

# Environmental, Social and Governance (ESG)

## Integration in Malaysia: *Navigating Challenges and Embracing Opportunities for a Sustainable Future*

July 2023



*This ICMR paper is produced to encourage the exchange of ideas and knowledge-sharing on the issues highlighted within, and to facilitate interaction among market participants, policy makers and academics. The views expressed are not those of any of the institutions with which ICMR is affiliated to.*

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# Summary

- This study aims to assess the current state of ESG integration in Malaysia, identify challenges and opportunities for integrating ESG principles, and provide policy recommendations to accelerate ESG practices in businesses. This aligns with the government's "Ekonomi Madani" policy, which emphasises sustainable development as a crucial pillar in the structural reforms of the Malaysian economy.
- Through stakeholder interviews and analysis of publicly available information, the study seeks to contribute insights for policymakers, businesses, investors, and other stakeholders interested in promoting sustainable and responsible investment practices in Malaysia.
- The study identifies six key challenges that may hinder the integration of ESG practices in Malaysia:
  - I. Disproportionate levels of ESG readiness among businesses and investors
  - II. Complexity in reporting sustainability
  - III. Potential conflict between short-termism and long-term investment goals.
  - IV. Insufficient investable universe
  - V. Growing pressure to manage transition risk
  - VI. Lack of expertise in ESG integration
- The lack of standardised ESG frameworks and reporting practices has led to disproportionate levels of readiness among businesses, investors, and asset managers. The constantly evolving ESG reporting standards and lack of a universal approach also makes it challenging for companies and investors to determine which standards to adhere to. Additionally, many still believe that adhering to ESG principles may come at the cost of compromised returns, creating a conflict between short-termism and long-term investment goals. Thus, shifting the focus towards the long-term positive correlation between ESG contribution and long-term value creation is crucial.
- Despite the challenges, global investors are increasingly seeking opportunities to invest in ESG assets, which have seen significant growth in recent years. While Malaysia may not be as advanced as other countries in offering sustainable investment products, it is doing relatively well compared to many other developing countries. The regulators have laid the foundations for sustainable financing development by instituting a regulatory framework, providing guidance, and promoting sustainable initiatives. Local investors and issuers are open to discussing and finding ways to integrate ESG principles into their decision-making. However, there is a need to introduce a wider array of Socially Responsible Investment (SRI) products, such as ESG ETFs and ESG REITs, in order to meet growing demand from investors. Malaysia can leverage its position as a leader in Islamic finance to develop blended instruments that link Islamic finance with sustainable finance and align them with the broader SDGs. Malaysia can also engage in collaborations with multilateral development banks (MDBs), such as the World Bank to raise financing for sustainable development projects. This can be done through issuing innovative instruments like Emission Reduction-linked bonds, which are designed on "outcome-based" principles and Catastrophe (Cat) Bonds with risk-bearing capacity of private investors where a specific set of underlying risks is transferred to the bond investors.

- There is growing demand for sustainable products, particularly among younger consumers who are willing to pay a premium for such products. Given the significance of the Halal industry to Malaysia's economy, it is important to align it with the emerging trend of ethical consumption. The industry should capitalise on commonalities between the Halal concept and ethical practices, and policymakers need to offer necessary support for these efforts. By integrating Halal certification with reputable ethical product certification bodies, market access can be expanded, and consumers can be assured that Halal products meet religious requirements while being produced in an ethical and sustainable manner.
- Islamic finance plays a crucial role in promoting the Halal industry, particularly for Micro, Small, and Medium Enterprises (MSMEs). However, financing the Halal industry is not limited to Islamic banks alone. Digital crowdfunding platforms such as peer-to-peer (P2P) lending and equity crowdfunding (ECF) are also gaining popularity among MSMEs and investors. By increasing the availability of Shariah-structured P2P lending and ECF funding programs for MSMEs in the Halal industry, we can further enhance our inclusive financing goals outlined in the Capital Market Master Plan 3. Moreover, these efforts align with our nation's policy of creating 'Malaysia Madani,' which aims to improve financial inclusion and reduce poverty.
- At a global level, there is increasing pressure to create more sustainable supply value chains. This will be a key determinant in driving sustainability practices among businesses in Malaysia, as buyer-supplier relationships will change to manage the risks associated with sustainability. Changes in regulations and policy direction in developed countries also impact smaller companies within the global supply value chain and developing economies like Malaysia. Therefore, companies in Malaysia will need to be better prepare to embrace these changes and shift to low carbon strategies to keep up with the global sustainability developments.
- Companies that integrate ESG factors into their risk management strategy can enhance their business resiliency and long-term value creation. ESG risks can be divided into three categories: physical, reputational, and transition risks. For example, climate change poses a significant threat, and companies should adopt mitigation and adaptation plans as part of their risk management strategy. Negative reputational risk can directly impact a company's performance and share price, so it is important to prioritise the managing of this category of risk. Furthermore, the changing landscape of business activities due to regulations, technology, consumer preferences and market dynamics presents transition risks that policymakers and businesses must address. To do so, increased regulatory efforts and coordinated policymaking can help companies estimate transition risks and build scenarios to minimise the impact.
- The study proposes the adoption of **three clusters of strategies moving forward**. These are:
  - I. **Policy coherence**, which emphasises the need to develop a comprehensive national sustainable policy that integrates environmental, economic, and social considerations into all government decision-making. Policies should also ensure accurate and comparable reporting of sustainability performance by aligning reporting standards and methodologies.
  - II. **Ecosystem motivation**, which focuses on incentives and awareness programmes to encourage individual and organisations to adopt sustainable practices, and leveraging behavioural considerations for policymaking to improve effectiveness of the policies in this area.

III. **Network cohesion** and effective partnerships between institutions, industry, universities and civil society to foster synergy and accelerate progress towards sustainable development.

- The government is forming sustainability policies and providing necessary tools, guidelines and policy framework towards achieving sustainable integration in businesses and the economy. However, policy effectiveness remains a concern given the lack of clarity in Malaysia's national sustainable policy as highlighted by our interviewees. A comprehensive national sustainable policy with a clear outline and targets is needed. Effective implementation of the sustainability policy with robust evaluation mechanism will promote consistency, predictability, and balanced economic growth while preserving ecological capital.
- Continued efforts are needed to develop a comprehensive and integrated reporting framework specific to Malaysia. This process should involve consultation with multiple stakeholders, including regulatory bodies, government agencies, companies, investors, and civil society. With the enhanced disclosure guidelines, quality of disclosures is likely to improve. However, the key focus should be on making the information available through a digital platform, offering stakeholders with consistent, structured and efficient access to ESG data. This approach will replace the current fragmented, inefficient, and costly practices. Effective information sharing via an open source portal will increase market efficiency and strengthen price discovery capabilities, particularly for ESG assets.
- Malaysia needs a "whole of nation" approach to undergo national, business, and individual-level transformation to transition towards sustainable practices. To remain competitive and attract investments, policymakers need to raise awareness of the importance of sustainability and work with businesses, civil society, and international organisations to address climate concerns. With a more human-centric approach, Malaysia can become a regional leader in sustainable development.
- Currently, Malaysia faces significant challenges in transitioning to sustainability due to a scarcity of sustainability expertise. However, companies that prioritises ESG integration are more likely to retain talent. To address the talent gap, stakeholders should join forces through capacity building programs focused on training and upskilling. Local universities can collaborate with international counterparts and industry experts to develop curricula that address the multidisciplinary nature of sustainability.
- Tax policies and incentives are critical tools to promote sustainability practice. Malaysia should promote businesses activities with best ESG international practices using tax and non-tax incentives while avoiding businesses with carbon leakage and greenwashing intentions.
- ASEAN is playing a pivotal role in championing the sustainability agenda. This is in line with ASEAN's agenda to encourage economic integration, social and capital mobility within the region. The ASEAN Member States (AMS) should leverage on various initiatives led by ASEAN to develop access to capital market financing to fund sustainable activities in the region.
- In conclusion, transitioning to sustainability is no longer optional but is a necessity for businesses in order to remain relevant and competitive in today's market. To achieve this goal, stakeholders from all sectors must work together to promote sustainability, using policies, incentives, financing and education to transition towards a sustainable future. By taking a holistic approach, Malaysia can lead the way in sustainable development and contribute to global efforts to address pressing environmental and social challenges.

# Why we did this research

The journey of sustainable investing in Malaysia began in 2014 with the introduction of the 5i-Strategy<sup>1</sup> by Securities Commission. Since then, there have been numerous developments, initiatives and research studies that have focused on integration of ESG principles into investment practices. In Malaysia, there has been more concentration of studies centred on establishing an empirical relationship between ESG practices and financial performance. As this field of interest is continuously evolving, new challenges and opportunities are emerging. The aim of this research is to fill the knowledge gaps in our understanding by adopting a qualitative approach and specifically focusing on the challenges faced by various stakeholders and given these challenges, to then consider some potential solutions to the barriers for better integration of ESG in Malaysia. We believe this approach allows for a deeper and more nuanced understanding of the subjective perceptions, motivations and barriers that drive or inhibit ESG practices.

The study is expected to contribute to the existing literature on ESG in Malaysia and provide valuable reference for policymakers, business leaders, and other stakeholders interested in promoting sustainable practices in Malaysia.

As part of the methodology, we have conducted semi-structured interviews with institutional investors, local asset managers, foreign asset managers, regulators and rating agencies. Based on the examination of views during the semi-structured interviews, the outcome of this study has led to the identification of three (3) key areas and strategies which includes:

## 1. Policy Coherence

Policy coherence is critical to ensure that the government's 2030 Agenda and aspiration to meet Net Zero as early as 2050 is achievable. A comprehensive national sustainable policy is proposed to integrate environmental, economic, and social considerations into all government and policy decision-making. Likewise, to attract more investment into ESG assets, harmonisation of sustainable reporting will provide clarity to investors and issuers to report sustainability performance accurately and in a comparable manner to allow for informed financial decisions.

## 2. Ecosystem Motivation

The government plays an important role in influencing ESG integration through tax and non-tax incentives. These tools can encourage sustainable behaviour, such as offering tax breaks for green investments or penalising companies for high emissions. Cultivating a sustainability culture means promoting sustainable values and behaviours through education and capacity building, creating awareness and stakeholder engagement.

## 3. Network Cohesion

Fostering strong and effective collaboration between institutions, industry, universities and civil society is critical to promote the transition to sustainable economy. Synergies between these groups through greater collaboration and knowledge sharing can accelerate progress of integrating ESG practices at both business and national levels. Extending the partnership and collaboration across borders is also important to address common sustainability challenges through the sharing of best practices.

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<sup>1</sup> SC introduced the 5i- Strategy to facilitate the development of SRI Ecosystem in the Malaysian Capital Market, focusing on instruments, investors, issuers, internal governance and information architecture.

