Adnan Zaylani Mohamad Zahid: Sustainability and the challenges ahead

Speech by Mr Adnan Zaylani Mohamad Zahid, Assistant Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the IFN Green and Sustainable Finance Forum, Kuala Lumpur, 3 December 2019.

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It is a pleasure to be here this afternoon. I would like to thank the organisers for once again inviting me to speak at their conference. I hope that I can further add to the valuable discourse that undoubtedly takes place at such events.

We must now acknowledge, that the sustainability agenda has gained increasing importance and a momentum of its own. Everywhere, there is a sense of urgency and call for action. Consumers are making their purchasing decisions with the environment in mind. Investors and shareholders are making demands for their companies and corporations to adopt environmental, social and governance or ESG standards. Corporate managers, emboldened with such mandates by their shareholders are reshaping their organisations into new corporate citizens, responsible, responsive and socially aware. Governments are certainly not left behind. Globally, societies are seeking ways to create sustainable solutions for their communities.

Achieving the sustainability goals will not be an easy journey. The global environment itself is more challenging than before with increasing volatilities and uncertainties arising from the global trade war, geopolitical developments and a multitude of factors. Many of these could derail or delay our efforts. How do we then stay on course to keep sustainability and responsible finance a prime focus of business in the financial sector?

In my view, Islamic finance is primed to advance the sustainability agenda. Islamic finance is developed with a higher overarching objective that emphasises maximising positive value creation and prevention of negative impact. The Maqasid Shariah first articulated by al-Ghazali in the 12th century outlines the goals of preservation of religion, life, family, mind and property with the ultimate aim of prevention of harm and attainment of benefits. Many scholars have developed this further, describing the Maqasid Shariah as the attainment of good, welfare, advantage, benefits and warding off evil, injury, loss. Modern scholars have also weighed in, touching on nurturing righteousness and establishing justice. Contemporary scholarship in Islamic law also recognises human development to be a prime expression of maslahah (public interest) pertaining to all economic activities.

These guiding principles for Islamic finance stands in contrast to the secular philosophy of utilitarianism, which has been deeply influential in developing the modern frameworks for economic and political decision making today. In short, utilitarianism, developed by Jeremy Bentham and John Stuart Mill in the 17th and 18th centuries, proposed a measure of ethics based on – ‘the greatest happiness for the greatest number of people’. On the surface, this is an attractive proposition, that is the goodness of an action is determined by its outcome in promoting common welfare. Both utilitarianism and the Islamic principle of al-Masalih al Mursalah are rooted in the rational pursuit of public welfare. However, a major critique of utilitarian ethics is that it ignores the interests of the minority in favour of the majority, downplays the importance of family and society over individualism and strangers, and prioritises aggregate benefits over other ethical principles such as justice or equality. One could thus argue that the Maqasid Shariah, which underpins the foundation of Islamic Finance and the Islamic Economy, has a more holistic perspective on the pursuit of public interests, in that it aims to leave no one behind in pursuit of prosperity while building a cohesive society.

In Malaysia, Islamic financial institutions are leading the sustainability agenda and spearheading sustainable finance through the adoption of value-based intermediation (VBI) initiatives. VBI is the vehicle to transform the industry, from one focused on profits and shariah compliance to one that is also focused on positive impact. Through VBI, Islamic finance will bring various stakeholders together to advance the sustainability agenda, encouraging Islamic financial institutions to assess how they create value and impact, particularly in response to changing economic, social and environmental conditions. This will support the socioeconomic development in line with Malaysia's long-term agenda of economic growth and shared prosperity for all.

The commitment by the Islamic finacial institutions has been encouraging. The formation of the VBI Community of Practitioners manifests the leadership by Islamic banks in this area with some of its members also being part of the Joint Committee on Climate Change (JCC) that was recently formed in September and chaired by the Bank and Securities Commission. The JCC aims to look at and create greater synergy in development of climate-related solutioning for the capital and financial markets. It should be noted that many VBI offerings of Islamic banks are already meeting contemporary sustainability themes but more will be forthcoming. Those already on offer include green and specialised financial products and services for retail and SME markets, financial solutions for lower income households, custom products for women entrepreneur and SMEs, green solutions that promote environmental sustainability and innovative solutions that promote physical and mental well-being. Takaful operators are also taking steps to explore value-based protection for their customers. A dedicated task force has been formed by the takaful industry to formulate a strategic roadmap to advance VBI in their business offerings and practices. VBI also encourages Islamic financial institutions to play a greater nurturing role in advocating sustainable practices among clients, such as adoption of Malaysian Sustainable Palm Oil Certification, as well as providing necessary funding and technical advisory services.

