

## Implementation of the Climate Change and Principle-based Taxonomy (CCPT) in the Financial Sector

In December 2021, Malaysia saw the severe effects of the torrential rain in several parts of the peninsular, the extent of which had not been seen since 1971. Erratic changes in climate patterns are impacting businesses and households with increasing frequency and intensity. This underscores the criticality of the climate challenge before us. The Government's commitment to achieve net zero greenhouse gas (GHG) emissions by 2050 will serve to mitigate future risks to the environment. However, this also gives rise to transition risks<sup>1</sup> that businesses must prepare for. Global actions to meet net zero carbon targets<sup>2</sup> will further amplify transition risks. Businesses that are slow or have no plans to adopt sustainable practices will risk being displaced and shut out by global markets. This in turn will affect the real economy and could pose threats to financial stability.

Financial institutions have a critical role to play in supporting orderly transitions while managing their exposures to climate risk from lending, investment, and underwriting activities. This begins with assessing exposures to climate-related risks in a consistent and credible way, both within a financial institution and across the industry. To this end, in April 2021, the Bank issued the Climate Change and Principle-based Taxonomy (CCPT) as a framework for financial institutions to assess economic activities and their associated impacts on climate and the broader environment. Consistent with the Bank's expectations for the financial sector to support businesses in transition, the CCPT recognises concrete actions to transform and progressively eliminate or reduce harmful activities. This is important to ensure financial flows meet the funding required to pivot business operations, invest in green technology, and obtain relevant certifications for products and services. To help financial institutions assess and classify economic activities, the Value Based Intermediation Financing and Investment Impact Assessment Framework (VBIIF) sectoral guides<sup>3</sup> have been issued alongside the CCPT to provide additional guidance on climate and environmental metrics relevant to specific economic sectors and activities. The sectoral guides also contribute towards mitigating risks of greenwashing.<sup>4</sup>

### Current observations on implementation progress and challenges

Beginning July 2022, financial institutions will start to report exposures in line with the CCPT classification system to the Bank. In anticipation of this, financial institutions have ramped up efforts to operationalise the CCPT (Diagram 1). The CCPT guiding principles and classification system are progressively being integrated in existing credit-related processes and assessment templates of financial institutions, including as part of annual or periodic due diligence reviews of existing borrowers. Compared to lending and protection, greater progress can be observed for investment activities where more financial institutions are able to build on existing policies and frameworks for ESG-aligned investments. The most progress is observed in intensified efforts by financial institutions to address gaps in knowledge and competencies in the first and second line of defence to ensure the effective implementation of the CCPT.

Financial institutions remain committed to support clients' transition. Instead of withdrawing support for sectors and activities deemed less green, financial institutions are seen taking a nurturing approach in helping such clients. As financial institutions continue to deepen knowledge and expertise, this will also help shape more focused engagements with clients especially those that present substantial exposures to climate risks. In turn, financial institutions will have better visibility on clients' business strategies and transition pathways

<sup>1</sup> Transition risk occurs as a result of adjustments to a low-carbon economy, whereby the adjustments may translate into financial and/or reputational risks. Sources of transition risk include changes in public policy and strategy, legislative and regulatory frameworks (e.g., implementation of mandatory disclosure requirements and carbon pricing), technological advancements (e.g., lowering the cost of renewable energy) and/or shift in consumer and investor behaviour (e.g., certification mandates and divestment strategies in carbon intensive sectors).

<sup>2</sup> Net zero carbon is a state of balance between the amount of carbon emitted into the atmosphere, and the amount of carbon removed from it. Net zero carbon target refers to setting a committed timeline to reach net zero carbon emissions.

<sup>3</sup> The VBI Community of Practitioners has developed six sector guides i.e., energy efficiency, renewable energy, palm oil, manufacturing, construction and infrastructure, and oil and gas.

