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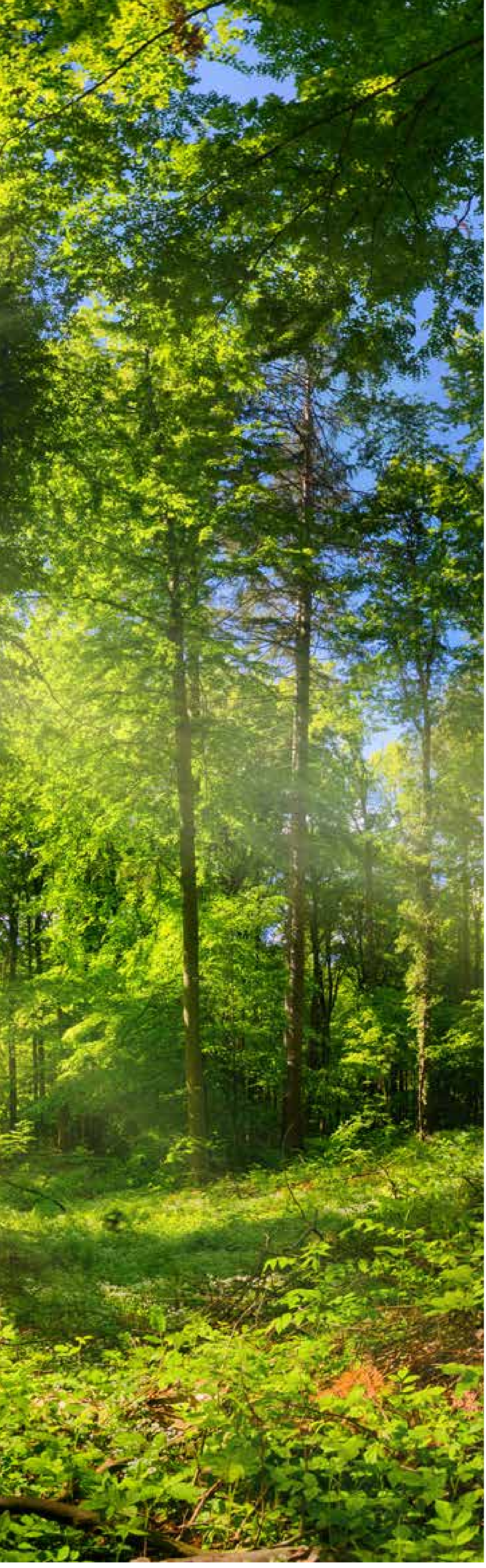
The Climate Change Principle-based Taxonomy and its implications to Financial Institutions

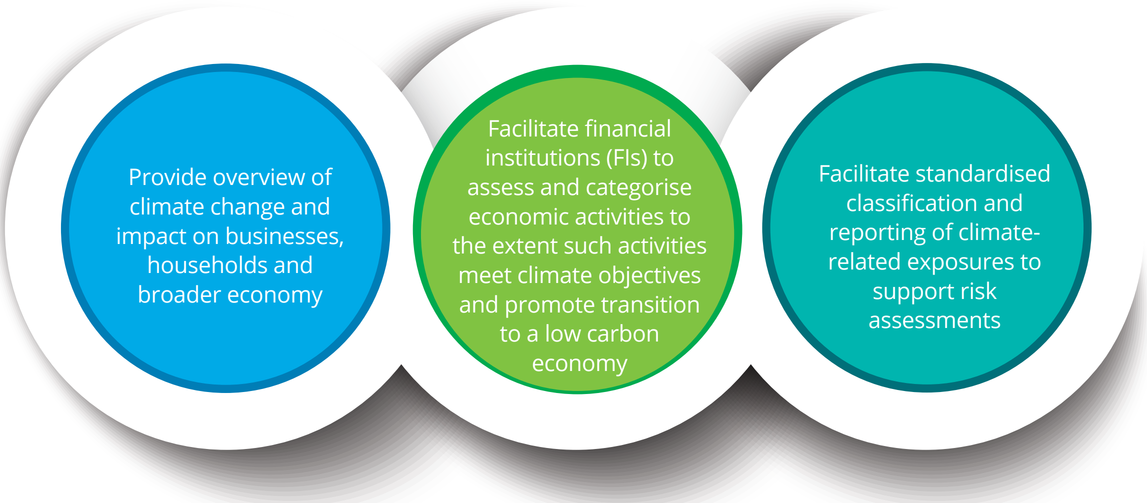


Deloitte's point of view on BNM's Climate Change and Principle-Based Taxonomy and how the financial services industry can implement the guidance paper provided

This document provides a Deloitte's point of view on the BNM's Climate Change and Principle-based Taxonomy (CCPT), its Guiding Principles (GP) and Classification System, and how the financial services industry can better respond to each guiding principle.

Overview of BNM's Climate Change Principle-based Taxonomy

The objective of the Climate Change Principle-based Taxonomy (CCPT) paper is to introduce guiding principles related to climate objectives. This is to provide a standardised classification and reporting of climate-related exposures, to support risk assessments and monitoring of their financing and investments.



The document comes into effect in April 2021.

Scope and applicability of BNM's Climate Change Principle-based Taxonomy (CCPT)

Retail vs Corporate

The CCPT does not distinguish its application for Retail or Corporate customer segments. However, the guidance by design, appears to be more applicable to corporate customers, given that corporate segments have a comparatively higher carbon footprint and is more susceptible to climate risk given its longer facility term tenure.

