

Feedback Statement – Consultative Document on VBI Financing and Investment Impact Assessment Framework (VBIAF)

Executive Summary

The Bank received constructive feedback from 23 respondents including 2 respondents which are not regulated by the Bank during the one-month consultation period which ended on 30 November 2018. The consultative document posed 12 questions relating to the overarching principles, governance and risk management aspects of VBIAF.

Respondents are generally agreeable with articulation of the principles which outline the design of an effective impact-based assessment framework proposed in the guidance document.

There are several challenges that may affect the effective implementation of VBIAF. These relate to consistency in measurement of positive and negative impacts from a Shariah perspective across the industry. Development of standardised parameters as industry reference may serve to promote such measurement consistency.

Majority respondents believe that changing mindset of internal and external stakeholders is highly critical and requires the board and senior management to play a pivotal role in setting the tone from the top. Respondents also acknowledge the need to accelerate stakeholder awareness and capacity building efforts to build the momentum for effective implementation.

Given the extensive recalibration on aspects of business strategies, operational policies and practices and infrastructure, varying pace of implementation could have adverse effect on institutional competitiveness. The magnitude of adverse effects is greatest against non-VBIAF adopters. This requires VBIAF adopters to implement the framework in a manner that balances between pace of transition, institutional capacity and financial implications.

This document summarises the feedback received and the Bank's views on issues raised by respondents.

Principles of VBIAF

- 1. Do you agree with the principles outlined in this section? If not, what do you believe should be the overarching principles to an effective impact-based risk management framework?**

All respondents agree. No specific feedback/comment received.

- 2. Do you agree with the articulation of the Shariah basis of the VBIAF? If not, what do you believe should be the Shariah basis for the VBIAF?**

All respondents agree. No specific feedback/comment received.

- 3. What are the challenges to incorporate a Shariah-focus in the impact-based risk management framework? What would be the effective solutions to such challenges?**

For most respondents, measuring “benefit” and “harm” from a Shariah perspective would be the biggest challenge particularly when these could be subjective in nature. Hence, respondents suggest for the Shariah fraternity to work collaboratively in developing standardised and practical parameters for industry reference. The second most cited challenge is the lack of expertise and capacity of existing talent to articulate Shariah values and impact-based risk assessment. This requires structured training and engagement programmes to develop technical expertise amongst the industry’s talent pool and create public awareness on the VBI initiative.

The Bank’s view on Q3:

The basic principle of Shariah states that everything is permissible unless expressly prohibited (i.e. haram) in the Quran and Hadith. Hence, in determining whether the nature of an activity is beneficial or harmful from a Shariah perspective, one should make reference to any specific injunction that prohibit the activity. In addition, developments in Islamic jurisprudence over the decades have further enriched the understanding and application of the injunctions in a contemporary context (e.g. the prohibition of drugs and smoking). As the society and economy continue to evolve, there would be new considerations that may affect or influence how an Islamic financial institution (IFI) measures the benefit and harm of its activities. Beyond the specific prohibitions, the IFIs are accorded flexibility to consider additional dimensions such as the consideration of priorities (awlawiyyat). However, this will greatly depend on the IFI’s perspective on ethics, risk, financial reward and customers’ profiles. In this regard, the Bank believes that standardised approach to decision making may not be tenable as the final determination would need to be based on the IFI’s articulated vision and risk appetite.

In respect of the talent issue, the Bank recognises the need for collective efforts in developing the expertise and competencies on integrating Shariah with impact-based risk assessment. Training organisations such as IBFIM, ISRA and ASAS can play an important role in developing training programmes and providing a platform for discussion and knowledge sharing.

Principles of Governance

4. What factors do you think are barriers to effective integration of the VBI strategies considering the way your institution currently operates? What would be the effective solutions to such challenges?

The main barrier identified by the respondents is changing the mindset of stakeholders and obtaining management buy-in to move from existing purely profit oriented mindset towards a sustainable triple-bottom line (TBL) approach. In general, majority of respondents agree the most effective solution is firstly, establishing the “tone from the top” whereby the roles and commitment of the Board and senior management with regard to the VBI implementation are clearly communicated throughout the institution.

Another key challenge is the leverage model structure under which IFI operate as subsidiary. Respondents commented that implementation capability is highly dependent on the direction and support of the conventional parent. The respondents argued that lopsided implementation by the Islamic subsidiary can potentially cause it to lose competitiveness arising from the additional requirements of impact-based risk assessments. Equally cited is the lack of capability and technical skillset to implement the VBI strategies and thus the need for structured training and engagement programmes.