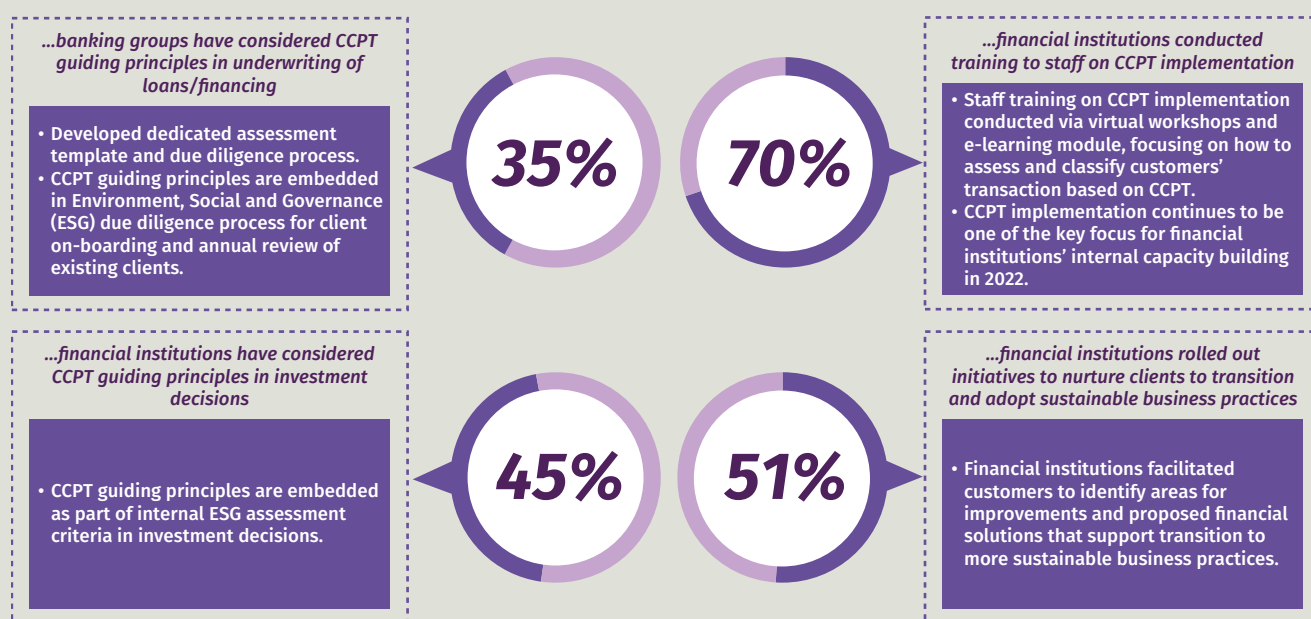
<sup>4</sup> Refers to practices where companies make false or misleading claims about their climate change mitigation and adaptation efforts or exaggerate the extent of their impact.

at a counterparty and sector levels, as well as their alignment to the national transition pathway. Such understanding, combined with greater access to data – an area that is being prioritised by one of the Joint Committee on Climate Change (JC3) sub-committees<sup>5</sup> – would enable financial institutions to develop more tailored financial solutions based on the specific needs of their clients.

To support its implementation, the CCPT Implementation Group<sup>6</sup> (CCPT IG) was formed under the JC3. The CCPT IG serves as a reference point and helps to identify implementation issues and recommend appropriate remediation. It also provides a platform for industry players to share knowledge, experience, and progress in implementing the CCPT.

Going forward, the systematic reporting of climate risk exposures of financial institutions to the Bank will serve to inform the Bank’s assessments of risks from climate change to financial stability and facilitate engagements with financial institutions on how they are managing such risks and supporting transition activities. It will also pave the way for financial institutions to make climate-related financial risk disclosures aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures which will be mandatory for all financial institutions licensed by the Bank from 2024. In addition, the reporting will assist the Bank in identifying financing gaps that may benefit from further enhancements to, and expansion of, the Bank’s lending facilities for SMEs.

**Diagram 1: Progress of CCPT Implementation among Banking Institutions, Insurers and Takaful Operators**



Note: Statistics derived from stocktake exercise conducted on 38 banking groups/institutions, 53 insurers and takaful operators (life, family and general) and 6 reinsurers and retakaful operators.

Source: Bank Negara Malaysia

<sup>5</sup> The JC3 Sub-committee 5 on Bridging Data Gaps is developing a data catalogue that contains information on specific climate-related data such as frequency and data sources relevant for various use cases. The top 8 data items identified, which will be made available to the financial sector by end-2022 are: 1) Scope 1, 2, 3 GHG emissions; 2) Green/sustainable lending/financing and bond/sukuk programme & issuance; 3) Non-renewable energy consumption, renewable and other source; 4) Exposure to physical risks including weather data; 5) Asset value at risk arising from natural catastrophe; 6) ESG score/rating; 7) Water consumption and waste management; 8) Biodiversity, deforestation indicators and geo-mapping.