Part of the progress in advancing VBI as a driver for positive change in the Islamic financial services industry has been the Bank's role in working collaboratively with the VBI Community of Practitioners. In November 2019, the Bank issued the "Value-based Intermediation Financing and Investment Impact Assessment Framework – Guidance Document" (VBIAF). This provides guidance on the assessment of financing applications and investment opportunities, taking into consideration economic, social and environmental impacts. VBIAF may also serve as a reference for the wider industry that seeks to incorporate ESG risk considerations in their own risk management system. We are also working with our industry partners to produce three sector-specific guides for the VBI Impact Assessment Framework, namely, palm oil, energy efficiency and renewable energy. These will be issued for consultation in 2020 to supplement the VBIAF with technical and step-by-step procedures for industry players in those sectors.

Ladies and gentlemen,

The sustainability agenda, carried by the VBI initiative for the Islamic Finance sector, complements directly to the national aspiration in this area. To date, the country is progressively marching towards growth with sustainability following its commitment to the UN Sustainable Development Goals (SDGs) and as a signatory to the Paris Agreement to tackle climate change. Strategic plans involving various sectors such as green technology and renewable energy have been and are being implemented to achieve the SDGs. In 2018, Malaysia ranked 55 out of 156 countries in terms of its overall SDG performance and is on track in increasing affordable and clean energy to fulfill this particular SDG7.

Under the 11th Malaysia Plan (2016 – 2020), green growth has been identified as the game changer in bringing Malaysia towards a sustainable socio-economic, development path. Since 2016, several new legislations, policies and action plans were introduced, while existing financing mechanisms were strengthened to support the uptake of green initiatives. As 2020 approaches, Malaysia is committed to continue implementing its strategic long-term plans and green friendly policies. Budget 2020 is reflective of this commitment, with the allocation of a matching fund of RM10 million towards a joint United Nations SDG-government fund to co-finance SDG initiatives in Malaysia.

While government funding is important to realise the SDGs, most of the investments would need to be sourced from the private sector. An annual target of RM350 billion from private investments by 2020 was identified in the national roadmap for the SDGs, in line with achieving the targets of the 11th Malaysia Plan. Thus, financial institutions are expected to embark on new financing and investment opportunities towards sustainable projects and practices.

There is a large financing gap needed to be filled to realise the SDGs in developing countries, which is estimated to be between USD 2.5 – 3 trillion annually. One major sector to drive a green economy is renewable energy. Projections provided by the Sustainable Energy Development Authority (SEDA) estimates that RM 33.5 billion is needed by private sector financing to achieve the national target of 20% installed capacity of renewable energy by 2025 in Malaysia. Beyond that, financing is needed for other important sectors such as education, healthcare, social entrepreneurship and food production to galvanize sustainable development. There is also a more prominent role for financial institutions to advocate for or provide advisory services to businesses in sustainability areas. For Islamic finance, green sukuk issuances have served as a bridge between Islamic finance and sustainable investment. However, more is required for Islamic finance to have greater impact and this pursuit can be further enhanced with the VBI initiative. With this Islamic financial institutions will be able to play an important role in supporting the 2030 Government's Shared Prosperity Agenda.

Nevertheless this will not be without its challenges. Balancing different priorities on the social, economic and environmental fronts is a delicate act, as these may seemingly pull in different directions. It is inevitable there will be issues and challenges that need to be addressed on the path to attaining sustainability goals. I would like to touch on three key challenges and share the Bank's views and strategies in responding to these and to further accelerate our journey.

First, is the low level of awareness, understanding and appreciation of sustainability practices and what it entails among stakeholders. This has led to limited integration of sustainability-related consideration in individual and institutional practices. Knowledge gaps among financiers in technical areas of the sectors relating to sustainable or green financing such as renewable energy, sustainable agro-production and manufacturing, and social entreprenuership has naturally contributed to apprehension in financing new and relatively unknown sectors. A necessity in achieving scale will be to inculcate awareness on the need for and benefits of a green and sustainable economy. This requires a significant shift in perspective towards how we value social and ecological factors. These should be viewed as inter-linked with the economy and economic well-being and not as silos. Neither as a zero sum game, or polar opposites.

Beyond this and given the multidimensional nature of the SDGs, knowledge and capacity building across sectors is crucial. In this regard, the Bank views climate resilience as a significant part of achieving the SDGs. Understanding and managing climate-related risks enhance the financial sector's role in enabling an orderly transition to a low-carbon and sustainable economy. Over the past 20 years, more than 50 natural disaster events occurred in Malaysia, accounting for RM8 billion losses. As climate-related events intensify, the economic costs arising from physical risk, transition risk and liability risk will escalate and may have persistent system-wide impacts on financial stability and adversely affect macroeconomic conditions. Viewed from this perspective, climate change developments therefore are crucially relevant to the Bank's mandate.

With this in mind, the Bank, as a member of the Central Banks and Supervisors Network of Greening the Financial System or NGFS is committed towards building a comprehensive understanding of the impact of climate-related risks to the Malaysian financial system and economy. In September of this year, a Regional Conference on Climate Change was organised to raise awareness and call for action in managing climate change risks and opportunities, attracting more than 500 board of directors and senior management of financial institutions, regional central banks and supervisory authorities. A technical workshop had also been hosted earlier by the Bank with strategic partners to evaluate and manage environmental and social risks in the energy and primary commodity sectors for VBI CoP members and risk managers of financial institutions.

