ESG Viewpoint

May 2020

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Sustainable Banking in the ASEAN region

The business case for banks to incorporate sound environmental and social risk due dilliegence in their lending and underwriting activities is clear – it improves overall risk management, helps identify new business opportunities, and enhances reputation and brand value. A 2019 study by MSCI[1] links banks with better ESG performance to better returns, lower risk profiles and higher valuations.

Southeast Asia is highly vulnerable to negative environmental and social impacts, including climate change. However, banks across the region, including those in ASEAN[2] member countries, have been slow to review existing risk management systems to ensure they capture increasingly significant sustainability-related risk factors. This can have negative impacts on credit quality and, ultimately, the bottom line.

In 2019, we sought to step up our engagement efforts with the largest and most influential banks in the region to encourage them to improve the integration of environmental and social issues into credit and other risk management systems. Our engagement, whilst focused on risk management, also addressed a more strategic dimension of sustainable banking – the business implications and opportunities brought upon by the environmental, social and developmental challenges of our time.

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[1] Panos Seretis, Ric Marshall, Banking on ESG: Examining the financial relevance of ESG to banks, MSCI Inc., March 2019

[2] The Association of Southeast Asian Nations (ASEAN) is a regional intergovernmental organization comprising ten countries in Southeast Asia: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Thailand, The Philippines, Singapore and Vietnam.

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Key risks

The value of investments and any income derived from them can go down as well as up and investors may not get back the original amount invested.

Investing in emerging markets is generally considered to involve more risk than developed markets.

Engagement expectations

We reached out to 15 listed banks with substantial wholesale banking operations in Indonesia, Malaysia, Thailand, the Philippines and Singapore. We have engaged with some of these banks on sustainable banking issues for five years or more.

Our research for this project drew from the Sustainable Banking Assessment (SUSBA) tool[3] developed by the World Wide Fund for Nature (WWF). In its 2019 update, the tool shows how 35 listed ASEAN banks perform in integrating ESG considerations in their corporate strategy and decision-making processes.

In our engagement, we asked companies to:

- Strengthen existing risk management systems by establishing client onboarding, due diligence and transaction-level environmental and social policies and procedures – with particular attention paid to clients in industries with high sustainability impacts, e.g. extractives, agriculture, food and beverages.
- Involve multiple expert teams across the bank, including from the sustainability, risk and client-facing teams, in the development and implementation of environmental and social risk procedures.
- Incorporate sustainability factors to guide financing decisions at the portfolio level.
- Investigate and develop dedicated climate risk management procedures, making use of the recommendations of the Taskforce for Climate-related Financial Disclosures (TCFD).
- Establish internal procedures for sustainability-related regulatory monitoring.
- Develop innovative products and services to address sustainability challenges.
- Improve disclosure on the management of material environmental and social risks and opportunities.
- Establish adequate governance to ensure accountability on sustainable banking issues at the highest levels.

[3] www.susba.org

Key findings

Every bank that we spoke to acknowledges that exposure to ESG risks embedded in their commercial and corporate lending portfolios can impact the credit quality of those portfolios. However, only a handful of leading banks have developed and implemented robust measures to manage those risks. These include dedicated policies and procedures, including due diligence and monitoring tools; internal capacity to identify and manage environmental and social risks; and good disclosure.

We found Singaporean banks to be at the forefront of environmental and social risk (ESR) management, with practices that are increasingly aligned with those seen in leading European and North American banks. Banks in other ASEAN countries still lag what is considered best practice; however, some of them have started to take action to catch up.

Our high-level findings include:

- The importance of setting up ESR management practices has clearly shot up management's and the board's agenda. We attribute this to increasing regulatory, investor and civil society pressure, along with the realisation that the impacts of economic, environmental and social megatrends are rapidly materialising.
- All the banks we spoke to have developed frameworks for ESR management to different levels of sophistication. In general, we found that most still need to address gaps in implementation – particularly around procedures to monitor compliance with their own ESR policies and action plans in case breaches are found.

"Only a handful of the banks we spoke to have developed and implemented robust measures to manage environmental and social-related risks."

- Disclosure of ESR management frameworks and outcomes of their implementation, including the ESR profile of loan portfolios, needs improvement.
- Banks have not yet thoroughly identified the scale of their portfolios' exposure to climate-related risks or developed a strategy to measure and manage these risks.
- Most ASEAN banks are significant financiers of the palm oil industry in Indonesia and Malaysia. Some of them have developed guidelines or requirements to address sector-specific environmental and social risks. These requirements are generally limited to compliance with local regulations or certification schemes, such as the Indonesian Sustainable Palm Oil (ISPO) and the Malaysian Sustainable Palm Oil (MSPO) standards. We recognise the importance of these schemes in driving sustainability in palm oil cultivation and supply; however, requirements for certification are not as strict as those in international standards, such as the Roundtable on Sustainable Palm Oil (RSPO).
- Many banks have developed green financial products and services for clients, largely focused on renewable energy and green buildings. We highlight Thailand's Kasikornbank and Indonesia's Bank Rakyat, which have launched successful sustainability-themed bonds. However, banks have not developed comprehensive strategies to capture opportunities linked to the transition to a low carbon economy.

Outlook and next steps

Our conversations with the 15 ASEAN banks, and our review of their publicly disclosed information, confirmed that all of them – to varying levels of sophistication – recognise the potential impacts of environmental and social risks on the credit quality and risk profile of their loan portfolios. In general, however, there is significant room for improvement regarding the scope and implementation of existing ESR policies, governance and disclosure.

Given the high vulnerability of countries in the region to the impacts of climate change, we are particularly concerned that banks have not taken decisive action yet to identify or manage climate-related risks and opportunities across their portfolios. As such, they face unmitigated risks in their balance sheets and stand to miss out on significant opportunities to support clients to transition to more sustainable business models in industries such as food, energy, infrastructure and transportation.

Going forward, we plan to continue our engagement with ASEAN banks to encourage them to continue improving their overall ESR management practices. Importantly, we will leverage the work we do as part of our 'Financial Institutions and Climate Risk' 2020 engagement project to ask ASEAN banks for strong climate risk and opportunity management.

Policy landscape and regional developments

- **Indonesia:** The Financial Services Authority (OJK) has a regulation in place requiring banks to develop sustainable finance action plans. For large commercial banks, the regulation came into force on 1 January 2019.
- **Malaysia:** The Central Bank is working with the World Bank on a taxonomy to facilitate banks in identifying and classifying economic activities that could contribute to climate change objectives.
- **Thailand:** The Thai Bankers' Association issued guidelines on responsible lending, with support from the Central Bank.
- **Singapore:** The Association of Banks in Singapore (ABS) has guidelines on responsible financing. Meanwhile, the Monetary Authority of Singapore announced plans to launch ESR risk management guidelines for banks.

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