Intended participants

FIs supervised by BNM i.e. Licensed banks, investment banks, international Islamic banks, Islamic banks, insurers, reinsurers, takaful operators and retakaful operators as well as prescribed developmental financial institutions.

The document may also be used by other financial sector stakeholders such as:

- Capital market players and intermediaries to guide investment and asset selection decisions
- Rating agencies for rating decisions
- Public sectors for policy formulation, prioritisation as well as fund allocation.

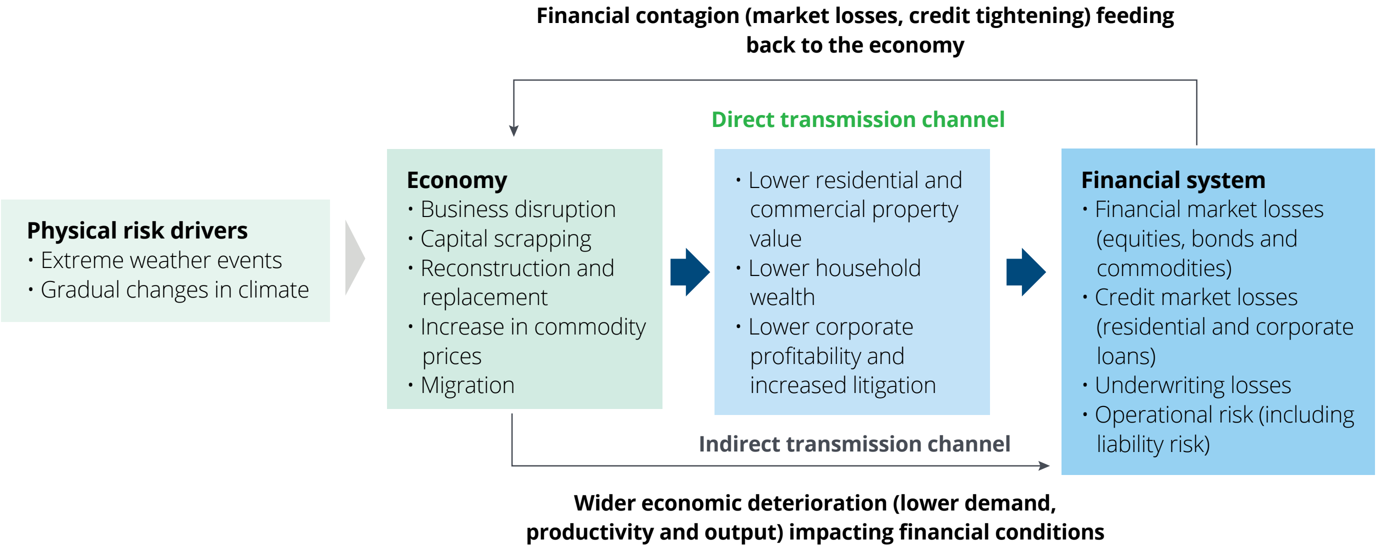
Overview of Climate-related Risk

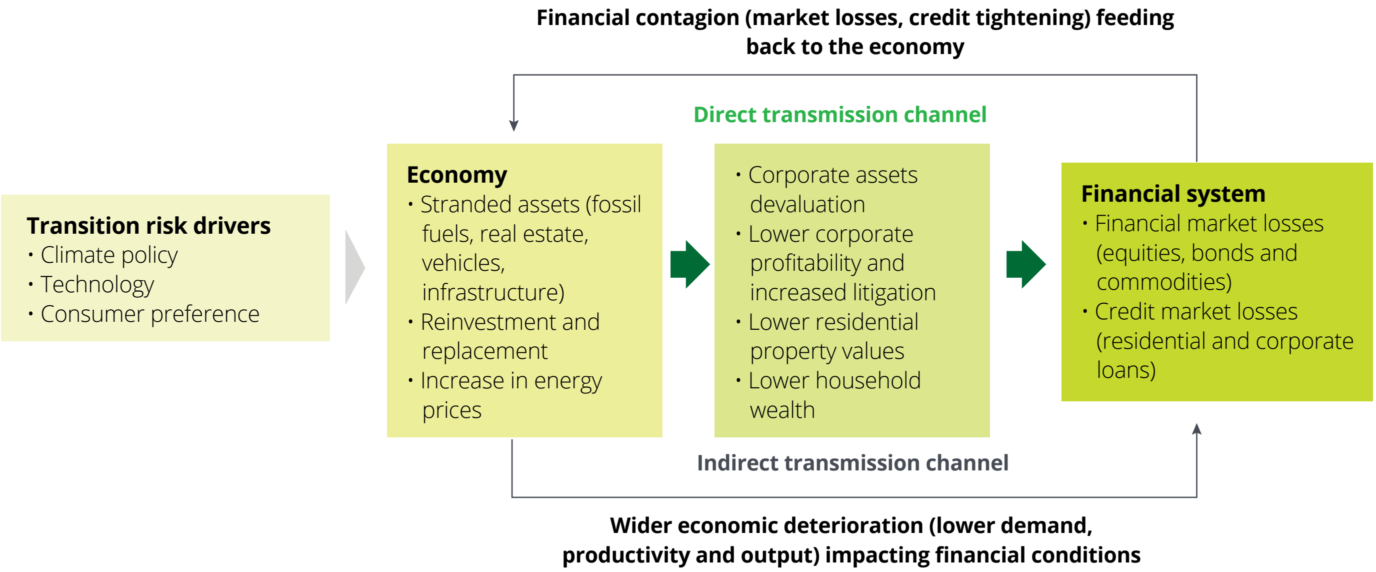
Climate-related risk and its impact on the financial system

