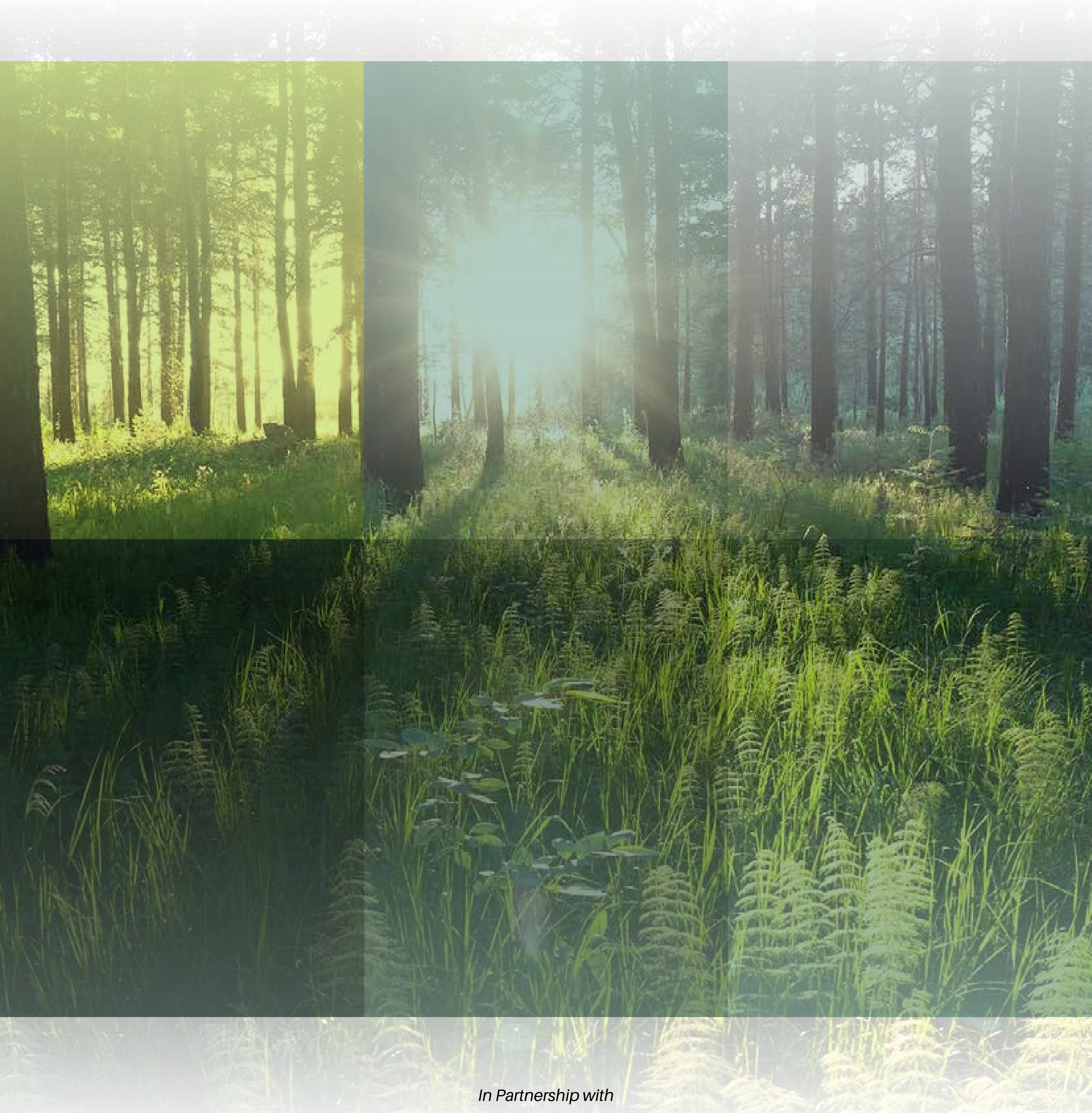
IFN ISLAMIC SUSTAINABLE INVESTING THOUGHT LEADERSHIP REPORT



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Sustainability: The future of Islamic finance

The call for finance to be a force for good has become more urgent than ever, and the Islamic finance industry is heeding that call. Despite practitioners often being quick to point out the similarities between it and the sustainable finance movement, Islamic sustainable finance remains but a drop in the multitrillion-dollar ethical finance industry. Industry leaders, however, believe we are moving in the right direction, and with the right steps, the industry could deliver more meaningful impact through Shariah instruments with a sustainable core. VINEETA TAN dives deeper.