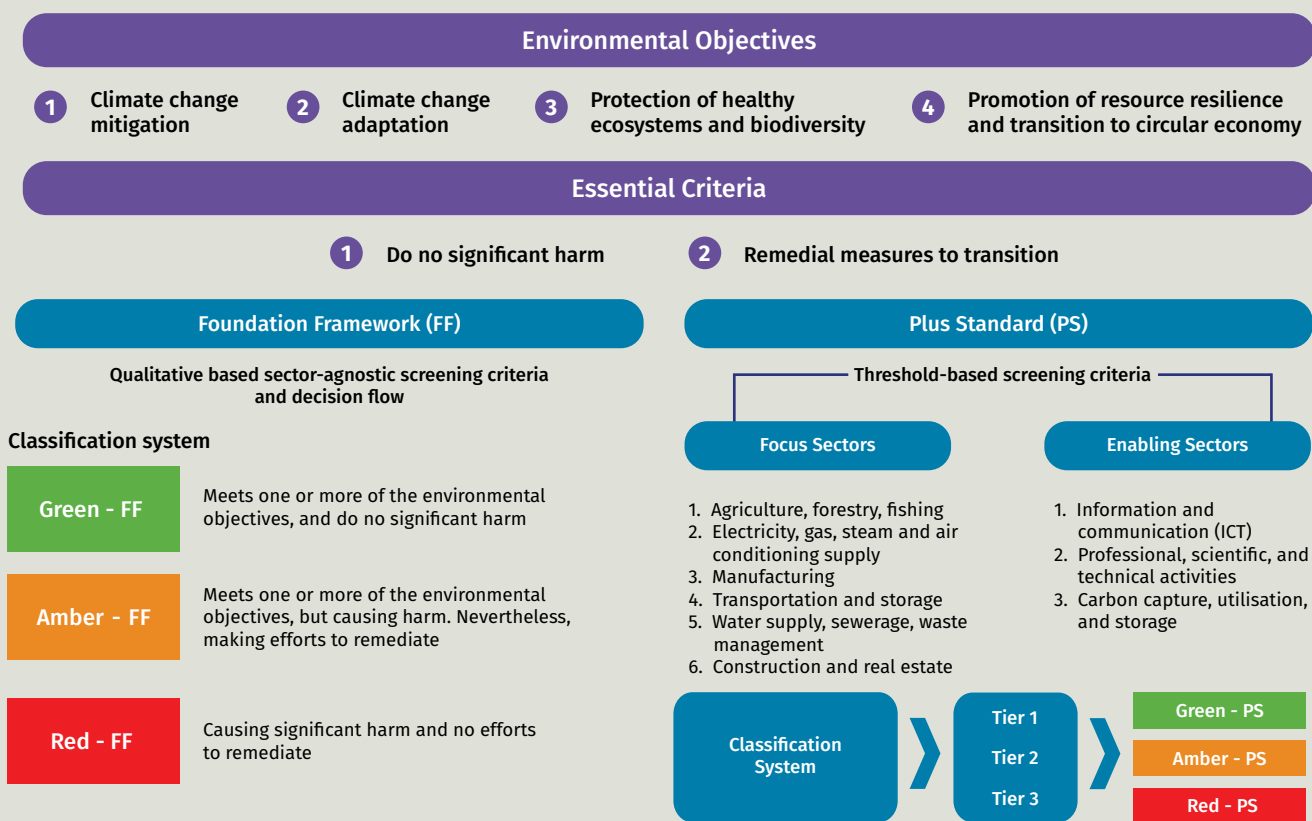
<sup>6</sup> The CCPT IG is established as an industry-driven working group under the JC3 Sub-committee on Risk Management. The working group is co-led by Malayan Banking Berhad and AIA Group and its membership consists of 12 banking institutions and 9 insurers and takaful operators.

### Alignment with the ASEAN Taxonomy

In March 2021, the Bank became one of the eight founding members of the ASEAN Taxonomy Board (ATB) established by ASEAN Central Bank Governors and Finance Ministers to develop, maintain and promote the use of the ASEAN Taxonomy for Sustainable Finance (ASEAN Taxonomy). In conjunction with the Glasgow Climate Change Conference (COP26) in November 2021, the ATB released the ASEAN Taxonomy – Version 1 for consultation.

The ASEAN Taxonomy serves to align national taxonomies across ASEAN member states while allowing for different initial conditions and phases of economic development among member states. To cater for the diversity within ASEAN, the ASEAN Taxonomy adopts a multi-tiered approach comprising a Foundation Framework and Plus Standard (Diagram 2). The principles-based Foundation Framework provides a qualitative assessment of activities that can be adopted by all ASEAN member states. Building on the Foundation Framework, the Plus Standard incorporates metrics and science-based thresholds for assessing and classifying activities and investments that meet green or transition criteria.