The Bank’s view on Q4:

As expressed in the VBIAF, consideration for impact-based risk management is critical to ensure a sustainable and resilient economy and hence financial stability. In the current environment, such consideration is expected of the entire financial system. In this regard, the Bank believes that the group would find it imperative to adapt to VBIAF in ensuring the safety and soundness of the Islamic entity and group as a whole. Failure to address issues surrounding the environment, social and governance (ESG) risks would cause financial institutions to underestimate their risk position that could lead to increased financial vulnerability. For example in 2017, Banco Santander was fined USD15.3 million for financing a project in an illegally deforested area in the Amazon. In its report, MunichRe estimated that in 2017 insurers paid USD138 billion for damages caused by natural disasters¹.

Incorporating impact-based risk management can also enhance the institution’s access to new classes of sustainable investors and capital providers. Research finds that increasingly, there is growing demand from sustainability-conscious investors evidenced from the premium priced into green bonds on average relative to conventional bonds². IFIs can also generate new business opportunities by providing technical and financial services to facilitate customers’ adoption of more sustainable practices.

¹“TOPICS Geo 2017” https://www.munichre.com/content/dam/assets/munichre/content-pieces/documents/pdf/302-09092_en.pdf

² Ehlers, T. and Packer, F. (2017), “Green bond finance and certification”, BIS Quarterly Review, September 2018. https://www.bis.org/publ/qtrpdf/r_qt1709h.htm

5. Do you agree that establishing a separate VBI Oversight Committee/Impact-based Risk Management Committee is the most effective governance structure? Why or why not?

Majority disagreed that a separate committee is the most effective governance structure. Existing Board Risk Management Committee or the Exco can absorb the functions related to VBI oversight by enhancing the mandate/terms of reference. Meanwhile a small group of respondents viewed establishing a separate committee would contribute towards a more focused oversight over the VBI implementation.

6. If you are a Shariah Committee member, or performs other Shariah governance functions, what challenges would you encounter to subscribe to the recommended principles? What would be your solutions or alternative proposals?

The key issues cited by the majority of the respondents were awareness, understanding, capacity building and embracing the VBI culture. Suggested solutions include training and more frequent engagements between Shariah Committee and the Board.

The Bank's view on Q5-Q6:

The Bank acknowledges that there is no one-size fits all approach and that there will likely be differences in the governance setup depending on the individual IFI's organisational structure and internal VBI transformation strategy. The VBIAF proposes key considerations to guide the IFI's discussion on efforts to enhance and integrate its governance design. This is necessary because the VBIAF introduces a multidisciplinary approach to credit risk management by incorporating non-conventional impact considerations. Hence, the Bank expects the IFIs to go through a learning process before they will be able to settle on the most efficient governance structure and process. The Bank encourages the IFIs to document and share their journey with other industry players in order to enrich the body of knowledge and catalyse best practices.

Principles of Impact-based Risk management

7. Do you agree with the approach to comply with national and international standards on impact-based risks described in this document? Why or why not?

All respondents agree. Respondents highlighted the need to allow flexibility in adopting the standards taking into consideration institutional readiness. Respondents also suggest that the relevant regulators can play a role in supporting the adoption of the standards by the industry by facilitating training and awareness.

8. What are the potential challenges you foresee in complying with either the national or international standards on environmental and social (E&S) risks? What would be your solutions?

Most respondents stated the lack of knowledge and awareness of the required standards for effective implementation as the biggest challenge. Hence, this requires capacity building on the part of the industry players as well as support from relevant government agencies in respect of enforcement and public education.

9. Do you agree with the approach to using quantitative and qualitative measures to quantify impact-based risks described in this document? Why or why not?

Majority of the respondents agree that a combined approach will provide the necessary balance as not all impact-based risks can be measured quantitatively. Respondents also highlighted the need for guidance to ensure consistent practices within the industry. A small number of respondents disagree with the use of any qualitative measure in the assessment as this would introduce variability and can be onerous to operationalise.