Slow and steady

Don't let the abbreviations confuse you. Be it ESG [environmental, social and governance], SRI [socially responsible investing] or impact investing, these terms are parked under the wider sustainable finance umbrella and are often used interchangeably albeit with delicate differences. ESG may be a jargon first coined in 2005 but the concept dates back earlier with SRI taking off in the 1960s. Within the Islamic finance sector, however, these concepts are a relatively new phenomenon, with Islamic ESG or Islamic sustainable finance gaining more momentum over the last half a decade or so.

Take green bonds as an example. The first climate awareness bond, or green bond, was issued by European Investment Bank back in 2007. The landmark EUR600 million (US$678.27 million) offering triggered a domino effect which led to an ESG finance market that is worth over a trillion dollars and growing exponentially. The Islamic finance industry, however, trailed behind and only issued its first green Sukuk 10 years later in 2017. From then until July 2020, only 17 green Sukuk issuances have entered the market, and are mostly concentrated in Malaysia and Indonesia.

According to Bashar Al Natoor, the global head of Islamic finance at Fitch Ratings, about US$5.5 billion were raised through sustainability-linked Sukuk in 2020; this figure has been superseded in the first three quarters of 2021 alone, with almost US$7 billion already raised.

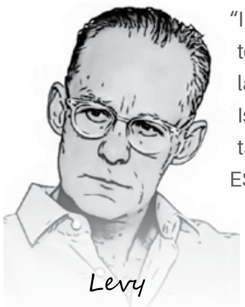
"If I look at how much was issued since 2017, it is less than US$20 billion, which is small compared to the size of the global Sukuk market which is around US$800 billion currently. So, in terms of actual size, the sustainable Sukuk market is still tiny," Bashar explained, adding that over 10% of Fitch's US$130 billion rated Sukuk outstanding has some elements of sustainable, transition and green, indicating that this theme is more apparent within the dollar space. Malaysia is an exception, with corporates driving the Islamic sustainable agenda in the local currency market.

Bashar

The growth may be slow, but market practitioners take this as a sign in the right direction.

"Sustainability has always been at the heart of Islamic finance. But I think perhaps in the past we didn't bring it to the fore as much as we're doing now. And one of the reasons that we're doing it now is because in the conventional markets, sustainability, ESG financing has grown enormously in the last 15 years or so, and increasingly so in the last five years. So that depth of funding liquidity that's available in the conventional sustainable markets is something that Islamic finance is becoming increasingly aware of and tapping into. The combination of liquidity plus the fundamental purpose of Islamic finance have come together in the last three or four years," observes Farmida Bi, Norton Rose Fulbright's chair for the Middle East, Europe and Asia and the firm's European head of Islamic finance.

> That depth of funding liquidity that's available in the conventional sustainable markets is something that Islamic finance is becoming increasingly aware of and tapping into



The Islamic and sustainable convergence is indeed gaining serious momentum, evident by the numbers.

"I think over the last 12 months, there's been a lot of discussion and the good news is that the discussion has basically crossed into almost every aspect of Islamic finance. Everybody is now talking about [Islamic sustainable finance], which is a good start," Dr Scott Levy, CEO of Bedford Row Capital, opined.

There is indeed a lot of talk, backed by meaningful measures, at the top of the industry and at government levels, with the likes of Malaysia, Indonesia, and several administrations in the Middle East putting together policies and incentives to spur the sector. Malaysia introduced its SRI Sukuk Framework in 2014, Indonesia launched its Green Bond and Green Sukuk Framework in 2017, and the UAE this year released its 10-year sustainable finance framework which features Islamic instruments while Oman is developing an ESG finance framework as well.

However, there is still a lot of work to be done, not only at policy level, but also at issuer level as we move from a mindset of maximizing profits to a mindset of profit with purpose.

Costly compliance

There is a cost to compliance, and this cannot be underestimated.

"In addition to complying with Shariah principles, you also have to comply with green bond principles and there are increasing layers of regulatory frameworks that are being built around Islamic sustainable finance," Farmida explained, adding that tapping the ESG market generally means having to get an ESG rating as well. "All of those are substantial obligations that you have to comply with, compared to going out into the market and issuing a conventional bond. So in order to jump through all of those different hoops, it has to be worthwhile."

> There is a cost to compliance, and this cannot be underestimated

Disclosure is a central challenge Islamic financial institutions face in fully embracing the sustainability agenda. Perhaps the lack of Islamic

financial institutions committing to globally-recognized frameworks such as the UN Principles of Responsible Investment and the UN's Principles of Responsible Banking, which require regular detailed reporting of one's sustainability efforts and impact, is an indication of the severity of this challenge. To date, only a handful of entities have adopted these principles.

"The commercial necessity of doing so isn't quite clear enough," Dr Levy highlighted. "If [issuers] can tap into the markets the way they have always done and take a very conservative and traditional approach, why do they need to do this? And there isn't yet a commercial imperative in the same way there is on the conventional side to put the effort into the reporting that's required."