The Climate Change Principle-based Taxonomy (CCPT) provides an overview of how the impact of climate change can manifest in three dimensions of risk:

- **Physical Risk** – acute (event-driven) and chronic (long-term shift) climate-related events that damage properties, reduce productivity and disrupt trade.
- **Transition Risk** – occurs as a result of adjustments to a low-carbon economy which may translate to financial and/or reputation risk to FIs.
- **Liability Risk** – stems from legal risk and claims on damages and losses incurred from inaction or lack of action that results in the effect of physical and transition risk – potential result in lawsuits, fines, insurance policy claims.

The diagram below illustrates the transmission of climate-related risks to the financial system:





Source: BNM's Climate Change and Principle-based Taxonomy, referenced against Network of Central Banks and Supervisors for Greening the Financial System (NGFS) publication.

Summary of Guiding Principles and Classification

The CCPT introduces 5 guiding principles for evaluating economic activities. The economic activities are then expected to be classified into one of the 5 classifications outlined by BNM.

Economic activities refer to the business activity that are being financed/insured/invested in by the FIs.

5 Guiding Principles (GPs)
to assess economic activities funded/invested in
- Climate Change Mitigation
- Climate Change Adaptation
- No significant harm to environment
- Remedial measures to transition
- Prohibited activities

5 Classifications
according to 3 classification themes to categorise economic activities
- Climate Supporting (C1)
- Transitioning (C2 and C3)
- Watchlist (C4 and C5)

Mapping of GPs to the Classification System

Facilitating the classification of economic activities
Economic activities are classified into 3 broad categories comprising 5 classifications based on how they meet the criteria of Guiding Principles GP1 - GP4:

Classification		Economic activity (Transaction level)		Overall business	
		GP1	GP2	GP3	GP4
Climate supporting	C1	GP1 or GP2 or both		✓	
Transitioning	C2	GP1 or GP2 or both		×	✓
	C3	×		×	✓
Watchlist	C4	GP1 or GP2 or both		×	×
	C5	×		×	×

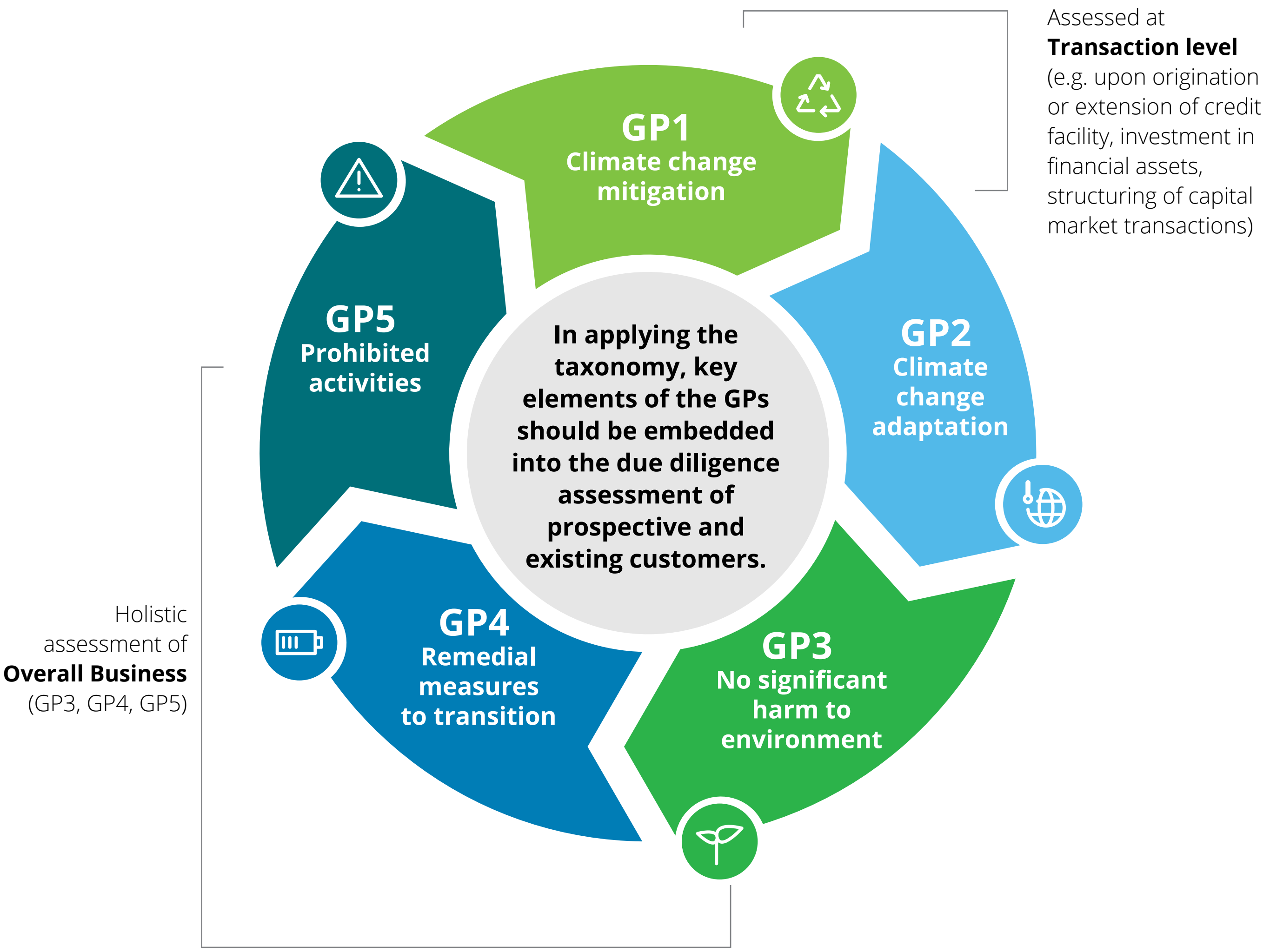
Note:
GP1: Climate change mitigation; **GP2**: Climate change adaptation; **GP3**: No significant harm to environment; **GP4**: Remedial efforts to promote transition