# 1 Introduction

The Covid-19 pandemic has been an unprecedented global crisis that affected every aspect of our lives. It has also shown us how interconnected our world is and how our actions can have a profound impact on the environment, society and economy. The pandemic has also provided an opportunity to reshape our economic recovery in a more sustainable manner. To this end, ESG (Environmental, Social and Governance) principles have emerged as a critical framework for building a more sustainable and inclusive future. In Malaysia, greater emphasis has been put on integrating ESG principles into the investment decision process of both private and public sectors<sup>2</sup>. However, ESG integration extends beyond the private sector, as it also involves embedding ESG principles into government policies as demonstrated by the 'Budget 2023', which has significant focus on inclusive and sustainable growth initiatives. Such initiatives are crucial to meet the government's commitment to the Paris Agreement and the Sustainable Development Goals (SDG) 2030 Agenda.

ESG principles were first introduced in 2004 through a joint initiative involving the UN Global Compact, International Finance Corporation (IFC), and the Swiss government. The resulting landmark study titled 'Who Cares Wins', inspired the UNEP-FI to produce the 'Freshfield Report', which made a strong case for integrating ESG factors into investment decisions. This in turn ultimately led to the formation of the United Nations' Principles for Responsible Investment (PRI) in 2006.

ESG principles are important to business, investors, and government because they cover a wide spectrum of non-financial factors, such as a corporation's position on natural capital, its response to climate change, its responsibility to stakeholders, health and safety policies, corporate culture, and trust. Despite being non-financial, ESG factors are still relevant to financial analysis. Investors and lenders increasingly regard ESG factors as mainstream considerations for responsible investment and lending decisions. Businesses with strong ESG disclosures and higher levels of integrated ESG principles gain trust from greater transparency of information, better risk management, and stronger and more resilient financial performance. In contrast, firms with poor ESG standards tend to have higher business risks, such as trust deficits from stakeholders, reputational risks, and regulatory risks as governments shift their policy direction towards greater sustainability.

The aim of this study is to assess the ESG ecosystem in Malaysia, by understanding the challenges and opportunities for investors and businesses as they integrate ESG principles into their investment decisions and business operations. Our methodology involved conducting interviews with various stakeholders includes institutional investors, local asset managers, foreign asset managers, regulators and rating agencies, combining the insights from the interviews with other sources of publicly available information such as media interviews, news articles, corporate reporting and third-party databases for further analysis on the current state of ESG integration in Malaysia. This report aims to contribute to a better understanding of the current state of ESG integration, the challenges faced by stakeholders, the opportunities presented by ESG integration, and policy recommendations to accelerate the integration of ESG practices into business practices.

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<sup>2</sup> As part of the 6R strategy, the PERKUKUH initiative announced in October 2021 emphasised the integration of ESG principles into the investment decision process of Government-Linked Companies (GLCs) and Government-Linked Investment Companies (GLICs) as well as linking these institutions to the national sustainability agenda.

Throughout this report, the terms 'ESG' and 'sustainability' are used interchangeably, as both terms broadly refer to the positive impact on the economy with the environment, society, and governance as key pillars that guide policy and business decisions.



## 2 Background to ESG integration in Malaysia

The development of the ESG ecosystem in Malaysia is still in relatively early stages, with the first regulatory initiatives being introduced in 2014. These initiatives include the issuance of the Malaysian Code for Institutional Investors and the SRI Sukuk Framework by the Securities Commission of Malaysia. In addition, Bursa Malaysia launched the FTSE4Good Bursa Malaysia Index in the same year. Additional initiatives have been introduced in the subsequent years, including making sustainability reporting as part of the listing requirements, introducing tax incentives for SRI Sukuk issuers and introducing the Guidelines for SRI Funds. A timeline of the key initiatives is provided below.

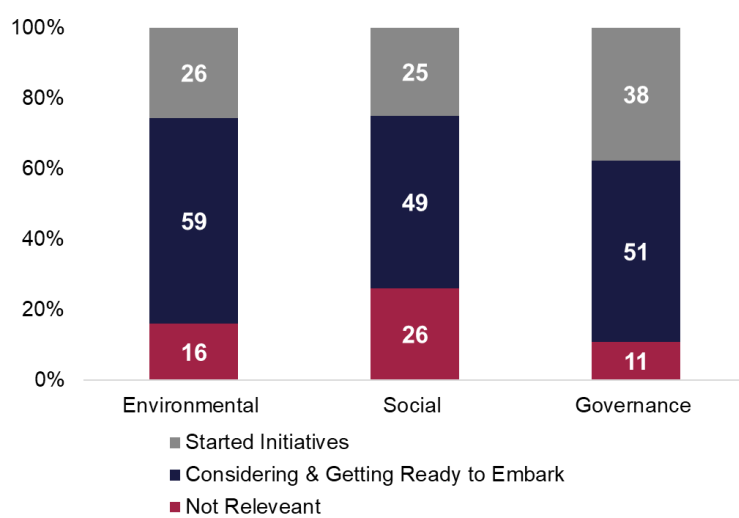
**Figure 1:** Market-based sustainable financing policy development in Malaysia



Source: Capital Markets Malaysia

As a result of these initiatives, businesses in Malaysia are becoming increasingly receptive to the voluntarily disclosure of ESG indicators. The Malaysian Business Sustainability Pulse Report 2022 which was led by the UN Global Compact Network Malaysia and Brunei (UNGCMB) in collaboration with Bursa Malaysia and several other organisations, analysed the readiness of Malaysian companies to transition and gained collective insights on the approach of businesses towards the sustainability issue. The results showed that majority of the respondents are either willing to consider or have already started reporting ESG indicators. **Of the ESG factors, the respondents prioritised the disclosure of governance (G) factors over environmental (E) and social (S) factors.**

**Figure 2:** ESG initiatives in Malaysian Companies



*Source: The Malaysian Sustainability Pulse Report, 2022*

Based on the Bloomberg ESG data for ASEAN-5 countries, a similar trend was observed within the region, as shown in Figure 3. From 2016 to 2021, the number of companies disclosing ESG data in the region has grown substantially with a corresponding improvement in the quality of disclosure as reflected by the rise in the median scoring for the ESG data across ASEAN-5.

However, despite the increase, the median scoring remains below 50 for the environmental (E) and social (S) components, which require more attention. **For Malaysia, the breakdown of the (E) and (S) components of Malaysian companies shows that companies need to improve their disclosure particularly on their “ecology and biodiversity impact” and almost all components within the (S) factors which includes “supply chain” and “health & safety” among others that need attention (refer to Tables 1 and 2).**

**Figure 3: ESG Scoring of the ASEAN-5 listed companies**



Source: Bloomberg

**Table 1: Environment Disclosure scoring of the selected Malaysian companies**

| Sector                 | Air Quality | Climate Change | Ecological & Biodiversity Impacts | Energy | Water | Materials & Waste |
|------------------------|-------------|----------------|-----------------------------------|--------|-------|-------------------|
| Consumer Discretionary | -           | 24.8           | 17.6                              | 15.1   | 29.4  | 3.4               |
| Financials             | -           | 37.3           | 5.9                               | 15.1   | 26.5  | 3.4               |
| Communication Services | -           | 32.2           | 5.9                               | 21.2   | 29.4  | 31.0              |
| Industrials            | 60.0        | 7.1            | 5.9                               | 27.2   | 29.4  | 31.0              |
| Consumer Staples       | -           | 16.0           | 5.9                               | 21.2   | 52.9  | 51.7              |
| Energy                 | 70.0        | 29.6           | 14.7                              | 39.4   | 29.4  | 27.6              |
| Materials              | 70.0        | 29.9           | 52.9                              | 39.4   | 61.8  | 22.4              |
| Information Technology | -           | 17.1           | 5.9                               | 39.4   | 17.6  | 24.1              |
| Health Care            | -           | 32.5           | 5.9                               | 15.1   | 29.4  | 31.0              |
| Real Estate            | -           | 24.8           | 14.7                              | 27.2   | 29.4  | 17.2              |
| Utilities              | 60.0        | 4.7            | 5.9                               | 15.1   | 29.4  | 17.2              |

Source: Bloomberg

**Table 2: Social Disclosure scoring of the selected Malaysian companies**

| Sector                 | Community & Customers | Diversity | Ethics & Compliance | Health & Safety | Human Capital | Supply Chain |
|------------------------|-----------------------|-----------|---------------------|-----------------|---------------|--------------|
| Consumer Discretionary | 46.7                  | 21.4      | 33.2                | 13.5            | 42.3          | 4.7          |
| Financials             | 34.4                  | 33.3      | 33.2                | 8.1             | 50.0          | 4.7          |
| Communication Services | 28.0                  | 26.2      | 33.2                | 24.3            | 34.6          | 14.2         |
| Industrials            | 37.5                  | 31.0      | 33.2                | 13.5            | 34.6          | 4.7          |
| Consumer Staples       | 24.7                  | 22.6      | 33.2                | 18.9            | 21.1          | 4.7          |
| Energy                 | 18.5                  | 21.4      | 33.2                | 35.1            | 19.2          | 4.7          |
| Materials              | 43.6                  | 21.4      | 33.2                | 35.1            | 34.6          | 4.7          |
| Information Technology | 24.7                  | 21.4      | 33.2                | 13.5            | 34.6          | 4.7          |
| Health Care            | 24.7                  | 11.9      | 33.2                | 13.5            | 25.0          | 4.7          |
| Real Estate            | 43.6                  | 23.8      | 33.2                | 24.3            | 34.6          | 4.7          |
| Utilities              | 24.7                  | 31.0      | 33.2                | 13.5            | 19.2          | 4.7          |

Source: Bloomberg

Colour scale for Table 1 & 2: 0 = No Disclosure; 100 = Full Disclosure

| 0-10 | 11-20 | 21-30 | 31-50 | 51+ |
|------|-------|-------|-------|-----|
|      |       |       |       |     |

## 3 Key Challenges within the ESG Ecosystem

The adoption of ESG principles among investors and businesses in Malaysia is progressing gradually. While some stakeholders have already taken steps to integrate ESG principles into their investment decisions, others are still concerned about short-term financial returns and are just beginning to track mostly the governance (G) indicators. The following section will discuss key challenges faced by stakeholders within the ESG ecosystem.

### 3.1 Disproportionate level of ESG Readiness

One major challenge is the disproportionate levels of ESG readiness among companies in Malaysia. While sustainability reporting has been mandatory for all PLCs since 2016, there is no standardised framework, leading to different ESG practices and disclosure standards among companies. As a result, the quality of ESG information available to investors is affected, making it difficult for them to assess and analyse the ESG performance of listed companies in Malaysia. Only a handful of large public listed companies have invested in building holistic ESG capabilities and can disclose ESG requirements which are more on par with global standards.