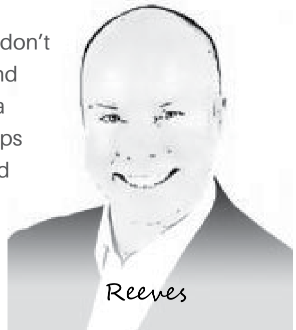
Professor Kevin Haines, Bedford Row Capital's head of social policy, echoes his colleague's sentiments: "There is an issue at the moment for Islamic finance about talking the kinds of language that is increasingly acceptable to investors. Investors are now expecting issuers to be conversant with these various regulatory frameworks and to be providing the data that investors need to demonstrate their compliance under these regulatory frameworks. This is early days but it is important for Islamic issuers to get conversant with these regulatory frameworks."

Making it worthwhile

The reality is: it is not easy to use finance for good without risking greenwashing. And it is costly too. These merely compound the concerns conventional issuers have with Shariah finance, which is already perceived as more complicated and expensive. This leads us to ask: is the payoff justified?

Market practitioners believe so, albeit the fact that it may take a while to realize such gains.

"(In general) getting a real yield that is actually positive is a challenge, and if you're an Islamic investor, then you have further restrictions. You don't have the entire universe available to invest in and so finding something that is going to generate a yield is one thing, finding something that perhaps can generate a positive inflation built in the yield is another. Islamic attributes attached is even more of a challenge and of course increasingly, Islamic investors also want sustainability, they're not different from everybody else. Having a sustainable Islamic investment I think is an incredibly positive and virtuous thing and I think in some respects they it could potentially lead this and certainly the opportunity is there," noted Craig Reeves, the founder of Prestige Funds.



When we compare the performance of conventional and Islamic indices, it does look like conventional edges ahead of its Islamic counterpart. The conventional S&P Global 1200 has modestly outperformed the S&P Global 1200 ESG Shariah. However, according to Michael Orzano, the senior director of global equity indices at S&P Dow Jones Indices, over the longer term, the ESG jurisprudence have led to outperformance and also some reduction in volatility.

"If we look at the trailing 10 years as of the 30th September 2021, the S&P Global 1200 Shariah gained an annualized 14.7% versus 13.1% for the conventional index, which is a pretty meaningful outperformance of over 1.5% per annum over 10 years. Interestingly on the volatility side, standard deviations were a little bit lower for the ESG SRI Index as well, which is interesting as it is a much narrower index," Orzano elaborated, adding: "Long-term outperformance was almost fully driven by the Shariah screens and the

ESG side of it didn't really have a large contribution because by design, the S&P ESG Index is constructed in an industry neutral basis so that it tends to closely track the conventional parent benchmark."

The ability to reach a wider investor base is often the driving reason to turn to Islamic sustainable finance. Beyond that, the trend toward doing good for the planet and people also attracts Islamic finance institutions to capitalize on this swelling demand.

Private capital really is vital and this presents a considerable opportunity for the Islamic capital markets to mobilize funding and is also a very unique opportunity for Islamic finance

"In Europe, you will see green issuances resulting in savings of at least up to 10 basis points as compared to normal issuances. But in the case of Asia, including Malaysia, generally the difference is very marginal," Chung Chee Leong, CEO of Cagamas, Malaysia's national mortgage corporation and the country's largest debt issuer, shared. "In our case, we managed to get two basis points (in savings) for our 2020 issuance. With increased awareness, we will probably see in the future, potentially some savings issuing sustainability Sukuk as compared to regular Islamic offerings." Cagamas in 2020 priced a combined issuance of its inaugural ASEAN Sustainability SRI Sukuk and Islamic medium-term notes totaling RM450 million (US$106.08 million). Proceeds from the SRI paper was used to specifically fund the purchase of eligible Islamic financing for affordable housing.


Leong

Urgent needs, attractive opportunities

For the most part, Islamic sustainable finance is here to stay, especially as the pandemic has created an urgent need for funding to recover.


Schwalbenberg

"There is now a much greater focus on how to build back better as we come out of COVID. Many of the people who have been impacted the most by the coronavirus are in Muslim-majority countries and I think when those countries are looking at how they can rebuild that infrastructure, whether that's health, education, employment, there has been in Europe a very big focus on social bond issuances to try and ameliorate the effect of the pandemic. And those are structures and capital flows that these Muslim-majority countries can also tap into as the world generally tries to support development post-pandemic," noted Farmida.

The Islamic Finance Council UK expects US$30-50 billion in capital for green and sustainability Sukuk up to 2025.