Other considerations for classification

- An economic activity must be considered together with the overall business on the wider eco-system when considering if it is sustainable.
- Due diligence assessment by FIs for this purpose should include ensuring that there is no track record of environmentally damaging practices.

5 Guiding Principles (GP)

To assess economic activities (to be) funded



Guiding Principle (GP) 1 – Climate change mitigation

Objective: Reduce or prevent emissions of Greenhouse Gases (GHG) into the atmosphere.

Meet GP1 if:

- Economic activity makes substantial[1] contribution in avoiding, reducing or enabling others to avoid or reduce GHG emissions.
- While contributing to climate change mitigation, the activity should not cause significant negative impact on the broader environment.

Examples:

- Generation of renewable energy, rehabilitation, retrofitting and/or replacement of energy inefficient technology and/or production of energy-efficient technologies, maintenance and strengthening of land-based carbon stock and sink[2], above and below ground

Guiding Principle (GP) 2 – Climate change adaptation

Objective: To increase resilience to withstand adverse physical impact of current and future climate change.

Meet GP2 if:

- Implement measures to increase own resilience to climate change or enable others to increase resilience to climate change.
- For adaptation activity to increase own resilience, the adaptation activity shall reasonably reduce material physical risk from current and future climate change. Impact assessment under a broad range of climate scenarios shall be conducted to provide better understanding and insight into effectiveness and benefits of adaptation activity.
- For an adaptation activity that is enabling adaptation of other economic activities, the activity shall reduce the impact of material physical risk from other economic activities and/or reduce barriers to adaptation through use of technology, service or product.
- The economic activity, while contributing to climate change adaptation, should be sustainable, does not negatively impact other adaptation efforts, or cause harm to the broader environment and community.
- The economic activity should have climate change adaptation outcomes that can be clearly defined. The outcomes shall be sustainable and fit-for-purpose. These outcomes should be observable, measurable and monitored over time against a set of pre-determined indicators.

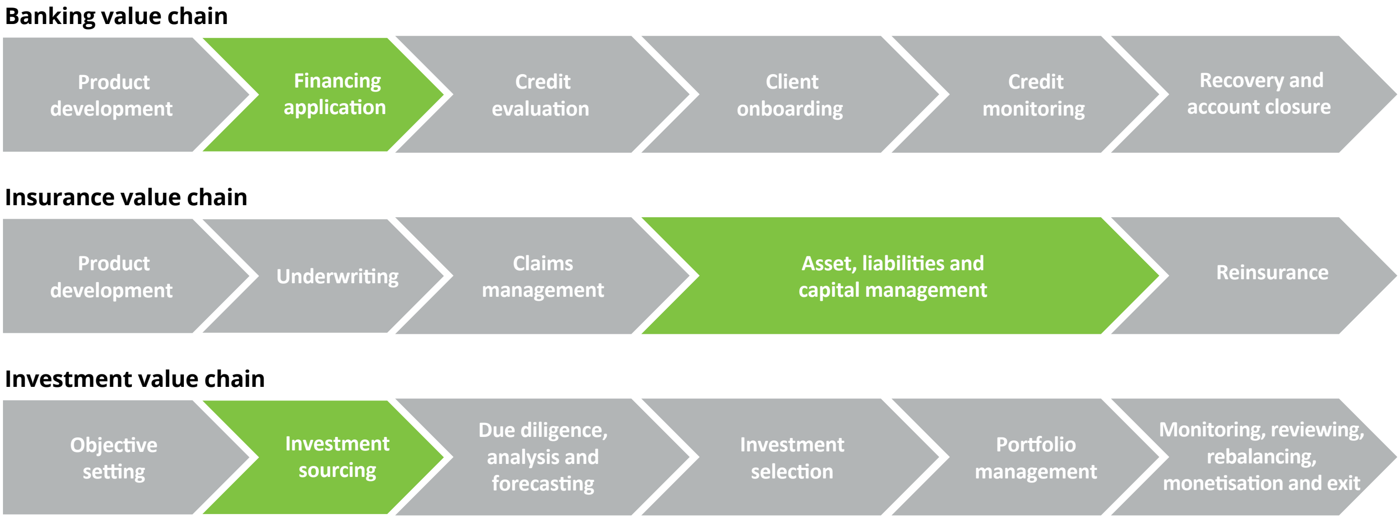
In order to demonstrate criteria – identify expected negative physical effects of climate change by leveraging evidence and appropriate climate information and demonstrate how the activity taken can build resilience, prevent an increase or shift the identified negative impact of climate change.