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*"It's a case of two different worlds that I see among the PLCs in Malaysia in term of disclosures. The ones that are serious are on par with the rest, the majority, are just doing it for the sake of doing it"*

*PWC Malaysia partner Herbert Chua "The Edge Malaysia, May 30, 2022"*

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In addition, the variation in the levels of ESG readiness and capabilities among investors and asset managers is also a challenge. Foreign asset management companies operating in Malaysia have better access to sustainability research support from their global headquarters compared to domestic asset management companies. According to asset managers that we interviewed, the cost of having an internal sustainable expert team is not commensurate with the economic opportunities of promoting sustainable assets for now. This discrepancy further weakens domestic asset management companies if they fail to invest in developing their internal sustainable expertise.

The readiness to adopt ESG practices within the GLICs (Government-Linked Investment Companies) also varies, mainly due to differences in company size and mandates. Larger GLICs have developed internal ESG research capabilities with strong ESG analytical teams. In contrast, smaller GLICs have only recently started to adopt ESG practices and are still in the nascent stages. For institutions still in the early stages of their ESG journey, strengthening the 'G' component is viewed as the most crucial while the 'E' and 'S' metrics are incorporated more slowly into their portfolio management.

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*"We are all moving in the same direction, but  
with slightly different trajectories"*  
*Institutional Investor A*

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On the other hand, retail investors have limited awareness and understanding of ESG investments. They also face the challenge of assessing ESG firm-level data, where accessing information from independent third-party database providers can be expensive. Due to information asymmetries, direct participation in ESG firm-level investing may be challenging. An alternative for retail investors is to invest in unit trust products or indices based on SRI (Socially Responsible Investing) or ESG labelling. In parallel, education and awareness programmes to promote ESG investing among retail investors are essential to foster demand and promote sustainable investments.

According to ICMR's study *"The Rise of Millennials and Gen Z investors: Trends, Opportunities and Challenges for Malaysia"*, more than 70% of young investors expressed strong interest in the concept of ESG investing even if they were not fully aware of the precise terminologies. They were also equally split on whether they would accept lower returns for ESG investments<sup>3</sup>.

### **3.2 Complexity in reporting sustainability**

One of the major obstacles to implementing sustainable practices is the fragmented nature of ESG reporting, with no universal approach in place. Constantly evolving global ESG reporting standards add to the complexity, making it challenging for companies and investors to determine which standards to adhere to. Continued efforts are needed to develop a comprehensive and integrated reporting framework specific to Malaysia. This process should involve consultation with multiple stakeholders, including regulatory bodies, government agencies, companies, investors, and civil society, to enhance transparency and competitiveness without compromising the survival rate of the business.

Presently, a range of international and local standards are being utilised to capture ESG practices (see Appendix 1). In a study conducted by PwC on the top 100 companies listed on Bursa, it was found that approximately 80% of the companies have adopted the Global Reporting Initiative (GRI), while the Task Force on Climate-related Financial Disclosures (TCFD) and the Science-Based Target Initiative (STBi) were becoming more popular. Each international standard, such as GRI, TCFD, and STBi, has their unique characteristics and is preferred for specific purposes. In June this year, the International Sustainability Standard Board (ISSB) issued its first two standards, namely (i) IFRS S1 – General Requirements for Disclosure of Sustainability-related Financial Information, and (ii) IFRS S2 – Climate-Related Disclosures. The disclosure standards set by ISSB is expected to create a comprehensive global baseline for the sustainability-related disclosures. This can be the new gold standard for sustainability disclosure requirement globally.

Meanwhile, to enhance clarity and introduce localised standards, the regulators in Malaysia (namely the SC and BNM), have introduced taxonomies that provide universal guiding principles for sustainable financing and investment. These taxonomies align with current readiness of our domestic economy and provide a classification of economic activities that qualify for sustainable financing and

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<sup>3</sup> ICMR (2021), *The Rise of Millennial & Gen Z Investors: Trends, Opportunities, and Challenges for Malaysia*.

investment. The efforts to provide greater policy clarity are crucial not only to support sustainable development in Malaysia, but also to reduce the risk of greenwashing, especially when there is lack of standardisation in ESG reporting.

### **3.3 Sustainable Goals: Short-termism vs Long-term investment**

Investors in Malaysia have differing opinions about the relationship between sustainability practices and portfolio returns. The empirical evidence to establish this relationship shows mixed results (Appendix 2). However, empirical studies mostly indicate a positive correlation between ESG ratings and firm performance in the long run. This is because ESG disclosure improves transparency and strengthens company risk management practices, which are critical factors in influencing firm performance and value creation in the long run.

Nonetheless, **several investors we interviewed are still sceptical of this relationship, especially in the short run. They are unwilling to compromise their short-term returns, as they have committed to declaring dividends to their contributors annually and their measurement of key performance indicators (KPIs) include short-term financial targets.** The portfolio strategy then usually takes into account multiple factors in the short run, and ESG considerations are just one of the factors.

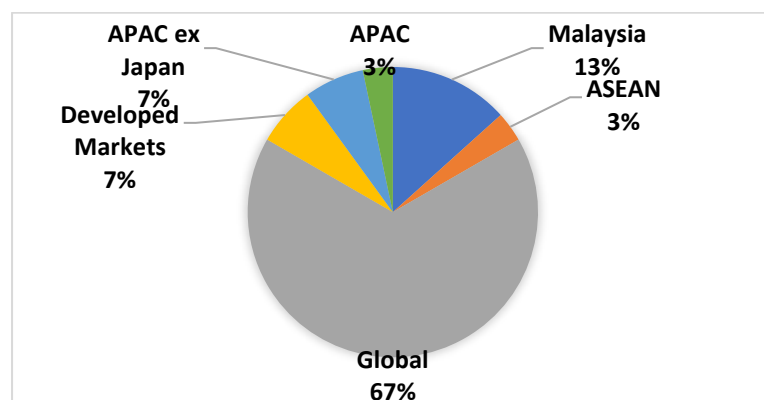
### **3.4 Insufficient investable universe**

The demand for sustainable assets, particularly among institutional investors, is on the rise. However, the availability of such assets on the supply side remains limited, both in domestic equity and debt markets. In our interviews, **investors and asset managers highlighted the lack of attractive ESG companies as a significant barrier to offering Malaysia-only based ESG funds.**

In Malaysia, ESG investment products are often labelled as SRI products. The analysis of SRI labelled unit trust and wholesale funds shows that demand is growing, as evidenced by the increasing number of funds over the years. However, majority of these funds originate outside of Malaysia (refer to Figure 4). Specifically, on equity funds, not a single Malaysian-based equity fund with SRI theme is being offered in the unit trust market. Additionally, only one ESG fund with SRI theme is offered in the wholesale fund market, by Singular Asset Management.

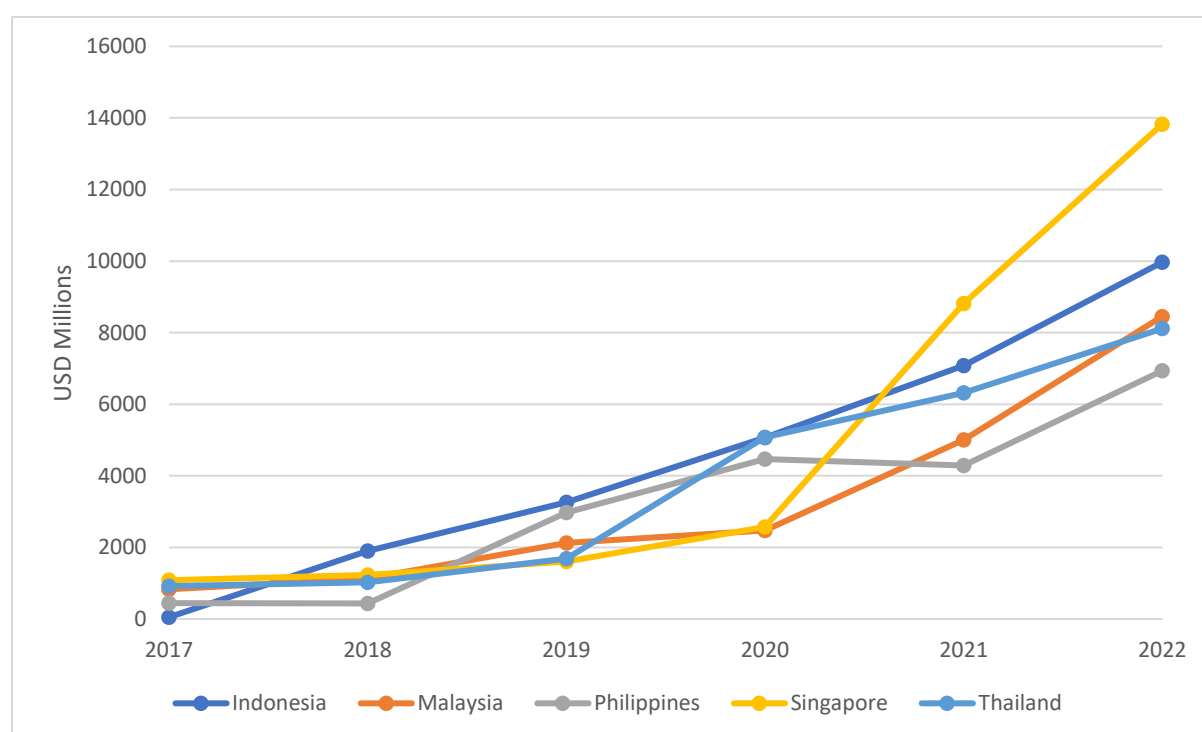
Similarly, in the bond market, **despite being a pioneering issuer of sustainability bonds in the ASEAN region in 2017, Malaysia's sustainability bonds market size is growing slower compared to countries like Indonesia and Singapore, which have made significant progress in this area** (refer to Figure 5).

**Figure 4:** SRI unit trust funds by geographical allocation



Source: SC Malaysia

**Figure 5:** Outstanding label bond issuance of selected ASEAN countries (in USD\$ million)



Source: Asian Bond Online

### 3.5 Transition risks and managing stranded assets

The transition to sustainability is often criticised for being too expensive, and many believe that achieving sustainability goals comes at the cost of compromised returns. Through our interviews, we have heard similar complaints, with high transition costs being identified as one of the main factors holding back sustainability practices. Adhering to ESG principles often leads to higher production costs for businesses, as environmental externalities are factored into the cost of production. In contrast, the traditional method of calculating cost-benefit analysis conveniently ignores these externalities. This means that the cost structure for low-carbon transition companies is often

overstated, while companies that ignore sustainability practices understate the cost of exploiting the environment and contributing to climate change risks.

A coherent national strategy is critical for Malaysia to ensure a seamless transition to sustainability, minimising transition risks and preserving the stability of the economy and financial market. A solid plan to manage stranded assets is essential to achieve this. Stranded assets are assets that suffer from unanticipated or premature write-downs, devaluations, or conversion to liabilities due to a shift in regulations, technology, and sustainability practices, resulting in economic and financial loss. The risk of stranded assets is growing, particularly in the extractive industry, given the increasing concern about climate change. According to the International Renewable Energy Agency (IRENA), the value of stranded assets in the upstream fossil fuel sector could total US\$ 3.3 trillion by 2050, with the loss almost doubling to US\$ 6.5 trillion if climate risks are not addressed in a timely manner<sup>4</sup>.