Another focus area of the Bank is in developing greater standardisation of understanding and definition of green finance for the domestic financial industry. The development of a principles-based taxonomy aims to achieve this, which would support informed decisions and analysis of exposures to climate change in fund raising, lending and investment activities. Ultimately, this can potentially increase financing to green projects. The first draft of the taxonomy is targetted before the end of this month and we would welcome feedback from the industry on this.

The Joint Committee on Climate Change is also there to build industry capacity, by sharing knowledge, expertise and best practices in assessing and managing climate-related risk. The four sub-committees formed under the Joint Committee are in the midst of developing their action plans, including strategies and initiatives to upskill financial institutions in managing climate-related risks and transition to a low carbon economy.

Ladies and gentlemen,

The second challenge is in forging strong collaboration and cooperation among key stakeholders and overcoming the collective action problem. When it comes to costly and difficult action, we always prefer others to do it. Ministries, government agencies, policymakers and regulators must therefore set aside their differences and work for the greater good, consolidate their strength based on their shared values and work collaboratively to develop and bring creative ideas for sustainable development into fruition. Initiatives need to be driven beyond personal motivation and belief. Strategies need clear milestones with clear accountability by stakeholders. Sector-specific approaches need to converge to limit risks of a disorderly transition.

The journey of sustainability is therefore one that is best navigated collectively. We have to come together to support joint and coordinated responses to mitigate unsustainable practices. For the Malaysian financial sector, the formation of the Joint Committee on Climate Change was an important milestone in pursuing collaborative actions for building climate resilience. A key mandate of the Joint Committee is to facilitate collaboration between key stakeholders in advancing coordinated solutions to address arising challenges and issues. This is in addition to building industry capacity, and identifying issues, challenges and priorities facing the financial sector in managing the transition towards a low carbon economy.

The third challenge that we face as a developing nation is in balancing sustainability and competing socio-economic priorities, given our limited resources for transition to low-carbon economy. For example, reduction in fossil fuel use may lead to significant trade-offs with growth and poverty reduction objectives, particularly in the short to medium-term. Targetting sustainable growth and development amidst capacity and funding constraints can thus present significant challenges for political leadership, economic priorities and social outcomes. In this context, given the higher cost of transition, the country may need a longer time to transition towards more sustainable growth policies. This may however result in delayed actions which would heighten physical risks. For the Bank, given the importance of financial inclusion, this could also involve placing different priorities on the impact of climate change in different community segments and to tailor interventions that are appropriate and relevant to provide effective financial protection, particularly to vulnerable segments.

A corollary of our pursuit towards a more sustainable, greener economy, would also be that some segments of the economy may face declining demand, big shifts in asset values or higher costs of doing business. “Brown assets” or non-sustainable assets such as fossil fuel reserves for example would potentially become “stranded assets”, which has implications on the value of investments in energy companies, particularly those dealing with oil, gas and coal. Globally, it is estimated that more than 80% of the known coal deposits, 50% of gas, and one third of the oil reserves cannot be used for energy production if global warming is to be kept below 2°C . Transition towards lower-carbon economy, through transformation of the current modes of production and consumption may come at a cost. Some have argued that on a macro level, this could lead to a positive ‘green growth’ effect. Climate policies associated with structural reforms, including mandatory climate-related financial disclosure could increase investment and benefit the global economy in the medium term. Investment in research and energy efficiency could have a positive impact on innovation and knowledge spillovers, while creating opportunities for economic growth, job creation, and financial innovation. An example of a new business opportunity that could arise is the upcycle of waste materials into new products. Nevertheless, as in many policy shifts of this nature, there will be winners and losers and public policy must strive to strike an acceptable balance to all the communities and sectors that have been adversely impacted.

Ladies and gentlemen,

To conclude, the journey towards sustainability requires careful and well-informed assessments, policy planning, coordination, execution and communication. Long-term planning is crucial to remain focused on the end goal. With a long lag between present actions and the impacts, as well as the prominence and visibility of the short-term outcomes, perseverance is key. We may have to overcome “sustainability fatigue” that may arise in the the efforts and resources that must be invested in pursuing sustainability. Failing to do so would lead us to fall into a pattern of disregard and laissez-faire, thus derailing us from achieving sustainability.

Ultimately, in striving for sustainability, we are endearing into each and every one of us our role as custodians and stewards of this planet and its resources. We all have a role to play in achieving the 2030 SDGs, including the financial sector which can be a significant contributor in this journey. This will be among the key themes in the next Financial Sector Blueprint 2021–2025 that is currently being developed. For the Islamic finance industry, the larger aspiration is the adoption of VBI to bring about continued, sustained, sustainable positive impacts to the economy and society. A long view is required to value social and environmental gains, and to recognise returns beyond financial profits. Being cognisant of the limited window of time that we have at present, our actions from now would lessen the potential losses and enhance the prospects of our future.

On that note, I wish you a productive forum ahead.