Examples:

- Use of environmental early warning systems as a preemptive measure to reduce flood damage, building flood barriers or walls to protect from future flooding, soil and water management to increase water availability in increased water stress areas.

[1] Positive impact from the activities should not be negligible and must be material enough to avoid potential greenwashing.
[2] Economic activities involving maintenance and strengthening of land-based carbon stock and sinks, above and below ground can only be recognised as meeting GP1 if undertaken at the source of emissions.

Considerations for embedding GP 1 and GP 2 criteria into business operations / risk management process



1. Embed criteria into financing/investment assessment criteria (at origination or upon facility/customer review).
2. Establish detailed guidance/threshold for front office to implement as part of their business-as-usual financing/investment activities based on widely accepted industry practice for consistency.
3. Collaborate among FIs to establish a consistent approach in assessing an economic activity, setting appropriate environmental threshold(s) and resolution across the industry. FIs and project owners may need to engage third party consultants/ environmental or climate change risk experts to assist in technical verification.
4. Identify type of information required to perform the assessment and source of data/information required to perform assessment (i.e. request directly from borrowers/investee/the insured) and/or through publicly available information:
   - Evidence of climate risk mitigation, adaptation and/or remediation measures
   - Social and human rights compliance and risk mitigation plans
   - Climate risk impact assessment
   - GHG emissions calculation
   - Reporting and disclosures
   - External certifications and verification
5. Communicate identified data and information required to be furnished by borrowers/investee/the insured (i.e. by extending checklist, website notice, customer on-boarding program etc.).
6. Consider lead time for financing approval when designing processes to embed additional due diligence activities to support implementation of CCPT.

Guiding Principle (GP) 3 – No significant harm to the environment

Objective: Ensuring that while economic activity may contribute towards climate risk mitigation and/or adaptation, the activity and overall business does not cause unintended harm to the broader environment

Meet GP3 if:

- The following environmental objectives are met:
  - Prevent, reduce and control pollution (air, water and land)
  - Protect healthy ecosystems and biodiversity, and
  - Use energy, water and other natural resources in a sustainable and efficient manner

Examples:

- Undertake cleaning measures immediately when there is a pollution, proper waste management practices, prevent soil erosion and run-off into watercourses, avoid land/site use on protected natural areas.

Banking value chain

Insurance value chain

Investment value chain

- Establish clear risk acceptance criteria for informed decision making, particularly in assessing if the economic activity and overall business is at risk of causing significant harm to the environment. All periodic monitoring and remediation activities must use a risk-based approach to address ecosystem and biodiversity concerns, including human-health risks.
- Embedding assessment on portfolio's progress of transitioning towards climate supporting (C1) category as part of annual due diligence assessment criteria.
- Look into activities that are genuinely 'green' to prevent pollution from one medium to another. Generally, certification serves as a starting point to understand the assessment criteria used and the strength of emphasis placed on specific climate and/or environmental objectives. FIs may also look into eco-labelling schemes as labels for environmentally responsible products/businesses.
- Obtain assurance that the certification can strongly demonstrate substantial contribution to climate and/or environmental objectives.

Guiding Principle (GP) 4 – Remedial measures to transition

Objective: To support an orderly transition by avoiding any outright exclusion of economic activities that are currently not contributing to climate change objectives and/or not sustainable.

Meet GP4 if:

- Remedial efforts are taken by businesses that directly contribute towards eliminating or significantly reducing the risks and impact towards the climate and/or environment.
- Commitment is demonstrated by the business through development, practice, or commitment of sustainable practices to ensure business is conducted in a sustainable manner, having all parties involved understand the potential risks and appropriate mitigating actions are taken to reduce any adverse climate and/or environmental impact.

Examples:

- Waste management remediation to prevent environmental pollution from waste excretion, strategic business targets to reduce GHG emissions from current levels, clear milestones on GHG emission reduction plan and/or reducing business impact on environment, time-bound commitment to pursue external certification/validation.

Banking value chain

Insurance value chain

Investment value chain

- Determine strategy to manage portfolios that are not aligned to the bank's ESG framework. FIs should assist businesses to transition to more sustainable practices by encouraging and facilitating businesses to align operations with a low-carbon and climate resilient economy, adopt practices that are both resource-efficient and minimise waste production as propounded by the concept of circularity or a circular economy.
- However, if the business does not demonstrate any meaningful effort or commitment to transition, FIs should consider refocusing the relationship in the near future.
- Expand scope of investing/insuring/lending assessment criteria to include broader ESG considerations for more holistic due diligence on the business transition commitment. FIs to be closely involved in assessment activities, thus ensuring they are aware of broader financing issues and are able to influence and step-in to refine ESG requirements.
- Establish baseline expectation(s) on the broader environmental strategy of businesses by ensuring businesses set mid-term target(s), identify pathways to meet climate objective(s) and establish implementation plan to meet the target(s) over a defined period of time.
- Enhance assessment criteria and conduct assessments to ascertain effects and significance of remedial efforts undertaken by businesses, taking into account business objectives, size of systemic importance to the economy, and impact of efforts to compensate short-term loss/harm to the environment.