During our interviews with various organisations, concerns were raised about the challenges of transitioning to a more sustainable approach, particularly in managing stranded assets. This is primarily due to investee companies' involvement in extractive industries and their limited implementation of Environmental, Social, and Governance (ESG) principles. Government-linked investment companies (GLICs) are key shareholders in many of Malaysia's strategic assets, including energy and utility companies. A sudden shift towards a low carbon strategy could result in financial risks for these industries. However, retaining stranded assets also poses long-term risks. Therefore, effectively managing stranded asset risks is of utmost importance. During our interviews with the GLICs, most of them mentioned that they have a plan in place to address transition risks. They are generally **adopting a more gradual approach in pushing transition plans to their domestic investee companies, particularly strategic national firms, while at the same time keeping up with international ESG best practices when managing their international portfolio.**

### **3.6 Lack of focus on human capital development**

There has been criticism that companies face practical issues in adhering to decarbonisation and integration of ESG, including data availability and data quality. However, the real challenge in improving data collection is not only due to lack of willingness of companies to share data but also lies in the lack of talent capabilities to collect and analyse the ESG data.

The lack of talent specialising in sustainability at the firm level is a common barrier to effective transition in developing countries like Malaysia. Most stakeholders within the sustainability ecosystem that we interviewed raised concerns about the lack of talent and expertise in the area of sustainability. Since **sustainability development in Malaysia is still in its early stages, the talent pool of sustainable experts is relatively scarce and expensive.**

To embed a sustainability culture within their organisations, the corporate sector should be ready to invest in developing sustainability competencies. However, according to the Pulse Survey, Malaysian firms' investment in developing sustainability competencies remains low (see Figure 6). Large corporates and SMEs have allocated a very small percentage of their revenue to developing sustainability competencies. **Interestingly, the survey results also indicate that more SMEs than corporates claim to have higher investment in sustainability-related competencies. The report**

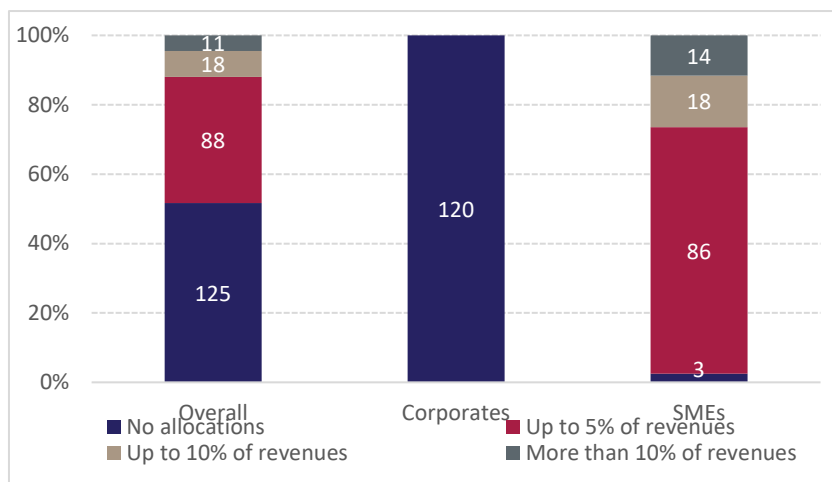
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<sup>4</sup> See IRENA (2022) NDCs and renewable energy targets in 2021: Are we on the right path to a climate-safe future?



suggests that this could be due to the fact that SMEs tend to take a broader definition of the term 'sustainability' compared to the larger corporations.

**Figure 6:** Investment in the Development of Sustainability Competencies



Source: *The Malaysian Sustainability Pulse Report, 2022*

## 4 Sustainability Strategy for the Post-Recovery Opportunities

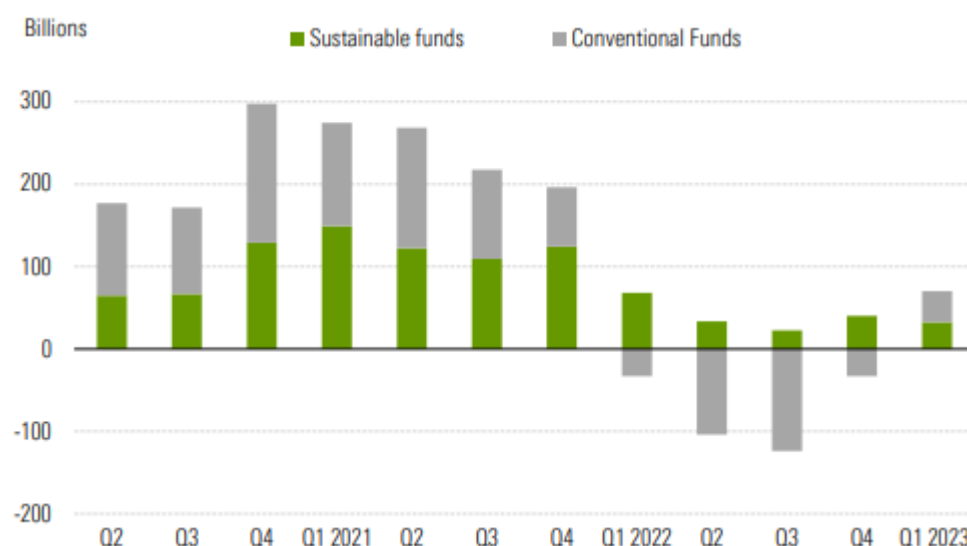
The Covid-19 pandemic has propelled sustainability to the forefront of recovery efforts, leading governments and businesses to prioritise building a sustainable and resilient future. This has created a unique opportunity for businesses and investors to meet the growing demand for ESG assets, expand their businesses by offering new sustainability products, and enhance their resiliency by focusing on risk management. **Furthermore, the pandemic has underscored the interdependence of environmental, social, and economic issues, further emphasising the importance of sustainability in recovery efforts.**

### 4.1 Attracting investment opportunities – domestically and abroad

#### *Growing global demand for ESG assets...*

Global investors are increasingly seeking opportunities to invest in ESG assets, which have seen significant growth in recent years. Bloomberg predicts that the assets under management (AUM) for sustainable assets will continue to rise from USD 35 trillion in 2020 to USD 50 trillion in 2025<sup>5</sup>. Nonetheless, recent jitters in the global capital markets as a result of interest rate hikes, the Russia-Ukraine War and significant tensions in the US and European banking sectors have affected fund flows toward sustainable assets. Despite that, fund flows to sustainable funds are doing better compared to fund flows to conventional funds (see Figure 7).

**Figure 7:** Sustainable Fund Flows Compared with Conventional Fund Flows (USD Billion)



Source: Morningstar Direct

<sup>5</sup> ESG by the Numbers: Sustainable Investing Set Records in 2021 <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021#xi4y7vzkg>

### *...and growing ESG awareness in the domestic market...*

While Malaysia may not be the most advanced in offering sustainable investment products for now, it is doing relatively well compared to many other developing countries, especially in areas such as providing regulatory readiness for the private sectors to promote sustainable financing. The regulators have provided the foundations for sustainable financing development by becoming one of the pioneers within the region to actively support sustainable financing development through instituting regulatory frameworks, guidance and promoting sustainable initiatives. An example of this is the Joint Committee on Climate Change (JC3), which is co-chaired by SC and BNM, established to pursue collaborative actions for building climate resilience within Malaysia's financial sector.

Local investors and issuers are open to discussing and finding ways to integrate ESG principles in their decision-making. In the interviews we conducted, the asset managers shared their experiences of introducing sustainable investment products in the Malaysian market, which demonstrated that these principles were being embraced. The asset managers described the challenges at the time when they started promoting ESG instruments several years ago compared to how it has changed and evolved now. **They concurred that awareness among investors and issuers has improved significantly from where it was a few years ago. According to them, regulators and institutional investors played a pivotal role in making this shift happen.** Nonetheless, the asset managers also emphasised the importance of ongoing support from policymakers and institutional investors to ensure that our market of sustainable financing instruments remains competitive and are seen as the preferred option for investors.

### *....and the need to introduce innovative SRI products to fulfil demand from domestic and foreign investors.*

In Malaysia, the current trend in SRI product development is not ideal for developing the domestic ESG market, as local investors are investing in global ESG funds rather than domestic options, resulting in capital outflows. To reverse this trend, more choices of domestic SRI products need to be introduced, with regulators and intermediaries playing a key role. This can include the development of innovative SRI thematic fund using artificial intelligence tools for ESG integration solution, ESG ETFs, and ESG REITs or GREEN REITs to promote the development of green buildings.

Similarly, Malaysia can also take advantage of its position as a global leader in Islamic finance to promote blended instruments that combine Islamic finance with sustainable finance, and which are aligned with the SDGs. There are noteworthy similarities between sustainable financing and Islamic financing as both are values-based investing that can be developed based on the principle of "Maqasid al-Shariah". Islamic finance should move from not only Halal but embrace Halal and Tayyib principles<sup>6</sup>. By incorporating both Halal and Tayyib principles, Islamic finance can evolve into a more sustainable and ethical form of financial practice. The combination of sustainable financing and Islamic financing can lead to greater product innovations to fulfil the demand from domestic and foreign investors. To this end, policy makers and asset managers need to work together to provide infrastructure, product development and promotional activities. Policymakers can also engage in collaborations with multilateral development banks (MDBs) such as the World Bank to develop innovative instruments for sovereign issuance. For example, Malaysia can consider Emission Reduction-linked Bonds/Sukuk which was designed using "outcome-based" principles and

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<sup>6</sup> Highlighted in Prime Minister's Speech during the launch of "Ekonomi Madani: Memperkasa Rakyat"

Catastrophe (Cat) Bonds/Sukuk with risk-bearing capacity of private investors where a specific underlying outcome risk is transferred to the Bond/Sukuk investors.

The groundwork to promote SRI investments has already started with the introduction of several SRI-based instrument guidelines, grants for issuance of SRI and SRI-linked Sukuk instruments, as well as capacity-building activities including the organisation of international conferences to create greater awareness among investors and issuers. The SRI-linked Sukuk Framework, introduced in 2022, provides a means to raise funds that can be used to address sustainability issues, which is ideal for transition purposes, and is particularly important for many businesses in Malaysia. By adopting an SRI-linked framework, issuers need only commit to clear KPIs for future improvements that will lead to sustainable outcomes. The financial return structure is varied based on the issuer's performance in meeting its KPIs and sustainability goals, allowing for the proceeds raised to be utilised for general purposes, unlike green bonds or social bonds, where proceeds have to be specifically targeted towards green and social development. **The restrictions in the use of these proceeds have been highlighted as a major barrier to issuing sustainability bonds or Sukuk.** For example, one of the rating agencies interviewed by ICMR explained how energy companies in Malaysia continue to use traditional instruments to raise financing, with green bonds only considered specifically for projects related to renewable energy, which constitutes a smaller proportion of overall energy production. Hence, with the SRI-linked Sukuk, these companies can now raise funds for their transition plans and gradually reduce their coal exposure over time.