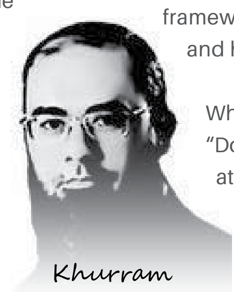
"It has been suggested that we need about US$7 trillion in infrastructure investment annually and between US$1.5 trillion to US$4 trillion every year for energy transition to meet the Paris [Agreement] targets; and with the commitments of the Glasgow Climate Pact, I'm sure

those numbers will then be increased and there aren't sufficient public funds to satisfy this. So, private capital really is vital and this presents a considerable opportunity for the Islamic capital markets to mobilize funding and is also a very unique opportunity for Islamic finance," according to Jennifer Schwalbenberg, the chief governance officer for the DDCAP Group.

The starting point is to understand and be aware of what the conventional [space] is doing, then look at your industry, see where you can capitalize on the things that you already have and then develop the things that you like

COP 26 [UN Climate Change Conference 2021], contentious as it may have been, nonetheless pushed various nations toward some serious climate commitments.

"The UAE was the first in the Middle East to announce their net zero ambition followed by Saudi Arabia and you must acknowledge that it's not easy for these countries. For these countries, which are some of the largest oil-producing countries in the world, to go next zero, they have to invest much more and they have to make much more effort as compared to other countries," said Khurram Hilal, CEO of group Islamic banking at Standard Chartered Bank.



This year's UN Climate Change Conference saw the formation of the Glasgow Financial Alliance for Net Zero, a global coalition of 450 institutions from 45 countries committed to accelerating the decarbonization of the world economy and reaching net zero emissions by 2050. These institutions are not only augmenting their internal policies but also revising their investing and lending criteria for projects focusing on achieving net zero, signaling deep capital flows into the sustainable finance sector.

Turning words into action

So how do we, as an industry, capture these Islamic sustainable opportunities? As Schwalbenberg observed: "We had two weeks of moving intentions and wonderful announcements [at COP 26] but now we need to put that into reality and make it happen. It's no longer about goals and aspirations. It really needs to be about action. And with this, I think there really is a key role in the Islamic finance agenda for green finance, but also transition finance."

Bashar concurs. "I think the starting point is to understand and be aware of what the conventional [space] is doing, then look at your industry, see where you can capitalize on the things that you already have and then develop the things that you like. First is to build awareness, then realization of putting strategies and regulations and frameworks to improve that and then installing that in the system and having an ecosystem and incentivize issuers."

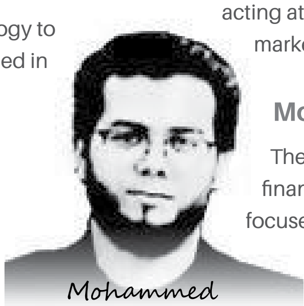
When it comes to regulations and policies, Dr Scott's advice is: "Don't be afraid of regulation – that's the first step. Look internally at your internal processes, have a brief read of the UN SDGs and understand where you fit into the things that the world is talking about at the moment."

At the heart of this movement is the importance of nurturing the right people to drive this change.

"We need to think about how do we get staff in Islamic banks to be equipped with the right knowledge? How do we create a future-ready workforce? We need our training and our learning institutions to focus in this area because this is the future of finance. They need to help develop the next generation of Islamic bankers who understand the dynamics of sustainable finance, who understand climate change, net zero carbon footprint, social finance and inclusion. They need to be fully up to speed with these concepts and not just knowing them, but also owning these concepts and also championing [them]," Khurram strongly believes.

Leveraging tech

And just as the Islamic finance industry is using technology to advance their cause, technology should also be leveraged in our journey of Islamic sustainability.



"Technology can definitely play a significant role in achieving environmental and social goals. We have instances of application of blockchain technology and Islamic social finance, such as the use of digital identities for monitoring the end-use of the contents of funds, as well as the preservation or development and proper use of Waqf or Islamic endowments for achieving various societal goals. Most of such goals find a place in the UN Sustainable Development Goals (SDGs)," according to Mohammed Alim, CEO-designate of IBF Net Group.

IBF Net is currently working on miniaturizing the Islamic economy, with a focus on Islamic social and sustainable finance using blockchain technology, and has launched several projects to this end. One of the projects is the Confluence platform which seeks to measure the impact of projects from the standpoint of Shariah and the UN SDGs.

"The platform combines the performance of the given projects against these metrics using an algorithm and produces a score or a classification scheme. This score reflects the impact of the projects using the lens of Shariah objectives, as well as the SDGs as perceived by the stakeholders. Given the availability of tools for measurement of environmental and social impact, for example carbon footprint, our platform identifies and adopts a suitable method for measurement and conversion of such impact into social cryptos. In this case, products can earn or liquidate such cryptos, which represent both types of impact acting at an exchange to alter their risk return impact profile in the market," Mohammed explained.

Moving forward

The notions of sustainability and ethics are not new in Islamic finance, although it is only in recent years that the industry is focused on harnessing and delivering sustainable impact in a more formal and structured manner. To many, this is the future of Islamic finance.