Guiding Principle (GP) 5 – Prohibited activities

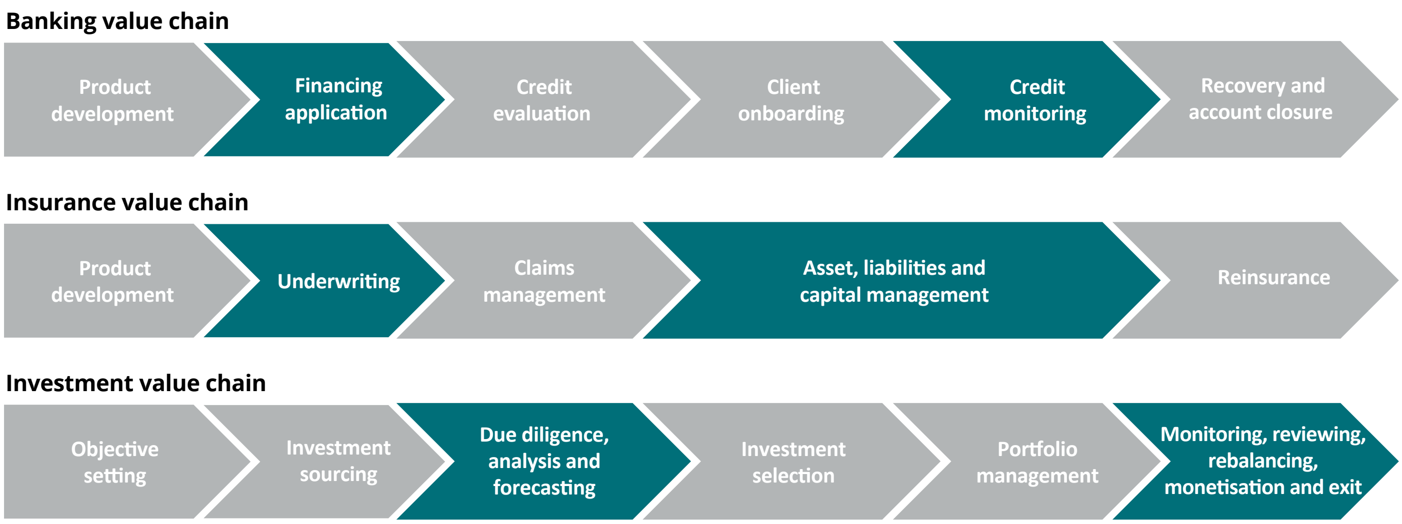
Objective: Economic activities being considered and/or financed are not illegal and do not contravene environmental laws.

Environmental laws include but are not limited to:
- The National Forestry Act 1984
- Wildlife Conservation Act 2010
- National Parks Act 1980
- The Fisheries Act 1985
- The Environmental Quality Act 1974

FIs are also strongly encouraged, as part of their lending and/or investment decisions, to ascertain if businesses are engaged in activities that are in contravention with national human rights and labour laws. These include but are not limited to the following laws:
- Employment Act 1955
- Children and Young Persons (Employment Act 1966); and
- Minimum Wages Order 2018

Examples:

- Operations involving illegal deforestation or the act of illegal deforestation, industrial process operations which involve illegal waste management and release of untreated toxic/hazardous industrial substances, operations involving fire for land clearance for agriculture or urbanisation purposes.



- Establish a list of prohibited economic activities as part of their risk appetite statement.
- Ascertain economic activities undertaken by prospective customers do not contravene any environmental, human rights or labour laws. FIs should not undertake or enter into new prospective customer relationship if the economic activities of the customers contravene any environmental, human rights or labour laws to mitigate potential legal and reputational risk.
- FIs may obtain written statements or enforce compliance clauses signed by customers in the Letter of Undertaking or any other form of facility agreements to give effect to GP5. This provides an avenue for FIs to take necessary actions in the event that customers are subsequently found to be involved in illegal activities post on-boarding. This includes actions to terminate relationships with the customer.

Summary of Classification System

To facilitate classification of economic activities

C1 – C5 represent the different levels of contribution of economic activities towards climate and environmental objectives

C1

The economic activities by the customer meaningfully contribute to climate objectives without causing significant harm to the environment in the immediate future.

FIs should encourage businesses to conduct sustainable business practices and to support climate objectives to reach C1 classification as a target state. FIs may consider providing incentives via e.g. competitive pricing to incentivise customers to achieve desired target state.

C2 – C3

Businesses who undertake efforts to transition to low carbon and sustainable practices but the initiatives and/or businesses may still, in the immediate and immediate future, cause some harm to the broader environment.

The categories C2 and C3 serve to represent the progressive stages of transitioning. FIs should recognise the efforts undertaken by businesses to transition, remediate business practices, and continue to encourage and monitor progress of transition to its desired state.