The Bank's view on Q7-Q9:

While the Bank broadly agrees that IFIs should be accorded flexibility in adopting the VBIAF, some degree of uniformity in certain aspects of the impact assessment such as customer on-boarding process, would facilitate customer understanding and experience with the new impact-based criteria. Issuance of certification and standardised tools by government agencies, such as the recently launched Sustainable INFRASTAR by the Malaysian Construction Industry Development Board (CIDB), directly supports the needs of the financial sector. In this regard, the Bank intends to continue collaborating with the CoP members and relevant stakeholders to develop sectoral guidance documents to facilitate the implementation and wider application of VBIAF by the industry. The Bank also supports any industry-led or stakeholder-led initiative on capacity building that will help reduce the overall cost of capacity building.

10. What do you foresee to be conflicts in existing credit control functions and the proposed nurturing programmes? What would be your solutions?

Majority of respondents stated that the nurturing exercise would likely demand more time from existing resources that could lead to competing priorities. Furthermore, existing talents may not have the relevant expertise to perform the nurturing exercise. Therefore, timely and effective re-training of staff is critical in ensuring the smooth transition to VBIAF.

In contrast, subject to availability of resources, some respondents opined that the two aspects are not necessarily in conflict so long as there are clear segregation of roles and responsibilities. They argued that the proposed nurturing programmes will in fact support the end-to-end credit management process. One respondent also recommended that an external third party with the requisite expertise could carry out the nurturing function (where it involves addressing E&S risks mitigation).

The Bank's view on Q10:

Nurturing programmes are intended to manage and improve the customer's credit risk profile that can be affected by impact-based risk factors. For example, non-compliance with environmental standards can result in severe penalties that could affect the financials of the customer and even the reputation of the IFI. The Bank is open to the suggestion for industry and external third party E&S expert collaboration in developing nurturing programmes for industry adoption. Notwithstanding this, the IFI is ultimately responsible to ensure implementation effectiveness of such nurturing programmes as these will directly affect risk assessment on customers.

11. What do you foresee to be the unintended consequences from adopting the impact-based risk management?

The majority of respondents identified lower competitiveness that may arise from longer turnaround time for the approval process and additional operational costs related to impact-based risk assessment procedures. As a result, the IFIs' performance and growth could be severely impacted. Stringent compliance with the environmental standards could also limit access to financing in high risk sectors such as agriculture and energy. Respondents also cited that the IFIs may potentially adopt more lax policies or provide incentives to promote high impact sectors such as renewable energy which could expose the IFIs to higher risks.

The Bank's view on Q11:

The Bank acknowledges the concerns raised by the respondents and wishes to reaffirm the intention to ensure implementation of VBIAF by the IFIs is done in a manner that is orderly and does not impose additional risks to financial stability. Impact-based assessment is aimed to facilitate the transition of customers and businesses including those in high risk sectors to adopt more sustainable practices in line with the ultimate objective of creating positive impacts. VBI promotes a holistic approach in generating positive/sustainable impact that is not just focused on the environment but more importantly also considers the balance with socio-

economic objectives. Hence, any implementation strategy by the IFIs must consider a measured approach to avoid creating added negative impact. For example, unintentionally excluding certain sectors/market segments from obtaining financing especially during the transitioning period would reduce economic activity. In this regard, the IFIs are expected to play a critical role in nurturing their customers' transformation such as recommending best-practice improvements and providing other relevant advisory services. The Bank believes that impact-based risk management can provide a competitive edge to the industry. Recent research finds evidence of positive long-term impact generated by firms that adopt more sustainable practices³.

Moving forward, the Bank will continue to work collaboratively with the CoP members and relevant stakeholders to identify and measure transition risk to VBIAF practices. This will enable issues to be pre-empted and effectively mitigated thus ensuring the safety and soundness of the IFIs and the financial sector. Based on the experience of other global banking institutions, a robust strategic plan, a reasonable implementation period and, clear and transparent communication to all stakeholders are important to mitigate any unintended consequences. In addition, technology also has an important role in increasing the efficiency of impact-based risk management and enhancing delivery channels of product and services to multi-stakeholder dimension proposed in VBI. The Bank believes that the industry can benefit from the growth of fintech by leveraging various technologies such as artificial intelligence, machine learning and gamification to facilitate VBIAF implementation.

12. If you are an IFI, who would you expect to prepare additional reports/disclosure for, and what would be the level of detail? If you are an external stakeholder, what would be the type of disclosure most important to you?