"This trend is a growth trend and I think this has already been cemented in the past three years; even at the height of COVID-19, we saw this segment growing, and I think this will continue in the short to medium term at least. If the government's strategies and milestones and objectives are really pursued in a very dedicated way, we could see more transformation of this segment, even in the long term, where it becomes a significant part of the industry," Bashar opined.

The push is also seen from the demand side, encouraging the supply side.

"We're definitely seeing a high level of demand from clients around the world for both ESG and for Islamic indices. Both of these are big areas of focus for us as an index provider. There have been significant inflows into ESG index products, including ETFs [exchange-traded funds] around the world over the past year, and we've also started to see Islamic ETFs in the US and Canada really gather momentum," Orzano shared. "I think the investment community is really just starting to think about combining broad-based ESG and Shariah investing together. I think we're likely to see a lot of new product development in the space over the next few years."

Schwalbenberg concurred: "I think as the strength of this agenda in the market increases, and that momentum builds, we will see the different institutions increasing their offerings and their options to the market. And it will be organic because as the sustainable finance sector grows and the products and services and practices become more prevalent, institutions will become more cognizant of this and they will realize they will miss opportunities and be at a disadvantage if they don't participate. Islamic sustainable finance will be recognized as the new normal and commitment will follow."

Corporates and Islamic issuers are already lining up their ducks.

"We see a lot of our traditional energy clients setting up new projects in a sustainable and renewable way and we are expecting a number of projects that were conventionally financed now being refinanced in a sustainable way going forward. So as a firm, we are expecting to do a lot more sustainable finance, certainly in the conventional markets, but hopefully much more in the Islamic markets as well," Farmida shared. It is learned that Cagamas and Standard Chartered are each preparing to introduce new products. Chung, CEO of Cagamas, revealed that the firm is looking to issue green Sukuk while Standard Chartered is working on expanding its Islamic green mortgage offering, Islamic social finance tools and Islamic ESG wealth management services, and is building on creating sustainability solutions for the wider Halal market including Islamic sustainable supply chain instruments.

As the multitrillion-dollar Halal industry continues to grow in its own space and globalize, I think it is important that they harness the socially responsible funding mechanism

"I think it's a great opportunity for growth that and we have this great upside in front of us," Khurram explained. "As the multitrillion-dollar Halal industry continues to grow in its own space and globalize, I think it is important that they harness the socially responsible funding mechanism, mechanisms of Islamic finance and strive to give holistic Halal solutions to faith-conscious clients.

"We need more innovation, we need more solutions in this space. This is an open field for all banks, all partners to come in and play their role."

By Sunita Rajakumar, the chairman of Climate Governance Malaysia, the second country chapter of the Climate Governance Initiative, founded in May 2019. The Climate Governance Initiative currently has more than 20 chapters around the world.

Authored by

CLIMATE GOVERNANCE MALAYSIA

"Climate change is a complex and inherently systemic issue making it an extremely difficult risk and opportunity to manage."
— World Economic Forum's Principles of Climate Governance

The massive build-up of ambition, expectations and momentum prior to the two-week Conference of the Parties to the United Nations Framework Convention on Climate Change in Glasgow (COP26) proved too weighty for the frail shoulders of mere politicians and leaders. More than 100,000 protesters took to the streets of Glasgow alone, significantly more than anticipated, while an estimated 500 representatives were present from the fossil fuel industry alone, significantly more than any single country.

The present outlook is a grave warning that global leaders simply do not have the capacity or political will or, for other reasons, are not able to set aside their differences and priorities to be able to effectively attain consensus about the action which is urgently needed in this existential crisis, as informed by science.

This could signify various responses:

- Governments which understand the enormity of the crisis and consequences will invest their time and resources in adaptation measures, to ensure a just transition within their spheres of influence.
- Civil society will endeavor to fill this vacuum and take the lead.
- Business strategies will continue to bifurcate sharply between those who understand the extent of the transition and those who do not and are essentially betting against society succeeding.

The unprecedented momentum of the past two years has been based on science and seen both prudential regulators (central banks, monetary authorities) and capital market regulators (securities commissions, stock exchanges) as well as allocators of capital (institutional investors, banks, insurers) demand for enhanced reporting and disclosure so they can make better informed decisions, as capital needs to be diverted away from businesses, industries, regions and countries which still have not internalized the enormity of this transition and are not prepared for a smooth transition.

The ultimate consideration is very clear: there can be no successful business on a dead planet ['companies do not succeed in isolation']. There is increasing evidence, especially from meta studies, that enterprises which have strong credentials in environment, social and governance (ESG) factors are delivering better risk-adjusted returns and financial performance. Non-ESG focused businesses will increasingly lose access to capital markets as allocators of capital signal that business and financial stability is synonymous with environmental stability.