## Box Article: The Role of JC3 in Promoting Climate Financing in Malaysia

### Background

The Joint Committee on Climate Change, or JC3, was established on 27 September 2019. The committee is co-chaired by Bank Negara Malaysia (BNM) and the Securities Commission Malaysia (SC) and aims to pursue collaborative actions for building climate resilience within the Malaysia financial sector. This is in line with Malaysia's commitment to the Paris Agreement and United Nation Sustainable Development Goals (SDGs), which includes accelerating responses towards ensuring a smooth transition to a low-carbon economy. Besides BNM and SC, the committee also consists of senior officials from Bursa Malaysia and representatives from 21 financial industry players, as well as, relevant experts

The JC3 is guided by three key mandates:

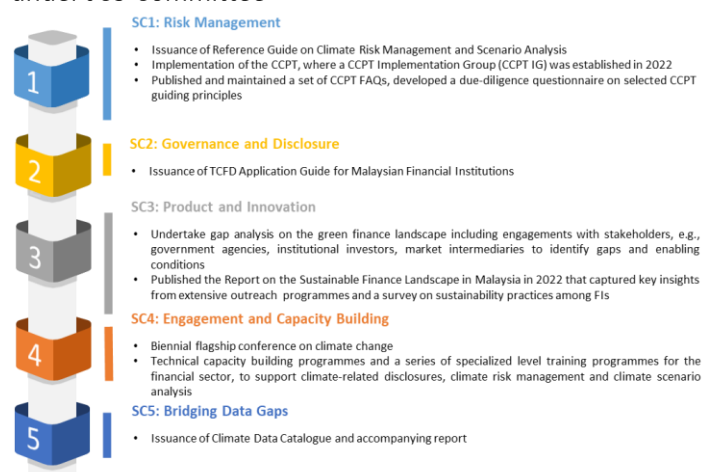
1. **Building Capacity:** JC3 facilitates sharing of knowledge, expertise, and best practices among the stakeholders to help assess and manage climate-related risks.
2. **Identifying Issues:** The committee identifies the issues, challenges, and priorities facing the financial sector in managing climate risk and ensuring a smooth transition to a low-carbon economy.
3. **Facilitating Collaboration:** JC3 encourages collaboration among stakeholders, such as policymakers, financial institutions, and industry players. By working together, they can find coordinated solutions to address emerging challenges and issues.

### JC3 initiatives

The JC3 plays a critical role in facilitating the government's efforts to promote a smooth transition to a low-carbon economy. It serves as a focal point for coordinating collective action to expedite the readiness of the financial sector in meeting the demand for transition financing, particularly for climate risk adaptation and mitigation. Since its inception, the JC3 has introduced various initiatives to support efforts to strengthen the management of climate-related risks and increase financial flows towards a greener and sustainable activities for the financial sector. The committee has established five sub-committees tasked with identifying crucial climate financing needs and initiating potential solutions to address them. These sub-committees focus on areas i.e., risk management, governance and disclosure, product and innovation, engagement and capacity building, and bridging data gaps.

In addressing the challenges of transition and climate change financing, the JC3 sub-committees work towards building climate resilience of the financial industry, collaborating with industry to drive financial product advancement and innovation, conducting engagements and capacity building initiatives, addressing data gaps, and leading by example by integrating sustainability practices in their own operations. Some of the key initiatives of JC3 include supporting the implementation of Climate Change and Principle-based Taxonomy (CCPT), the Task Force on Climate-Related Financial Disclosures (TCFD)-aligned Application Guide for Malaysian Financial Institutions, and the Climate Data Catalogue.

The figure below shows the major initiatives announced under JC3 Committee



Source: JC3 Reports and joint statements on meeting proceedings

## **Moving Forward**

The JC3 will continue its efforts to engage and collaborate with relevant government ministries, agencies, and industry associations to promote greater alignment between the financial sector's response to climate-related risks and national and business strategies. Additionally, it has prioritised assisting Small and Medium Enterprises (SMEs) in their transition journey. To achieve this, the JC3 has established the SME Focus Group, which aims to raise awareness, reduce the cost of transition for SMEs, facilitate green certification, and improve disclosures by SMEs. The committee also supports product innovation and the expansion of investment products and financing instruments that facilitate sustainable and transition finance. This includes the development of pilot projects and capital market initiatives such as greening supply chains, scaling up green technology adoption in the agriculture sector, increasing climate resilience through parametric flood insurance and supporting the development of the sustainable sukuk and bond market.

In conclusion, the JC3 plays a critical role in preparing Malaysia's financial industry and the broader economy for a sustainable and low-carbon transition. Through collaboration, support for SMEs, improvement in data quality and the promotion of innovative financial solutions, the committee actively contributes to the development of a greener and more resilient economy.

## 4.2 Expand business by offering sustainable products and services

### *Growing awareness for ethical consumerism...*

We have now reached a point where integrating ESG practices is no longer just a Corporate Social Responsibility (CSR) activity. Instead, it is associated with substantial business opportunities that directly impacts business performance. **Demand for sustainable products is on the rise, driven by ethical and conscious consumerism, especially amongst the younger consumers shaping consumer behaviour. Consumers are deliberately making choices with a preference for products with positive impact and services that do not harm the environment and that bring benefits to society and the economy.** According to a study by the IBM Institute for Business Value (IBV), 93% of the respondents said that the pandemic had affected their perception of sustainability, and half of them are willing to pay a premium for sustainable brands<sup>7</sup>. This includes opting for Fairtrade products, avoiding child labour products, and choosing natural toiletries- ethical considerations that are becoming increasingly important for consumers when making purchasing decisions. These shifts in consumer preferences will significantly influence businesses to rethink their business strategies to better integrate ESG principles, as it is now recognised as a driver of business performance and a way for companies to meet the evolving demands of consumers who are prioritising sustainability. Various certification bodies, such as the Global Organic Textile Standards (GOTS), Positive Luxury and B Corp Certification have emerged. These certifications serve as a mark of trust and loyalty in products and companies committed to sustainability. Malaysian companies that are practicing ESG disclosures can consider applying for these relevant certifications to open up new business opportunities and gain access to new markets that are willing to pay a premium for sustainable goods and services.

### *...aligning ethical consumerism with key strategic sectors*

Integrating ESG considerations into key strategic sectors can unlock new opportunities for innovation and growth in the long-term. For instance, the **government's push to develop the Halal industry as a strategic sector can be further enhanced by ensuring that all halal products are developed with ESG considerations.** The Halal industry contributed 7.4% to Malaysia's GDP in 2018 and is projected to increase to 11% by 2030. By 2030, the industry is also expected to contribute RM 70 billion to national exports and create 0.71 million jobs<sup>8</sup>. Given the significance of the Halal industry to Malaysia's economy, it is important to align it with the growing trend of ethical consumption. The industry should leverage the commonalities between the Halal concept and ethical practices, and policymakers need to provide necessary support for these efforts.

Among the actions that can be taken is to collaborate on the development of Halal certification with ethical product certification bodies. Integration of Halal certification with trusted ethical product certifications bodies such as Fairtrade, Positive Luxury, and B Corp Certification would broaden market access and build consumer trust and potentially allow Halal products to benefit from the price premium enjoyed by current ethical brands. Furthermore, such certification would provide consumers with the

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<sup>7</sup> IBM (2021) "Sustainability at a turning point: Consumers are pushing companies to pivot"  
<https://www.ibm.com/downloads/cas/WLJ7LVP4>

<sup>8</sup> Halal Industry Master Plan 2030, <https://www.hdcglobal.com/wp-content/uploads/2020/02/Halal-Industry-Master-Plan-2030.pdf>

assurance that Halal products meet religious requirements while being produced in an ethical and sustainable manner. This would help build trust in the industry and increase consumer confidence.

To encourage the Halal and ESG industries to pursue certifications, the government could offer tax incentives to offset the cost of certifications and incentivise more companies to adopt sustainable practices. For Micro, Small, and Medium Enterprises (MSMEs), the government could fully absorb the cost of certification and provide necessary training to ensure their success in exploration of new markets. Currently, the government provides tax deductions for expenses related to assessment fees, annual fees, and other fees imposed by certification bodies under Standards Malaysia. Consideration could be given to extending tax incentives to fees imposed by international certification bodies for sustainable practices, so that companies can enjoy similar benefits. This, in turn, could generate greater demand for sustainable products and services, positioning Malaysia as a leader of the Halal and ethical consumer goods industries.

Furthermore, the Halal industry should no longer be confined to a small cottage food processing sector; it needs to expand its scope and modernise by adopting frontier technology and digitalisation. This modernisation is timely, as it is closely linked to our national strategy on food security and the greening of the industry, particularly in relation to the Agro-industry. To achieve this, the industry requires the accumulation of capital, technology, and talent.

While government funding for research, development, commercialisation, and innovation (RDCI) can facilitate the modernisation of the industry, the access to private capital plays a significant role in this process. Malaysia, being a leader in global Islamic finance, is well-positioned to attract capital for funding these activities. Developing financing instruments that combine Shariah and ESG principles will attract a larger investor base compared to separating the two. To facilitate this combination and product development, regulators can explore integrating the existing sustainability taxonomies developed by BNM and SC with Shariah principles as a guiding tool for the industry. Successful development of "Shariah-ESG" instruments to attract domestic and international investors will be another milestone in Malaysia's leadership in Islamic finance worldwide.

While modernisation is important, support for small cottage Halal industries should continue. Islamic finance has an important role in promoting inclusive development and supporting Micro, Small, and Medium Enterprises (MSMEs). This role has been acknowledged by major multilateral banks such as the IMF and ADB. Now, not only can Islamic banks provide access to finance, but digital crowdfunding instruments such as P2P and ECF are also gaining traction in this field. Increasing the availability of P2P lending with Shariah structures for MSMEs and cottage Halal industries will further enhance inclusive financing goals as envisioned in the Capital Market Master Plan 3. Moreover, the push to promote financial inclusion and reduce poverty is also in line with our nation's policy framework and government slogan of creating "Malaysia Madani."