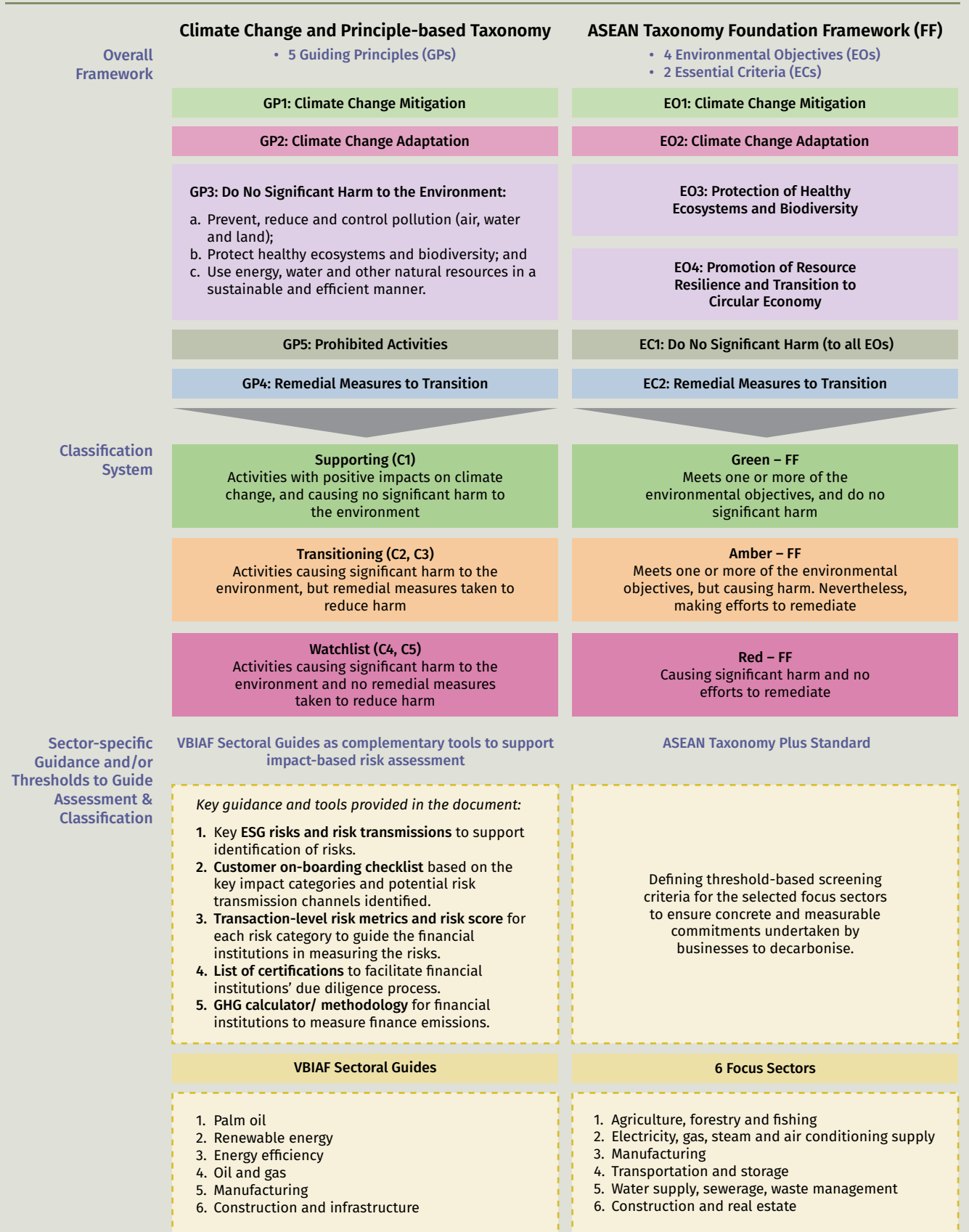
Diagram 2: Overview of the ASEAN Taxonomy



Source: Bank Negara Malaysia, adapted from publication of the ASEAN Taxonomy Board

The CCPT guiding principles are closely aligned with the environmental objectives and essential criteria of the Foundation Framework (Diagram 3). The classification systems are also aligned. This will reduce the regulatory burden for Malaysian financial institutions and businesses which are already preparing to adopt the CCPT. The metrics and thresholds set under the Plus Standard will further complement the ongoing rollout of VBIAF sectoral guides in Malaysia to support the credible implementation of the CCPT domestically and strengthen alignment with the ASEAN Taxonomy.

Diagram 3: Alignment between the ASEAN Taxonomy, CCPT, VBIAF and VBIAF Sectoral Guides



Source: Bank Negara Malaysia