Some of the key challenges facing many countries are:

- Lack of national and local climate-related data to make informed decisions, with such data needing to be accurate, timely and relevant.
- The absence of forward-looking scenarios which are relevant for their industry and region.
- Adequate policy signaling from legislators in decarbonizing the economy and the transition strategy, specifically necessary adaptation measures.

Science

Humans have relied on environmental and climatic stability for societies and civilizations to prosper and mature, yet the greatest existential crisis which human civilization is now facing involves the destruction of the natural conditions necessary for our own survival.

The effects of the triple crisis of climate, destruction of biodiversity and pollution are clearly established as arising from human activities. Changes in water cycles, rainfall patterns, sea level rise, the ocean and extreme weather events are further amplified by a rapid increase in urbanization and the destruction of the natural environment. Malaysia and Southeast Asia will be disproportionately adversely affected by rising temperatures.

Further, the Paris Agreement of December 2015 was not just about reducing emissions across all sectors, but about remaining within planetary boundaries, including the need to keep carbon sinks in nature intact and preserve nitrogen, water and phosphorus cycles. The majority of earth's massive biosystems have reached or are very close to tipping points beyond which reversion will be impossible or could take centuries, including the Atlantic Ocean's key circulation system with immense consequences for Earth's climate if/when it collapses.

Scientists have been warning about the consequences of the climate emergency for many decades — 'the world listened but did not hear' — and guided that global emissions need to be halved by 2030, just over eight years away, and be net zero by 2050.

Landmark commitments to decarbonizing include OECD countries by 2050 while China, Russia and Indonesia have committed to net zero by 2060 and India by 2070. It is important that these commitments are based on the reduction of absolute emissions, versus emission intensity, accompanied by a declaration of when emissions will peak, while considering the different combinations of transition of physical risks.

To illustrate the sheer scale of reduction which is necessary, in 2020, with almost the entire world under lockdown, during the COVID-19 pandemic, the International Energy Agency estimated that emissions only reduced by 6%.

The UN's Intergovernmental Panel on Climate Change's 6th Assessment Report issued in August 2021 is much more comprehensive, with over 234 authors having assessed more scientific evidence than ever before. It was described by the secretary-general as a "Code Red for Humanity" and compacted the expected range of warming to be between 2°C and 4.5°C.

[In the five previous assessments, the IPCC estimated the range of warming would be between 1.5°C and 4.5°C. The 6th Assessment Report is an unprecedented warning that limiting warming to 1.5°C is no longer an option, based on current declared national targets, the majority of which are not yet backed by legislation or frameworks for implementation. The minimum threshold of warming of 2°C is already locked into the ecosystem.]

So, the implications are clear: climate has already warmed by 1.2°C in 2021 [during a La Nina phase] and there is a high likelihood of achieving 1.3°C of warming during an El Nino year in 2022, which will cause massive upheaval around the world.

Therefore, with warming of 1.5°C well within range, it is increasingly clear that a decarbonization strategy alone is insufficient; in a crisis where no business or industry sector will be untouched, there is an urgent need to consider the needed resources, scenarios and strategies to ensure adequate adaptation measures for the impacts of climate change which would likely be prohibitively costly, damaging and deadly.

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Direction of travel

Emissions can be traced to sources, indicating those industry sectors and businesses which are significant emitters.

As carbon is unequivocally recognized as an environmental pollutant which is destroying the natural conditions necessary for our own survival, this leads to a real and present danger that corporate earnings are misstated where it fails to capture the price of carbon. Further, nations which have declared climate ambitions and targets are reluctant to be accused of outsourcing their emissions.

Thus, there are increased concerns of drastic action in the near future, such as the inevitable policy responses from governments that have a vast arsenal of policies they could implement at short notice, including regulations and taxes.

Virtually every transition scenario is built on the pillars of electrification of multiple activities [such as transportation, heating, buildings, industrial processes], increased source of green fuels [such as hydrogen, renewable energy] and preservation of carbon sinks and biodiversity [halt to deforestation, restoring degraded ecosystems].

Asia, which accounts for 36% of global GDP, has made great progress in economic development and poverty reduction, but it is also responsible for around 80% of the world's coal consumption and up to 60% of current CO2 emissions.

Thus, a critical global fault line is the lack of financing of clean energy investments in developing countries. Fatih Birol, the executive director of the International Energy Agency, observed that while rich countries were cutting their emissions, some developing countries would continue to increase theirs unless they could gain more in shifting to a low-carbon economy.

"More than 90% of emissions in the next two decades will come from emerging economies, but they are less than 20% of global clean energy investments," he said. "If we can't accelerate the clean energy transition in these countries, I believe this will be the most critical fault line in global efforts to reach climate goals."

