THE EDGE MALAYSIA DECEMBER 12, 2022

Climate financing: Pursuing a just transition

The curtains came down on the 27th Conference of the Parties to the United Nations Framework Convention on Climate Change (COP27) a few weeks ago. The conference prompted collective action globally in pursuit of climate funding to support developing nations most affected by the effects of climate change. Reflecting on the last COP26 a year ago, climate finance committed by major multilateral development banks increased by more than 24% last year compared to 2020, based on the 2021 Joint Report on Multilateral Development Banks' Climate Finance. However, efforts need to be more synergised.

Climate finance has been directed either towards mitigation or adaptation. Mitigation focuses on efforts to reduce greenhouse gas (GHG) emissions that cause global warming, such as transitions towards renewable energy sources. Conversely, adaptation focuses on resilience building efforts to minimise damage from climate change including building the infrastructure and technology needed to manage climate adversity.

The success of mitigation efforts will depend on the ability of financial institutions (FIs) to finance the transition to a low-carbon economy in an inclusive and just manner, while considering the risks involved across the environmental, social and governance (ESG) dimensions. The risks of inaction will mean more financing is needed to address adaptation efforts.

The challenge is how can FIs strike a balance between championing social initiatives in pursuit of long-term societal value and environmental issues that have been pushed to the forefront because of the pandemic? A key point to note is the impact of climate decisions on the most vulnerable groups in society that could influence how far or how fast the journey should be in advancing the climate agenda.

COP27 also emphasised the critical role played by FIs in enabling a global transition to low carbon emissions, while influencing what gets funded and in what circumstances.

Central to this is the pursuit of a just transition. It considers all aspects of transition, in avoiding or limiting risks to all stakeholders affected, be it directly or indirectly.

Locally, Malaysian FIs have been placing a higher emphasis on climate commitments; for instance, through the adoption of the Task Force on Climate-related Financial Disclosures (TCFD) recommendations by 2024 as well as Bank Negara Malaysia's requirements around climate risk stress testing and scenario analysis, among other drivers.

With the clock ticking in Malaysia's race to carbon neutrality by 2050, how can FIs balance the complex trade-offs between social and economic issues against carbon reduction goals?

We will focus on two main considerations for FIs in supporting net zero goals, specifically rebalancing their portfolios in a just and equitable manner. First, highlighting what they are currently financing or plan to finance and how to go about doing so; and second, how FIs can be at the forefront in stimulating the low-carbon or net-zero conversation among their investees.

Assessing conditions for financing

1 Green finance: Increase financing for low- or zero-carbon activities

Reaching net-zero emissions comes with a host of opportunities in supporting the green transition such as required investments in technology and infrastructure. PwC's State of Climate Tech Report 2022 highlighted that eight in 10 investors surveyed this year plan to increase their investment in ESG products over the next two years. Such investments can be considered for low- or zero-carbon activities, including those that facilitate a reduction in GHG emissions or the carbon intensity of an activity in the course of doing business. Today, several of our local banks provide green financing as well as Sustainable and Responsible Investment (SRI) Sukuk to facilitate sustainable and responsible funding. This will pave the way for new innovations and product developments in the industry.

However, diligent assessments towards green investments are necessary to consider wider impacts on communities. This includes considering the whole value chain's net social impact and the economic and social benefits of investments to communities (such as energy accessibility, job security and fair distribution of benefits). For example, efforts to switch to renewable energy can be detrimental to health if not managed properly. Take, for instance, EV batteries, which produce hydrogen fluoride and other pollutants when they degrade; if not disposed of or recycled properly, they will cause harm to humans.

There are many frameworks to guide FIs in assessing ESG risks, including for new ESG sectors. In Malaysia, our FIs are developing specific ESG policies; for instance, the Employees Provident Fund released its Sustainable Investment Policy (SIP) and sector-specific ESG policies earlier this year. FIs may further engage in dialogue with other stakeholders such as board members through platforms like the Climate Governance of Malaysia. Such initiatives could go a long way towards influencing the narrative on sustainable finance in promoting low- or zero-carbon financing.

2 Managed phaseout of high-emitting assets

Another area FIs can start considering is their exposure to existing high-emitting assets accounting for significant production of GHG emissions, whether directly or indirectly. This can range from energy assets like coal mines and oilfields to consumer assets such as vehicles. We are starting to see Malaysian companies, including banks, incorporate phaseout plans for assets like coal in their sustainability statements.