### *...and integrating domestic business with the global sustainable supply chain.*

Sustainability transformation in businesses is not only influenced by consumer behaviour, but also driven by pressure from cross-border, highly integrated, and complex supply chains. **In fact, the Pulse Survey highlighted that customers/buyers are the second most important factor after government regulation in driving sustainability practices among businesses in Malaysia.**

For emerging markets like Malaysia, changes in regulation and policies in developed countries such as the EU and US can impact our companies through the value chain. The Greenhouse Gas (GHG) Protocol



on GHG Inventory Guidance provided by the US Environmental Protection Agency (EPA) divided the inventory into three scopes – Scope 1 (direct emissions), Scope 2 (indirect emissions within facility and control of the organisation associated with the purchase of electricity, steam, heat and cooling) and Scope 3 (indirect emissions via the value chain and not within assets control by the reporting organisation). For companies looking to shift to low carbon or net zero targets, reducing GHG inventory will be at the forefront of their strategy. This strategy to reduce carbon intensity will also be extended to the buyer-supplier network within the value chain, especially to reduce Scope 3 emissions, which the Climate Disclosure Project (CDP) estimated accounts for 75% of total emission shares on average<sup>9</sup>. In March 2022, the United States Securities and Exchange Commission (SEC) proposed a new climate disclosure rule requiring companies to provide GHG emission data for scope 1 and 2, whereas scope 3 reporting is based on what is deemed as material to investors. **Malaysian companies with trade relationships in these developed markets will need to urgently embrace changes as large global corporations are already moving towards low carbon and net-zero targets.**

### 4.3 Enhancing business resiliency

Integration of ESG is crucial for business sustainability and resiliency, as it allows for the creation of effective and robust risk management tools. Strengthening business resiliency can lead to better long-term value and increase the longevity of the business, which are key factors driving investment decisions. The argument of a potential trade-off between sustainability practices and business resiliency is no longer valid if the business has the right attitude to manage risk and adopt ESG practices.

#### *Managing physical risks...*

Climate change poses a major threat to businesses and individuals, with environmental and social risks consistently topping the list of major concerns over the decade, according to the World Economic Forum (WEF) in its annual Global Risks Report. ESG risks on a business can be classified into three categories- physical risk, reputational risk and transition risk.

Physical risks from climate change can disrupt businesses and communities, resulting in human and financial losses. ASEAN is particularly vulnerable to climate change with mitigation and adaptation efforts required from the government, businesses and citizens to avoid or minimise the impact of climate disasters. Climate and health disasters such as floods, drought and pandemics will also severely impact the global value chain and the world economy, as demonstrated by the events during the Covid-19 pandemic. As part of the risk management strategy, companies must incorporate mitigation and adaptation plans to manage their environmental risks, such as setting specific targets and deadlines for achieving net zero and SDG targets.

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<sup>9</sup> CDP(2022) CDP Technical Note: Relevance of Scope 3 Categories by Sector  
[https://cdn.cdp.net/cdp-production/cms/guidance\\_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf?1649687608](https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf?1649687608)

### *...and reputational risks...*

Growing sustainability awareness means companies engaging in activities that harm the environment and society face reputational risks. 'Naming and shaming' companies for irresponsible practices can impact its business performance and share price. **According to the asset managers interviewed by ICMR, foreign investors remain sceptical of Malaysian corporate ESG practices due to several Malaysian companies being reprimanded for poor ESG practices such as environmental damage, biodiversity loss, poor governance and discriminatory labour practices.** The negative perception has resulted in the banning of several Malaysian products in the international market, the loss of international customers and the sharp sell down of the stocks. This form of reputational damage will take longer to recover from, and companies will need to invest in a rebranding exercise that can be both expensive and highly uncertain in terms of its success.

Therefore, it is important for businesses to avoid negative reputational risk in order for the business to remain resilient over the long run. The asset managers also emphasised the importance of addressing these issues to improve both foreign and domestic investor confidence which is crucial for our markets.

### *...and transition risks to ensure business sustainability.*

According to United States Environmental Protection Agency (EPA) transition risks *"are those associated with the pace and extent at which an organization manages and adapts to the internal and external pace of change to reduce greenhouse gas emissions and transition to renewable energy"*. Transition risks arise from changes in regulation, technology, consumer preferences and market dynamics.

The regulation on carbon pricing mechanism (in the form of carbon tax or a cap-and-trade system) are impacting business activities by requiring the inclusion of environmental costs into the companies' cost of production. Companies that fail to transition to cleaner energy sources may face higher costs of production and decreased competitiveness. It's important for companies to anticipate and manage transition risks to remain competitive and sustainable in a rapidly changing business and regulatory environment.

The implementation of carbon pricing mechanisms has a significant impact on companies, particularly through global supply chains. For example, the EU parliament has agreed to implement a carbon border adjustment mechanism (CBAM), which requires EU importers to purchase certificates equivalent to the weekly EU carbon price starting in 2026. The CBAM would initially apply to imports in five emissions-intensive sectors deemed at greater risk of carbon leakage: cement, iron and steel, aluminium, fertilisers, and electricity. The CBAM charge would cover imports of these goods from all countries except those participating in the ETS or a linked mechanism<sup>10</sup>. **Since the EU is Malaysia's fourth largest export destination and accounts for 8.3% of total exports in 2022, the changes in EU regulation will directly impact Malaysian businesses exporting to the EU.** The government will have to find a way to address this by participating in the EU's emissions trading system (ETS) via a linked mechanism or finding an alternative to avoid business disruption in 2026.

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<sup>10</sup> See Jana and Henrique (2022). Extracted from Think Tank European Parliament "EU carbon border adjustment mechanism: Implications for climate and competitiveness"  
[https://www.europarl.europa.eu/thinktank/en/document/EPRS\\_BRI\(2022\)698889](https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2022)698889)

Increased regulatory efforts and coordinated policymaking are crucial in estimating and minimising transition risks. Policymakers should provide a clear long-term plan for investors and businesses to incorporate the regulatory shift into their business and investment plans. This has been reiterated during the recent announcement of Malaysia's 2023 Budget, where the government will provide RM10 million in matching grants to support the preparation of carbon assessments by SMEs and for eligible related products. Research shows that optimal carbon pricing can minimise the discounted social cost of transitioning to clean capital, but it could lead to the premature retirement of existing polluting capacities and impose significant private costs in the form of stranded assets<sup>11</sup>. The private cost can be minimised with clear policy direction or by using alternative policy instruments such as mandates, feebates and phased-in carbon prices, but these policies may be less efficient in managing social costs.

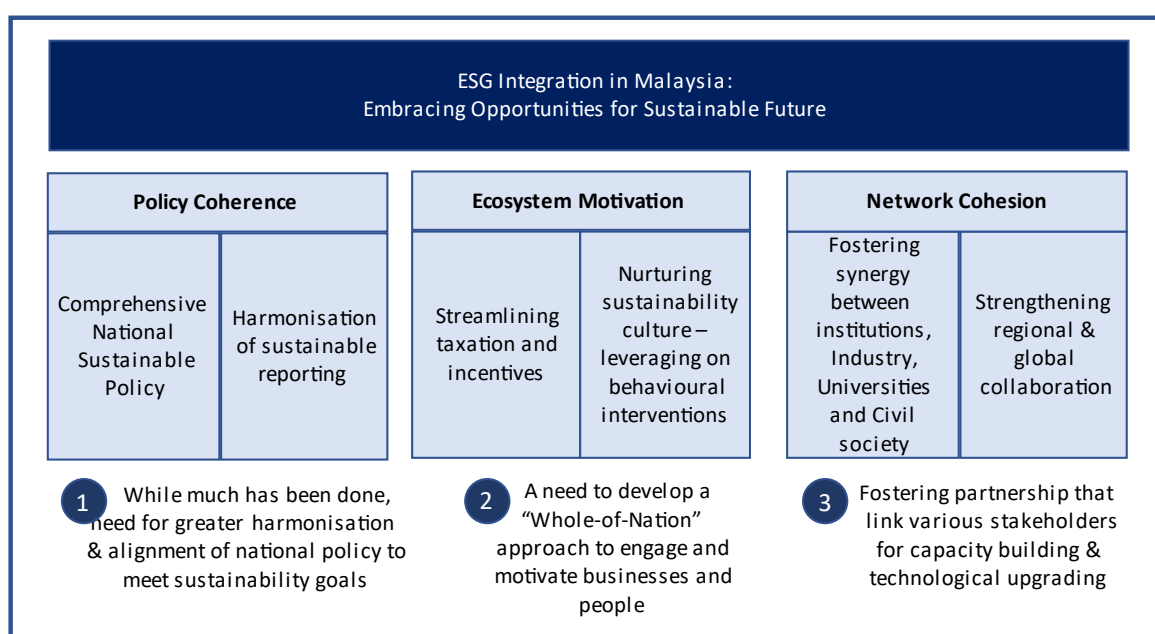
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<sup>11</sup> Rozenberg, Vogt-Schilb, Hallegatte (2020) "Instrument choice and stranded assets in the transition to clean capital", *Journal of Environmental Economics and Management*, Volume (100)

## 5 Ways Forward

The integration of ESG practices in Malaysia has made progress with growing interest at both the government and business level. However, ESG integration is still in its nascent stage, and effective policy action is necessary to accelerate the integration of economic, social, and environmental considerations. To achieve this, promoting policy coherence, facilitating ecosystem motivation, and fostering network cohesion is essential (see figure 8). Policy coherence is necessary to minimise uncertainty and drive investment for sustainable initiatives. Awareness and incentives are critical to motivate people and businesses to embrace a sustainability culture. Behavioural interventions will also increase policy responses to nurture a strong sustainability culture in Malaysia. Finally, given the complexity of integrating sustainability practices, it is necessary to foster a strong network cohesion that links institutions, industry, universities, and civil society to improve the flow of talent, create more opportunities for skill-building and technological assimilation, and increase comparative and competitive advantages for the economy and businesses, respectively.

**Figure 8:** ESG Integration in Malaysia



Source: Author

### 5.1 A comprehensive national sustainable policy for Malaysia

Malaysia has made significant efforts to integrate sustainable practices in government policies. Various government agencies have been developing blueprints based on their mandates such as the National Renewable Energy Policy, the National Green Technology Policy, the National Energy Transition Roadmap (NETR), and several others. The NETR, along with the upcoming New Industrial Master Plan (NIMP), will play a pivotal role in charting the long-term economic reform of our country

in a more sustainable and inclusive manner. This initiative aligns with the national policy of Ekonomi Madani. The NETR introduces 10 wide-ranging catalytic initiatives that are projected to create investment opportunities between RM435 billion to RM1.85 trillion by 2050 and generate approximately 23,000 high-impact jobs in the economy.

To achieve this vision, two crucial guidelines will play a pivotal role: the Value-Based Intermediation (VBI) guidelines by BNM and the Sustainable and Responsible Investment (SRI) guidelines by SC. These guidelines will streamline capital allocation to support national sustainable initiatives, making it an appealing opportunity not only for local investors but also for foreign capital investments.

Despite all these efforts, during our interview sessions, stakeholders still raised a common concern regarding the lack of clarity on Malaysia's national policy direction towards sustainability. **While the government has made various announcements about sustainability policies and expressed its desire to decarbonize and achieve net-zero targets, there is still considerable ambiguity, inconsistency, and unpredictability surrounding policy action and lack of a specific timeline for implementation.** The absence of clarity has hindered businesses and investors from investing in new sustainability business models. Financial institutions have also become more risk-averse in their lending practices to avoid the possibility of stranded assets due to new environmental and sustainability regulations.