There are recent laudable efforts in the region to enable the early decommissioning of coal power plants but a persuasive argument has been advanced, based on the principles of equity, that the party responsible for any damage must be accountable for the reparation, also described as 'common but differentiated responsibilities'.

The argument is that those countries which have contributed historically to the bulk of accumulated emissions have an opportunity to demonstrate leadership in limiting emissions, restoring ecosystem stability and extending assistance [whether soft loans, grants or knowledge transfer] to those countries which will be adversely and disproportionately affected, through no act of their own.

This is a persuasion to reduce emissions but meanwhile, significant work is needed within each jurisdiction to ensure adaptation measures are well underway.

Existing plans to limit global warming rely too much on "increasingly unrealistic assumptions" that societies will be able to remove huge amounts of carbon from the atmosphere while simultaneously maintaining incessant economic growth over the next 50 years, according to a May 2021 **study** in Nature Communications. These strategies appear to be speeding the planet deeper into the climate crisis, the authors said.

Another option is economic degrowth — strategies to shrink the economies of rich, developed countries while maintaining the wellbeing of the people and environments they are based on — which appears to be less risky, and possibly, a better way to simultaneously meet both the goals of the Paris climate agreement and a growing population on earth.

Some conversations are still focused on raising awareness and encouraging a willingness to pay [also described as a 'green premium'], which might not be an accurate way of describing the consumer's purchasing decision. It stands to reason that with an existential crisis, there are many opportunities to generate significant value, especially where staggering amounts of capital are looking for sustainable investment opportunities which, in turn, will need appropriate risk allocation models. Businesses which are able to provide products and solutions which are simply better value for money, more attractive and efficient, while being sustainable and good for the planet, will clearly have an edge and break away from competitors.

Many countries have already experienced the devastating consequences of climate change: floods, droughts, heat waves and storms. We will not be able to self-isolate from these events. While we urgently need to focus on the quality and integrity of these promises made by nations and alliances, and ensure that commitments actually support the real economy transition, it is clear that business leaders are the key drivers of this transition.

Business leaders

Thought leaders in business are responding decisively to help address the clear and present dangers of the climate emergency, demonstrating they can be a force for good, advocating for and supporting long-term value-accreting zero-regret investment decisions to future-proof their business and communities, as well as increasing our collective climate resilience.

Thought leaders in business are responding decisively to help address the clear and present dangers of the climate emergency, demonstrating they can be a force for good

First-order implications which need addressing are physical and transition risks, including an understanding of what the extent of exposure is and an assessment of resilience to adverse climate events [such as fire, floods].

As mitigation efforts alone are no longer sufficient, leaders need to deepen their thinking and efforts on second-order implications including the availability of foreign labor, institutional stability and other significant social impacts such as mass climate migration, huge social disorders, which can escalate very dramatically and very quickly.

However, while such leaders are evolving their transition strategy to be a competitive advantage, there are laggards among the boards: one of the key findings from a recent Deloitte Asia Pacific survey was that 72% of audit committees had not completed a comprehensive climate change assessment.

In Malaysia, the central bank [Bank Negara Malaysia], which joined the global Network for Greening the Financial System in 2018, is very clear: the climate crisis poses a systemic risk to the financial system; it is simultaneously foreseeable and yet unpredictable. The prudential regulator is relying on licensed entities to be high-impact contact points with customers in raising awareness on sustainability ['force for positive change'], starting with the recently-issued Principle-based Taxonomy, which will also increase capacity as institutions grapple with implementing these principles internally.

The upcoming International Sustainability Standards Board standards in June 2022 will be a game-changer, having galvanized multi-stakeholder inputs in less than a year. The prototype disclosure requirements issued by the Technical Readiness Working Group during COP26 requires a level of granularity which we are certainly unaccustomed to, including detailed transition plans; how investments in research and development relating to mitigation, adaptation and identifying opportunities are being advanced internally; how assumptions underlying the accounts are aligned to Paris; which scenarios were used for the assessment; inputs into the scenarios; and policy assumptions.

Directors also need to be fully alert to misalignment of interests and attention between the board and management. As climate risks are longer-term and often extend beyond the considerations of the typical business planning cycle, this can lead to a phenomenon former governor of the Bank of England Mark Carney described as the "Tragedy of the Horizon".

It is abundantly clear that the costs of inaction are significantly more than the costs of action but, despite the increased ambition recently demonstrated in the nationally determined contributions, which signatories to the Paris Agreement are required to submit, and industry-wide commitments [most noticeably Glasgow Financial Alliance for Net Zero or GFANZ with an eye-watering US$130 trillion of assets backing it], all of the stated intentions need to be translated into legislation or policies; almost none of the assets are net zero today or fossil fuel-free while new fossil infrastructure is still being supported and financed, most famously the auction of a colossal 81 million acres to be leased by the US government for oil and gas production in the Gulf of Mexico, just four days after COP26 in Glasgow.