When strategising high-carbon asset phaseouts, the urgency of the exercise should not override the impact of the closing or decommissioning of the asset towards the local community or the workers affected by the transition. For example, a phaseout of coal will need to consider trade-offs like how workers can be retrained to perform higher value work, and whether they need to be relocated or compensated in the event of a downsizing exercise. Energy security is another consideration in terms of scale, reliability and affordability to benefit low-income households.

Assets can be decommissioned in tiers based on the returns or the availability and financial viability of alternative energy sources. FIs can determine how they may influence managed phaseouts by identifying decarbonisation strategies. In scaling up decarbonisation plans, further due diligence and strategies will need to be considered. Besides identifying the type of support workers require to ensure that their livelihoods are not adversely affected, FIs will need to consider the impact on broader industry supply chains and what it takes to reinvigorate or boost local economies.

Part and parcel of an FI's role is to identify the type of funding facilities they should provide, taking into account the costs required, including compensation of workers and communities affected by scenarios like coal mine closures.

3 Conditional transition finance: Limit financing for high-emitting sectors as part of net-zero energy transition

Energy accessibility or energy security is essential in observing social goals like health and well-being, and day-to-day livelihood. In this regard, conditional transition finance could be justified on the grounds of addressing a gap in energy access and other essential goods and services. Whether all financing to high-emitting sectors should cease will depend on the FI's own criteria in assessing social, environmental, economic and climate-related considerations as they support Malaysia's transition plans.

If high carbon-emitting projects are deemed necessary for energy security or social impact but are unable to secure sufficient private financing in the light of net-zero commitments, some conditional financing may be required as a short-term remediation. This refers to continued investments in high-carbon activities with appropriate conditions and the necessary feasibility studies in place. A just transition plan will be crucial in highlighting the risks and forming the necessary safeguards or mitigation plans to protect the interests of workers or the wider community.

For example, natural gas has been seen as an energy source alternative as part of transition plans, as it produces lower carbon emissions than coal. However, FIs will still need to ensure that environmental goals and social principles are satisfied. Emission thresholds in the use of natural gas can be set and monitored using strict screening criteria as part of a responsibility to stakeholders to ensure that the gas investments are part of a wider transition plan with a set target date in place.

4 Responsible divestment and exclusions: No financing to high-emitting sectors

Investors are influencing a shift in behaviours in the FI landscape through increased expectations on alignments to requirements like TCFD, net-zero targets and transition plans. Amid increasing investor pressure, FIs may resort to divesting from ownership of high-carbon equities and bonds altogether if they conflict with a net-zero aligned portfolio. This could be a viable option, considering the commitments made locally. According to our 25th Annual Global CEO Survey this year, which polled a cross-section of Malaysian companies, 50% of Malaysian companies are currently working to solidify their net-zero commitments, while 18% have made net-zero commitments.

With divestments, FIs are able to direct capital away from high-emitting carbon companies that place pressure on the transition to net zero. This must also be done responsibly by considering the direct and indirect impact of the divestment towards carbon emission and towards communities, including small and medium enterprises (SMEs) in the wider value chain.

Bringing an influential voice to the community

With the various options available, how can FIs be strategic in their approach? An immediate start is by engaging with the companies they are investing in and to examine these organisations' carbon footprint and transition plans towards a low-carbon future. Many businesses, communities and local governments may be resistant towards abrupt changes on such initiatives. Alternatively, they may push for accelerated transition that may neglect the social effects of the transition.

FIs can set the bar for other companies by emphasising social priorities, paying attention to how the transition considers job creation and reskilling opportunities, for example. They can also educate their customers on how they are practising ESG, especially FIs with a large SME base. The effectiveness of a just transition plan hinges on how inclusive FIs are in engaging all affected stakeholders, providing balanced focus and attention to environmental sustainability and equitable economic development. Platforms like the CEO Action Network can be an avenue to promote sharing between peers to advocate sustainability across Malaysian businesses.

FIs are in an influential position to create long-term societal value through their financing initiatives. Through regular engagement with their portfolio and rigorous due diligence, FIs can set the right tone for a transition that is fair, inclusive and transparent. E

Glenda Eng is sustainability and climate change director, and Sarah Yuzaidi is sustainability and climate change manager at PwC Malaysia