The key to overcoming policy uncertainty is for the government to provide predictable policies with a clear timeline. For example, Singapore has introduced carbon tax in 2019 at a modest level at S\$ 5 per tonne to give companies time to adjust low-carbon transition initiatives. The tax is applied to all facilities across sectors that directly emit at least 25 kt CO<sub>2</sub>e of Green House Gasses (GHG) emission annually. To provide policy certainty, the government also provided the carbon tax trajectory with a clear tax revision plan to raise the current rate to S\$25/t in 2024-2025, S\$ 45/t in 2026-2027 with a view of reaching S\$50-80/t by 2030. With such clarity in the carbon tax policy, the decision to invest in sustainable initiatives is more quantifiable, which is an important factor for bankability and investment in low carbon technology.

All levels of government decision-making i.e. federal, state and local authorities should be aligned with national sustainability goals. Government agencies with sustainable development mandates should be coordinated to increase policy efficiency. In line with this, Malaysia has put in place the National SDG Council chaired by the Prime Minister. The Economic Planning Unit (EPU) acts as a coordinating agency on initiatives related to sustainable development. To streamline the national policy and prepare a credible plan to achieve the 2030 SDG target and net zero commitment as early as 2050, we propose that the government consolidates the fragmented policy documents into a comprehensive national sustainable policy document to provide coherent policy direction moving forward. The national sustainable policy needs to have a clear implementation strategy, measurable goals and timelines. It should outline key criteria for sustainable development policy, such as having a national definition of sustainable development, integrating national development policy with SDGs and NDCs as well as embedding sustainability principles in the education system.

While strengthening coordination is important, the government also needs to have a clear evaluation mechanism to meet the set targets. The evaluation assessment is important to gauge the progress and success of sustainable policy initiatives and formulate recommendations to further enhance the public policy delivery mechanism. For example, Finland which has been ranked first among the 199 UN member states for its SDG performance, committed to a comprehensive evaluation of the national implementation efforts of the 2030 Agenda once per electoral term. This transformative and

coherent policy is the critical ingredient for the success of Finland in being inclusive and has become broadly accepted in society<sup>12</sup>.

Effective implementation of the national sustainable policy will help Malaysia optimize its people's quality of life and promote more balanced economic growth while preserving ecological capital. It is a crucial step towards building a sustainable and prosperous future for the nation. In the recent budget, the government announced targets to achieve 25% green procurement by 2025. This is a clear indication that our sustainability policy is moving in the right direction, where over the coming years the allocation for green procurement must be increased and implemented across various levels of the government.

## 5.2 Harmonising ESG reporting standards

To improve the comparability and reliability of ESG information in Malaysia, it is necessary for regulators and policymakers to adopt global ESG standards and frameworks, while developing a unified national standard tailored to Malaysia's specific needs and context in a more coordinated manner. The sustainable product guidelines and taxonomy by BNM and SC help greatly in product development and provide clarity to bankers and investors to identify economic activities that are aligned with environmental, social and sustainability objectives.

While a prescriptive set of unified ESG standards may be easier for comparability purposes, the disproportionate level of readiness of the domestic companies would make it difficult for the regulators to fix a single and specific standard of ESG disclosures. Moreover, in our interviews with asset managers, they highlighted that it is challenging to fulfil multiple requests on ESG related disclosures from various stakeholders, especially the institutional investors given that every GLIC and foreign institutional fund has its own ESG framework and targets. This adds to the industry's costs, while it is also faced with pressure to reduce fees. Hence, the asset managers recommend streamlining ESG practices to reduce the pressure on the industry to meet these multiple and varied requests. There are several initiatives taken under the *Perkukuh* initiative to collaborate and streamline ESG practices among the GLICs. In May this year, the Ministry of Finance (MoF) launched the Sustainable Investing Standards (SIS) to enhance the role of government-linked investment companies (GLICs) in driving sustainable investments through providing guidance on incorporating sustainability considerations in their investment process. While the SIS provided the outline for broad requirements and practical guidelines, individual GLICs are still required to align SIS with their own mandates and objectives. Members of the GLICs that we interviewed also mentioned that it is not possible to streamline the ESG practices entirely for now given that each GLIC would have their own mandates to fulfil.

As a first step towards adopting an international reporting framework, Bursa Malaysia recently issued enhanced guidelines on the sustainability reporting framework where listed companies in the main market are now required to include climate change-related disclosures aligned with the Task Force on Climate-related Financial Disclosures (TCFD) starting in 2025. Likewise, Bank Negara Malaysia has also required all financial institutions to be fully aligned with TCFD disclosures by 2024. With a specific

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<sup>12</sup> See Annuka et al (2019). PATH2030 –This publication is part of the implementation of the Government Plan for Analysis, Assessment and Research for 2018

climate change disclosure framework and a clear timeline defined, the issuers, intermediaries and investors can now be better prepared to comply with disclosure requirements.

Another part of the enhanced guidelines by Bursa Malaysia specifies the common sustainability matters and indicators that are deemed material for all Public Listed Companies (PLCs). The enhanced guidelines are anticipated to enhance the quality of disclosures. However, to provide investors with consistent, structured, and efficient access to ESG data, it is crucial to make this information available through a digital platform. Effective information sharing through open-source portals will increase market efficiency and enhance price discovery capabilities, particularly for ESG assets. A similar portal, “ESGenome” has been jointly introduced by Singapore Exchange (SGX) and the Monetary Authority of Singapore (MAS) to support companies in their ESG disclosure process as well as enhance stakeholder access and use of ESG data.

The ESG portal can serve multiple purposes. Firstly, it provides an opportunity to harmonise ESG disclosures by offering a centralised platform where companies can automatically map their ESG metrics and generate sustainability reports. This automation process can significantly reduce the cost of ESG reporting. Moreover, the portal presents an opportunity for investors to make investment decisions based on a comparable ESG dataset. It enables them to benchmark listed companies according to their ESG performance and track their commitments to ESG practices. This standardised information empowers investors to make informed choices aligned with their sustainability mandate.

To incentivise PLCs to prioritise ESG practices, a committee can be set up to publish the ESG ranking of the PLCs based on standards achieved from disclosures advertised, and to recognise the top ten best-performing companies while identifying the bottom ten based on the ranking. The government can announce preference for companies with good ESG practises to participate in public procurement exercises, in line with 2023 Budget announcement which sets a target to achieve 25% green procurement by 2025. This recognition system encourages companies to prioritise ESG practices and avoid being perceived as industry laggards. A similar special review can be conducted for government-linked companies (GLCs), ranking them from best to worst which sends a strong signal to the other industry players. This approach would expedite GLCs' transition to sustainable practices and support the government's efforts in achieving net-zero emissions and SDG targets.

By leveraging the ESG portal's functionalities, Malaysia can create a more transparent and accountable investment landscape. This will not only facilitate better decision-making for investors but also encourage companies to embrace sustainable practices, thereby driving positive change towards a more sustainable future.

### **5.3 Streamlining taxation and incentives**

#### *Increase effectiveness of government incentives...*

To promote the sustainability agenda, the government has provided various incentives through government agencies such as research grants, tax exemption, investment tax allowance and the promotion of green procurement. These incentives are distributed across agencies based on their mandate. **However, coordination is necessary to ensure the effectiveness of these incentives.**

The large number of ministries and agencies has led to a higher degree of fragmentation, decreasing the efficacy of program implementation, especially those agencies and ministries which cover the

Micro, Small and Medium Enterprise (MSME) segment<sup>13</sup>. There is a need for more efficient support programmes, specifically on the distribution of research grants to develop sustainable products to accelerate technological development and adaptation to sustainability. Efforts must be made to increase transparency surrounding grant recipients and their research progress in order to minimise abuses and wastage.

To start it is crucial to establish a database that registers all recipients of research incentives across various agencies. This database should include clear descriptions of the impact of the research based on the SDG targets. This measure is essential to prevent duplication and overlaps in research efforts.

**In addition, all research grants provided by the government should include SDG targets as an outcome of the research projects to increase the positive impact of the projects on the economy and society. Research grants should also emphasise frugal innovation activities, which focus on small scale technological innovation, especially to support the economic and social needs of the rural people.**

Entrepreneurs and start-ups should also be encouraged to apply for research grants as basic financing support and as a tool to build trust before they can tap into more mature sources of market-based financing such as venture capital and private equity or alternative sources of finance such as equity crowdfunding markets. The start-ups can leverage various supporting agencies such as the Malaysian Research Accelerator for Technology and Innovation (MRANTI) to help bring their ideas to fruition and toward commercialisation by tapping a larger network of entrepreneurship ecosystem.

Meanwhile, sustainable tax policy in Malaysia is still at a nascent stage. More policy innovation is required to ensure tax policies and tax incentive instruments are used effectively to promote sustainability without compromising fiscal prudence which can affect economic growth. Likewise, **the evaluation of government incentives to attract foreign direct investment should not be limited to the economic contribution alone. It should also include an assessment of the environmental and social impact to prevent polluting industries from relocating to Malaysia to avoid stringent sustainability requirements in their home country.** Encouraging carbon leakage and greenwashing to attract foreign direct investment to Malaysia is not advisable.

The government has made a commitment to introduce a carbon tax and regulated emission exchange scheme, although they have not yet provided a specific timeline for implementation. As a step towards this, Bursa Malaysia has already launched the world's first Islamic Voluntary Carbon Market, which works with VERRA, a leading voluntary carbon markets program and international standard setters managing the Verified Carbon Standard programme. Once the carbon tax is introduced, the revenue generated from it can be used to fund sustainability projects.

### *...changing consumer, investor and business behaviour...*

Tax incentives can change consumer behaviour and minimize the impact of higher production costs for sustainable products, such as electric vehicles, energy-saving appliances, green energy, and recycled materials. Green tax expenditures have become increasingly popular among G20 countries as a means of attracting consumers who favour sustainable products. Although some similar tax

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<sup>13</sup> See Kuriakose et al (2022) where the World Bank has produced a report on Malaysian SME Program Efficiency. The report highlighted that in the period from 2016 to 2019, more than 270 different SME support programs were implemented by more than 80 different agencies across almost all the line ministries. The large number of programmes creates significant coordination challenges.



incentives already exist to encourage sustainable consumption in Malaysia, more needs to be done to attract consumption and investment into sustainable business activities. Many incentives and initiatives have been implemented to promote sustainable capital market development in Malaysia. For example, the Securities Commission Malaysia (SC) has extended the SRI Sukuk and Bond Grants to SRI-linked Sukuk, which allows the issuer to offset up to 90% of the external review costs incurred, subject to a maximum of RM300,000 per issuance<sup>14</sup>. In addition, the government has proposed to provide tax exemptions on the cost of issuing SRI-linked Sukuk for a period of 5 years in the Budget 2023. These grants and tax incentives will reduce the burden of higher transaction costs and increase demand for the issuance of SRI-linked Sukuk in Malaysia.