To be clear: a decarbonization strategy is a subset of the transition strategy. When we are not pricing in the cost of pollutants or environmental destruction which critically impairs our ability to be resilient, are we misstating earnings of corporations worldwide? And if so, who are the stewards of the business who would be responsible for that?

Many investors are naturally using this difficult conversation as a proxy to the quality of management: starting with understanding of the issues [climate literacy] and measuring internal carbon, waste and water footprints as well as energy efficiencies, closely followed by benchmarking to best practices, reporting and disclosure in accordance with the Taskforce for Climate-related Financial Disclosure and finally, setting science-based targets for carbon emissions and/or a declaration of operating within planetary boundaries.

Climate governance

The best practices of corporate governance require the majority of the board of directors, including its chairman, to be independent non-executive directors. These non-executive directors need to be sufficiently climate-literate to guide the direction of travel of the business they are accountable for as well as grapple with the forward-looking concepts of double materiality — where issues material to environmental and social objectives may develop financial consequences over time — and dynamic materiality — "what appears financially immaterial today can quickly prove to be business-critical tomorrow".

In January 2019, the World Economic Forum issued the Principles of Climate Governance which have proven to be a valuable framework for boards to adopt in developing climate resilience and recognizing the opportunities which are arising. Issued in the format of a set of principles with guiding questions for directors to consider, they walk the board through key considerations which recognize the important role directors are to play in embedding climate literacy across board committees and throughout the organization.

These principles are "intended to enhance the discussions on climate competence of directors to the extent that climate risk considerations become embedded in normal board processes. This should enable better-informed investment decision-making, more systemic thinking and an integrated approach to crafting and implementing [a] business strategy that is informed by consideration of climate impacts in both the short and long term."

Principle 1 — Climate accountability on boards
The board is ultimately accountable to shareholders for the long-term stewardship of the company. Accordingly, the board should be accountable for the company's long- term resilience with respect to potential shifts in the business landscape that may result from climate change. Failure to do so may constitute a breach of directors' duties.

Principle 2 — Command of the (climate) subject
The board should ensure that its composition is sufficiently diverse in knowledge, skills, experience and background to effectively debate and take decisions informed by an awareness and understanding of climate-related threats and opportunities.

Principle 3 — Board structure
As the stewards for long-term performance and resilience, the board should determine the most effective way to integrate climate considerations into its structure and committees.

Principle 4 — Material risk and opportunity assessment
The board should ensure that management assesses the short-, medium- and long-term materiality of climate-related risks and opportunities for the company on an ongoing basis. The board should further ensure that the organization's actions and responses to climate are proportionate to the materiality of climate to the company.

Principle 5 — Strategic and organizational integration
The board should ensure that the climate systemically informs strategic investment planning and decision-making processes and is embedded into the management of risk and opportunities across the organization.

Principle 6 — Incentivization
The board should ensure that executive incentives are aligned to promote the long-term prosperity of the company. The board may want to consider including climate-related targets and indicators in their executive incentive schemes, where appropriate. In markets where it is commonplace to extend variable incentives to non-executive directors, a similar approach can be considered.

Principle 7 — Reporting and disclosure
The board should ensure that material climate-related risks, opportunities and strategic decisions are consistently and transparently disclosed to all stakeholders — particularly to investors and, where required, regulators. Such disclosures should be made in financial filings, such as annual reports and accounts, and be subject to the same disclosure governance as financial reporting.

Principle 8 — Exchange
The board should maintain regular exchanges and dialogues with peers, policymakers, investors and other stakeholders to encourage the sharing of methodologies and to stay informed about the latest climate-relevant risks, regulatory requirements, etc.

As long-term stewards of the enterprise, directors are tasked with identifying material risks and effectively managing them, as well as those opportunities which will arise as a result of the climate emergency

Conclusion

Capital markets are pulling climate risks forward in their assessments of value. Allocators of capital are demanding for increased reporting and disclosure to enable capital to be allocated to those businesses, management teams, industries, regions and countries which appear most capable of making a smooth transition to a greener economy, while diverting capital away from those businesses which still do not appear to comprehend the enormity of this existential risk.

As long-term stewards of the enterprise, directors are tasked with identifying material risks and effectively managing them, as well as those opportunities which will arise as a result of the climate emergency. It will be very difficult for any director to claim they were not fully aware of the material financial risks arising from this critical transition.

Thus, directors need to balance competing board priorities against a backdrop of limited time and capacity to address all strategic topics and the constant pressure to meet expectations of all stakeholders.

When responsible and conscientious directors and businesses accurately anticipate the direction of travel, we can be a force for good.

CLIMATE GOVERNANCE MALAYSIA