for climate disclosures given their comprehensive coverage, focus on financial impact and strong industry support.

Indonesia	Malaysia
<ul style="list-style-type: none"> Mandatory disclosure regulation is in place, however there is the need to improve the quality of disclosure by monitor and align it with TCFD requirements. 	<ul style="list-style-type: none"> Whilst the TCFD is already recommended by BNM, mandatory environmental disclosure is required to monitor performance of the banks.

3 Increase Southeast Asian banks' capacity on understanding and measuring climate and forest-related risk within their lending portfolios

Capacity is lacking in Southeast Asian banks to adequately understand, measure and integrate climate and forest-related risks and impacts within their lending portfolios, including for scope 3 emissions. Increased data and understanding will allow for banks to develop and implement safeguards, as well as better integrate risk into their decision-making. Regulators can send clear policy signals and incentive measures to green financial performance, including developing and implementing green taxonomies that align to other regional and international jurisdictions. Creating a common language to categorize economic activities based on their impact on deforestation and climate change will help facilitate financial flows to activities that support the transition to a lower-carbon economy.

Indonesia	Malaysia
<ul style="list-style-type: none">Wider socialization and explanation on how to integrate OJK's sustainable finance regulations into bank lending portfolios is required. Clear technical guidelines need to be included in the upcoming Green Taxonomy, outlining the specific actions required by different stakeholders in the financial services sector. To ensure private sector questions are addressed, a public consultation should be held ahead of the development of the taxonomy.	<ul style="list-style-type: none">Guidelines on the updated Climate Change and Principles-based taxonomy and Value-Based Intermediation Financing and Investment Impact Assessment Framework-Guidance (VBIAF) with sectoral guidelines on palm oil, renewable energy and energy efficiency need to be disseminated widely throughout the financial sector. The JC3 should include this dissemination and capacity building in their roadmap.





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About CDP

CDP is a global non-profit that runs the world's environmental disclosure system for companies, cities, states and regions. Founded in 2000 and working with more than 590 investors with over \$110 trillion in assets, CDP pioneered using capital markets and corporate procurement to motivate companies to disclose their environmental impacts, and to reduce greenhouse gas emissions, safeguard water resources and protect forests. Over 10,000 organizations around the world disclosed data through CDP in 2020, including more than 9,600 companies worth over 50% of global market capitalization, and over 940 cities, states and regions, representing a combined population of over 2.6 billion. Fully TCFD aligned, CDP holds the largest environmental database in the world, and CDP scores are widely used to drive investment and procurement decisions towards a zero carbon, sustainable and resilient economy. CDP is a founding member of the Science Based Targets initiative, We Mean Business Coalition, The Investor Agenda and the Net Zero Asset Managers initiative.

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