Respondents are generally agreeable that reports relating to the progress of VBI and the impact contributed by the IFIs should be prepared for internal and external users. Respondents suggested a wide range of information that can be prepared such as risk profile and performance of the impact-based assets and contribution to economic indicators (e.g. job creation, wage growth). Respondents referenced existing reporting initiatives such as Integrated Reporting (IR) and Global Reporting Initiative (GRI) Standards as an appropriate benchmark for content and format.

The Bank's view on Q12:

Disclosure and transparency is important to inculcate market discipline and generate public awareness about VBI and VBIAF. When considering the type and extent of disclosure, the IFIs should consider the perspectives of the preparer and the users. This encompasses types of data that are currently available at its disposal compared to the data required by the users. Multiple users will require different information and this will increase the cost of disclosure. The IFIs would

³ Eccles, Robert G. and Ioannou, Ioannis and Serafeim, George, The Impact of Corporate Sustainability on Organizational Processes and Performance (December 23, 2014). *Management Science*, Volume 60, Issue 11, pp. 2835-2857, February 2014. Available at SSRN: <https://ssrn.com/abstract=1964011> or <http://dx.doi.org/10.2139/ssrn.1964011>

also need to assess the impact to their information systems in compiling the new data. In this regard, the IFIs should exercise professional judgment in determining the granularity and frequency of information that would be meaningful for the various users. Where critical information is not presently available, the IFIs should also have a plan to enhance existing information systems to allow timely improvements in disclosure practices.

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Frequently asked questions (FAQs)

13. Does offering financing for personal or commercial vehicles that generate carbon emission constitute a negative impact activity?

Carbon footprinting disclosure and overall carbon emissions reduction⁴ are the key targets advocated by international frameworks and conventions on climate change. When considering financing to the transportation sector, the IFI will be required to assess the sufficiency of mitigating factors. For example, a vehicle with a hybrid transmission system would constitute a mitigation compared to a fully combustion engine and as such may still qualify as a positive impact activity or TBL. The IFIs should also assess the impact of the sector activity on a portfolio basis.

Currently, banking groups in Malaysia that are subject to the Listing Requirements by Bursa Malaysia are already disclosing some information on carbon footprint generated by their own activities such as use of office buildings for operations. As a next step, the IFIs may strategise to set a specific and measurable target to reduce the overall carbon footprint by quantifying contributions from their financing and investment activities. This target would facilitate impact-based risk management by having a clear and transparent mitigating control e.g. establishing a portfolio limit on financing petrol fuel vehicles.

14. Why should the IFIs be involved in efforts by government agencies to facilitate alignment with international standards? What are the potential issues that may arise?

Participating in relevant government working groups would allow the IFIs to manage their risks better in anticipation of any policy change and impact on the credit quality of their affected financing customers. For example, a change in government policy relating to increasing the use of biodegradable products would have a direct impact on businesses who manufacture non-biodegradable products. IFIs can also give feedback for consideration by the government to help manage transition risk or influence the pace and strategy of any policy change. However, the IFIs need to ensure adequate governance is in place to avoid potential conflict of interest issues⁵ that could have a negative impact on the IFI's reputation.

15. What is the difference between the exit mechanism (from the financing/ investment) of an IFI that adopts the VBIAF and a non-VBIAF adopter?

Traditionally, non-payment of contractual obligations, such as in a financing, would trigger a default event. An IFI would typically try to recover the amount due through various means such as rescheduling/restructuring the financing or when all else fails, selling off the asset. For an IFI that adopts the VBIAF, the exit trigger may arise from persistent failure of a counterparty to meet impact-based covenants in the terms and conditions of the financing/investment contract, despite regular repayment behaviour. In such events, IFIs need to have in place an effective

⁴ These frameworks and conventions strongly advocate the financial sector's role to reduce carbon emissions including those generated through its financing and investment activities.

⁵ For example, political lobbying could inflict negative perception on the IFI's credibility with the public.

escalation plan to address the breach or potential breach of terms (e.g. failure to comply with hazardous emissions limit).

The escalation plan should outline the various levels of action by the IFIs. From a customer-nurturing perspective, the IFIs are to attempt to rehabilitate/rectify the customer's negative impact at the first instance/indication of breach/potential breach. The IFIs need to monitor and assess the severity of such events (particularly if the impact is persistently high) before taking more drastic actions such as recalling the financing facility, which should be considered only when all other efforts have failed or unlikely to result in positive changes. Further guidance is provided in paragraphs 59-67 of VBIAF.

End of document.