C4 – C5

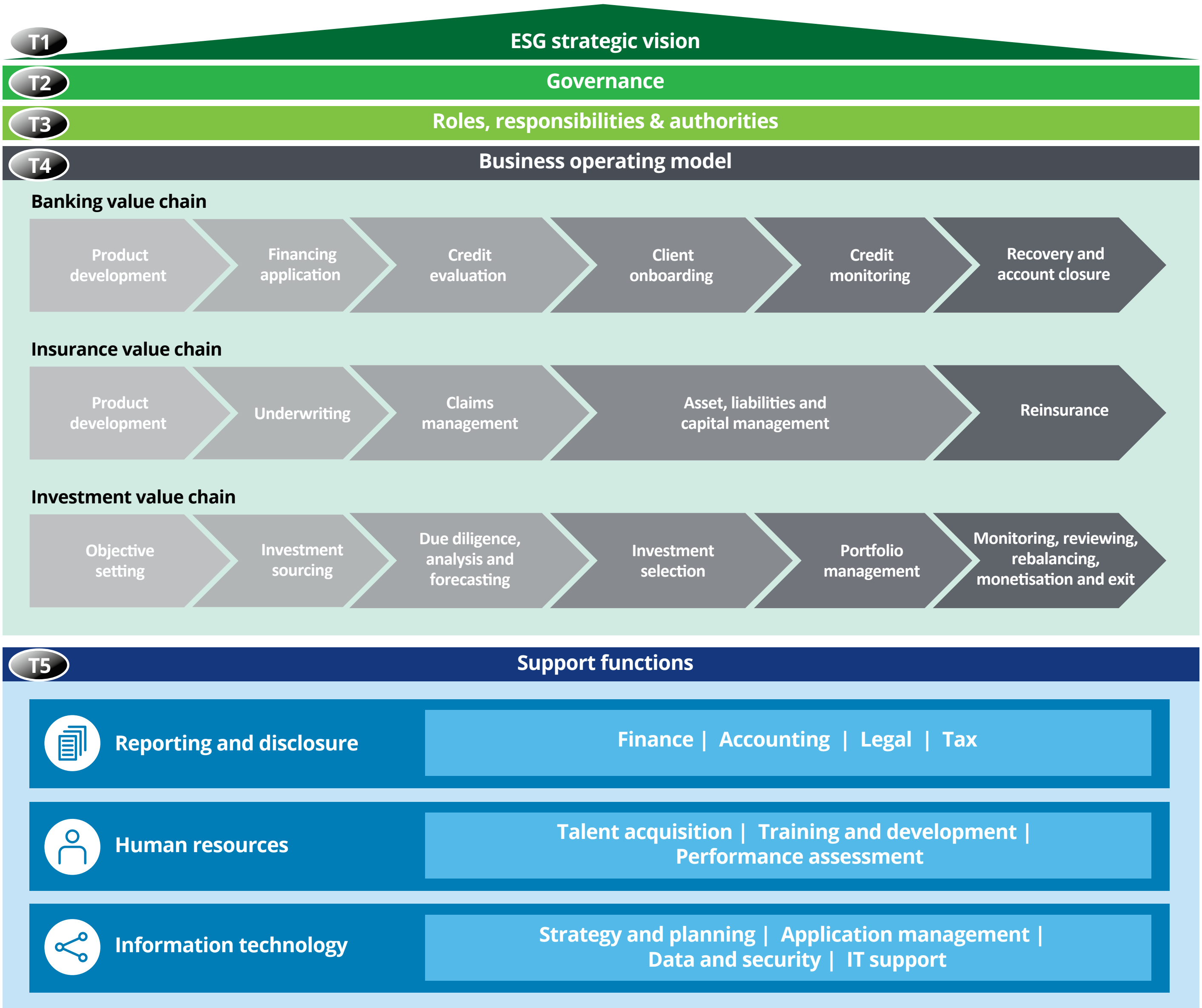
Businesses that do not display any commitment or are not serious in their commitment to remediate the harm identified and/or do not undertake any initiative to transition to more sustainable practices.

These categories reflect the heightened cost of transition and represent reputational risk associated with the economic activity or business. FIs should constructively engage customers in these categories to develop concrete actionable plans to address the identified harm to the environment and promote business viability associated with more sustainable practices.

Should the customer fail to demonstrate serious commitment in implementing remediation measures or failed to effectively limit or reduce harm caused by the activities, FIs can consider applying more stringent lending terms such as a shorter tenure, a lower loan limit, increasing the pricing or reassessing its relationship with the customer.

Considerations to be undertaken to embed Climate Change Principle-based Taxonomy (CCPT) in business operations of the FI

- The CCPT will influence FIs' business operations through their financing and investment decisions, by channeling capital and funds through their green financing, investments and advisory activities.
- The key elements of the CCPT should be embedded within the due diligence of existing and prospective customers, thus elevating the levels of due diligence of customers to incorporate considerations of purpose of credit facilities, investment in financial assets and structuring of capital market transactions in meeting the climate objectives and environmental considerations.



*T: Target Operating Model

What does Climate Change Principle-based Taxonomy (CCPT) mean to FIs and recommended actions

T1 T2 T3

Governance and strategy

- Establish governance structures such as dedicated committees and/or functions for oversight and management of sustainability and climate-related risks.
- Incorporate climate considerations into business strategy and/or develop a holistic bank wide sustainability strategy as 'tone from the top' and to institutionalise the mindset and advocacy for sustainability throughout the organisation.
- Clearly establish roles and responsibilities of senior management to integrate climate-related considerations into business operations, decision making and risk management for management of sustainability and climate-related risks.

T4 T5

Risk management

- Integrate climate-related risks considerations into bank-wide risk appetite framework to guide strategic direction and approach when implementing the CCPT to align initiatives undertaken with FI's overall strategy.
- Embed climate-related risk considerations into bank-wide risk management frameworks, policies, processes and practices.
- Establish data requirement needs and consider exploration of metrics or science-based targets to guide assessment criteria.
- Consideration to promote transparency via voluntary disclosure of climate-related risks and information aligned to recognised sustainability reporting/disclosure standards

T4

Products and offerings

- Consider new opportunities and growth areas to tap into such as new product offerings (e.g. hybrid vehicle financing, green building loans).
- Consider providing incentives to customers (e.g. lower loan pricing, fee rebates) if businesses meet certain climate/sustainability targets and milestones (e.g. GHG emission reduction target, environmental remediation plan, completion of adaptation projects, achieving long-term objective of adaptation project).

T5

Capacity building

- Consider existing capabilities within the organisation in evaluating the financing/investment decisions in meeting the GPs.
- Consider intensifying capacity building for all levels (Board of Directors, senior management, and staff) to increase awareness and build competencies.
- Consider leveraging the assistance of independent technical consultants, in-house environmental and social experts, or a hybrid of the two models.

What does Climate Change Principle-based Taxonomy (CCPT) mean to businesses seeking funding/investments and recommendations

- The CCPT will influence FIs to begin encouraging customers to transition towards more sustainable practices in business operations.
- Such expectations would mean that businesses will have to begin taking into consideration the impact of climate change onto their businesses, as well as the impact of business operations onto the climate and the broader environment.
- The failure to recognise and manage climate and environmental-related risks by businesses may lead to substantial financial consequences, as being unprepared to manage the significant impacts of climate change may lead to abrupt disruptions to business operations (e.g. flood damaging business properties, haze disrupting business operations, public policies such as carbon pricing imposition impacting business strategies).
- Businesses will need to take greater accountability for their business operations to ensure its operations do not cause harm to the climate as well as the broader environment and society. This will ensure that businesses will not be eventually excluded from the financing and economic ecosystem in the long term, in view that FIs and the wider stakeholders (e.g. investors, shareholders, consumers, regulators) are growing proponents for sustainable and ethical businesses.
- While the principle-based approach of CCPT considers the nascent stage of climate risk management businesses are currently in and FIs are encouraged to take on a nurturing approach to assist the transition of its customers, businesses should also play a proactive role in ensuring its operations transition in an orderly manner aligned with growing market expectations.

Financing process	Recommendations for businesses	Relevant GPs
Customer on-boarding	Businesses should consider and begin putting in place the following:	
	• Business strategy taking into consideration climate and environmental considerations, objectives and/or target(s), and establishing implementation plans to meet such target(s) over a defined time period.	GP 1-GP 5
	• Consideration for social and human rights risk mitigation plan and compliance.	GP 3, GP 4
	• Impact assessment of climate-related risks on business operations based on a range of climate scenarios and to document the performance and assumption criteria of such assessments.	GP 2, GP 4
	• Identify how climate objectives such as climate change mitigation and climate change adaptation can be embedded within business activities and projects in order to contribute to the climate objectives.	GP 1, GP 2, GP 3, GP 4
	• Reporting and disclosures in accordance to recognised sustainability reporting standards including GHG emissions calculation.	GP 1 – GP 5
On-going due diligence	Businesses should consider and begin putting in place the following:	
	• Remediation action plans with clear specific milestones if business operations cause or may potentially cause significant harm to the climate, broader environment and/or community.	GP 4
	• Diligently perform and deliver actions in accordance with remediation action plans and specific milestones.	GP 4
	• Reporting and disclosures in accordance to recognised sustainability reporting standards.	GP 1 – GP 5

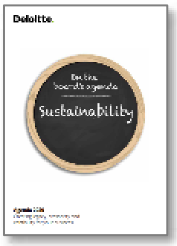
Deloitte thought leadership

Integrated solutions

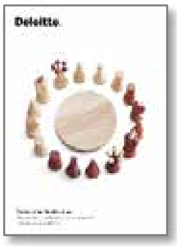
Bringing you solution offerings for your Sustainability needs

Board effectiveness
Supporting board members to create long-term value

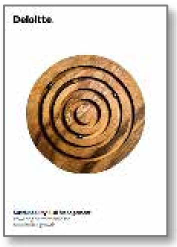
Climate change and business
Responding to the pressing crisis



Agenda 2030
Creating legacy, prosperity and continuity for your business

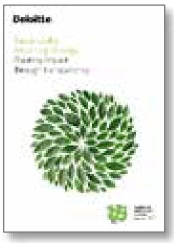


Partnership mobilisation
Discovering and leveraging synergies for mutual value creation



Sustainability risk management
Powering performance for responsible growth

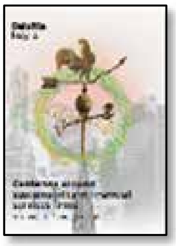
Social responsibility in business
How to adapt to the changing world



Sustainability reporting strategy
Creating impact through transparency

Contribution to peace
Tangible actions for business leaders to drive an inclusive and prosperous future for all

Water, sanitation and hygiene
Safeguard livelihood by expanding access to clean water



Sustainability in financial services firms
Navigating risks and finding opportunities for financial services industry

How we can help

Our Risk Advisory team have been assisting major Financial Services clients across the Southeast Asian region including Malaysia and Singapore in the areas of regulatory framework and compliance, operational risk, credit risk modelling and process review, digital banking, cyber risk, data management et cetera.

Our team comprises of Sustainability and Climate Risk experts and have been serving clients across the region on Sustainability Advisory and Reporting services including Task Force on Climate-related Financial Disclosures (TCFD) implementation, Sustainability and ESG Framework design and implementation, climate risk impact assessment, and Sustainability Reporting among others. If you would like to find out more, please get in touch with us.

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