The participants interviewed had mixed views on the use of monetary incentives to promote sustainable financing. **While some believed that tax incentives and interest subsidies were necessary to attract investors and companies to raise sustainable finance, others felt that incentives alone would not be enough to change the mindset of businesses, investors and the people towards sustainability practices. They agreed that while monetary incentives are critical for businesses to transition towards sustainability, there needs to be a fundamental shift in attitudes towards sustainability practices for effective change.** It is worth noting that tax incentives and interest subsidies are already widely offered in other jurisdictions, predominantly in the US (refer to Appendix 3).

### *...leveraging on behavioural interventions.*

To promote sustainable consumption and financing, one possible solution is to use behavioural interventions, such as nudges and social norms. Governments can encourage sustainable behaviour by implementing opt-out policies, where individuals are automatically enrolled in sustainable options, and by highlighting successful sustainable financing initiatives and showcasing companies that prioritise sustainability. These measures can help shift the mindset of investors and companies towards sustainability practices, increasing the uptake of sustainable options and attracting sustainable finance.

## **5.4 Nurturing sustainability culture**

Adapting to sustainable practices requires reforms and transformation at the national, business, and individual levels. While policymakers prefer a seamless transition, reforms can be disruptive in the near term. However, it is essential for Malaysia to remain competitive internationally and to attract foreign investment. To achieve this, government will need to address the underlying factors that prevent companies from adopting sustainable practices, such as the lack of awareness and understanding of sustainability principles and best practices. By providing education, training and capacity building programmes, governments can ensure that companies have the necessary knowledge and skills to adopt sustainable practices and take advantage of sustainable financing incentives.

Raising nationwide awareness of sustainability is also essential to gain greater buy-in on the national sustainability agenda. Schools should integrate ESG values into the national education syllabus to

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<sup>14</sup> <https://www.sc.com.my/resources/media/media-release/expansion-of-sri-sukuk-and-bond-grant-scheme-to-facilitate-sustainable-finance>

instil a culture of sustainability from an early age. Developed countries, such as the UK, Japan, Sweden and Finland, have recognised the importance of embedding sustainability competencies in their schools. Malaysia can learn from these examples to reduce resistance from the public on government's move to introduce low carbon policies, such as abolishing fuel subsidies, introducing carbon taxes, and increasing local taxes for waste management.

**A "whole of nation approach" is necessary to ensure that the actors within the ESG ecosystem progressively transition towards achieving the nation's sustainability goals.** The ESG practices at the firm and government level are critical in driving this change. When it comes to creating greater awareness, a human-centric and holistic approach is necessary, where businesses and people are both the cause and solution for a sustainable world. Government should work with the business sector, civil society, research community and international organizations to address climate concerns scientifically. Through concerted efforts, Malaysia can become a regional leader in sustainable development, contributing to a greener and more equitable world for all. Organising campaigns to introduce Malaysia's initiatives and incentives for sustainable development will improve awareness and acceptance for sustainability adoption. For example, the Green Flag-certified preschool programme in Sweden has become one of the key contributors for nurturing sustainability culture in Sweden. The education for sustainable development (ESD) in Sweden starts at preschool level, where children are viewed as an active agent to promote acceptance of sustainability culture in society<sup>15</sup>. The ESD effort improve acceptance of sustainability practices in Swedish society, making them one of the leading countries in achieving SDGs and the low carbon transition.

## **5.5 Fostering synergy between institutions-industry-universities-civil society**

### *Bridging the talent gap...*

Talent is a significant challenge in the transition to sustainability, particularly in Malaysia where expertise in sustainability remains scarce. However, companies that prioritise ESG integration are likely to retain talent due to greater transparency and good labour practices. The talent gap in sustainability can be addressed by multiple stakeholders joining forces to provide greater capacity-building programs that focus on training and upskilling.

**To tackle the significant talent gap in Malaysia, local universities can collaborate with international counterparts that have already developed curricula on sustainability and ESG to accelerate knowledge transfer.** For instance, by co-developing post-graduate programs with leading universities such as the University of California, Berkeley's Haas School of Business and the London School of Economics, local universities can tap into the wealth of experience and expertise that these institutions offer. They could also partner with industry experts to develop curricula that address the multidisciplinary nature of sustainability, for instance combining engineering and finance expertise to meet science-based target requirements to finance sustainable initiatives.

Unfortunately, various studies have highlighted that university-industry linkages in Malaysia remain weak. Trust issues, differences in work culture, and perceptions that universities are disconnected from real-life situations are among the major challenges to build the linkages<sup>16</sup>. To overcome this, universities can leverage on the strong industry network from capital market institutions, such as the

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<sup>15</sup> See Borg, F. (2019)

<sup>16</sup> See Razak, A. A., & Saad, M. (2007).

Securities Industry Development Corporation (SIDC), Capital Markets Malaysia (CMM) and Institute for Capital Market Research (ICMR) to connect with industry experts. In ICMR, we established the Research Collaboration Network (RCN) in 2022, that focuses on building network and research collaboration between regulators, industry and universities. This will enhance development of the capital market and improve quality of tertiary education in Malaysia.

Encouraging existing employees to learn new skills in the sustainability field is just as important as supplying new talent. Human resource departments should proactively identify people to take the lead in developing ESG practices within their organisations. By communicating the firm's intention to transition towards sustainability and highlighting career opportunities in the field, existing employees can be motivated to upskill.

Major training institutions in financial sectors such as the Institute Bank-Bank Malaysia (IBBM) and Securities Industry Development Corporation (SIDC) can facilitate upskilling by designing training modules that focus on sustainability, ESG, and specific programs to support the skillsets needed for the transition to a low-carbon economy. Capital Markets Malaysia (CMM) has initiated capacity building programs by spearheading Centres of Excellence (COE), such as the Malaysian Sustainable Initiative, the Sustainable Investment Platform, the Centre for Sustainable Corporations, and the Elevate program to provide capacity building and knowledge support to the industry. While these COEs have built strong connections and collaboration with industry players and regulators, they still lack collaboration with universities and research institutes. In contrast, the Money Authority of Singapore (MAS) has established COEs that focus on a sustainable finance research and talent development ecosystem hosted by Singapore Management University (SMU) and National University of Singapore (NUS). **Our COEs should consider adding the role of universities to develop the financing ESG ecosystem and facilitate talent development and research in the sustainability area in Malaysia.**

### *... and managing reputational risk*

To ensure the long-term success of Malaysian companies, it is crucial to manage reputational risks by implementing robust risk management systems and enhancing ESG practices. This includes focusing on key areas such as strengthening corporate governance, prioritizing environmental protection, being vigilant about data breaches and securities, implementing fair labour practices, and avoiding any form of human rights violations.

To achieve this, the government has an important role to play in protecting companies and ensuring that they adhere to global best practices. This involves reviewing existing laws, strengthening enforcement activities, and imposing stricter punishments for those who exploit environmental assets unlawfully. **Participants in interviews emphasized the need for the government to enhance enforcement activities and implement fair labour laws that are in line with international best practices and SDGs, which promote fair wages, protect vulnerable workers, and provide safe working conditions.** The recently launched SRI taxonomy also included broader aspect of sustainability beyond environmental component and included social components with specific focus on enhanced conduct towards workers, consumers and communities. Leveraging on international organisations such as the International Labour Organization (ILO) and Human Rights Commission can provide valuable assistance to improve the reputation of Malaysian companies in the international market.

However, sustainability standards are often also used to lobby against Malaysian products in the international market. Environmental pressure groups have called for boycotts of Malaysian palm oil, alleging that the industry has contributed to environmental degradation, biodiversity loss, and human

rights violations. Although some concerns have been addressed by the Malaysian government, such as developing certifications like the Malaysian Sustainable Palm Oil (MSPO) which covers 98% of palm oil plantation areas in Malaysia<sup>17</sup>, the EU continues to impose anti-palm oil measures on Malaysia and our neighbours. In response, the Malaysian government has filed complaints against the EU with the World Trade Organization (WTO) and acted in solidarity with Indonesia in a separate WTO case<sup>18</sup>.

To address these claims, allegations against Malaysian products, the industry and government must take proactive steps to promote transparency and produce evidence-based arguments. This involves working with universities, research institutions, civil society, and the industry to produce science-based evidence. To enhance the visibility of counterarguments and remedial measures taken, Malaysia should embark on an effective public relations strategy, collaborating with NGOs and scientific communities, and using both physical and digital platforms to disseminate information. The government has allocated RM 10 million in the recent budget to counter anti-palm oil campaigns globally. Malaysian companies must manage reputational risks by adhering to global best practices and promoting transparency, with the government working with various stakeholders to ensure effective response to the allegations.

## 5.6 Strengthening global and regional collaboration

Sustainability issues such as climate change are increasingly recognised as a global problem that transcends national boundaries. As such, it is critical to work together as a collective voice to raise sustainable issues on the global platform. The international communities and multilateral development banks (MDBs) have a greater role in promoting sustainability through technological assistance, financing sustainable development and promoting capacity building in sustainability areas.

ASEAN has emerged as a pivotal player in championing the sustainability agenda in the region, aligning with its agenda to encourage economic integration, social and capital mobility within the region as envisaged under the ASEAN Community Vision 2025.

International trade is now facing increasing threats with the growing trend of imposing non-tax barriers, including the imposition of standards. **While the push for sustainability standards in advanced economies, such as the introduction of the Carbon Border Adjustment Mechanism (CBAM) in the European Union, ASEAN policymakers need to have a common strategy to respond to such acts, especially if the act goes against their own international trade principles.** ASEAN should take the lead in providing the guideline for the development of carbon trading platforms in the region, which can be linked to the EU's CBAM regulations<sup>19</sup>.

In line with the effort for harmonisation, the ASEAN Taxonomy Board (ATB) was launched in March 2021 to develop, maintain, and promote an ASEAN Taxonomy which is an overarching guide to identify and classify sustainable economic activities among the AMS and serves orderly transition to finance sustainable activities across the region. The ATB comprises capital market regulators, central banks and insurance regulators where all 10 AMS are represented. The ATB comes under the auspices

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<sup>17</sup> Highlighted in 'Budget 2023' budget speech.

<sup>18</sup> See <https://www.isis.org.my/2021/01/31/malaysia-draws-battles-lines-with-eu-over-palm-oil-focusing-on-public-relations-blitz/>

<sup>19</sup> See Chris (2021) which highlighted the needs for ASEAN to collaborate on carbon market mechanism

of the ASEAN Finance Minister and Central Bank Governors Meeting, which both SC Malaysia and BNM are actively involved in.

The first version of the ASEAN Taxonomy for Sustainable Finance was introduced by ATB in November 2021, in conjunction with the 26<sup>th</sup> Session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (COP 26). The ASEAN taxonomy is unique with a multi-tiered framework, catering for the diversity of the economic and financial development among the AMS while adhering to science-based approach and remains credible internationally. While version 1 served to provide the overall framework, in March 2023, the ATB released the ASEAN Taxonomy Version 2 with a view to have the Final Version launched at COP28 (around November or December this year). The ASEAN Taxonomy version 2 aims to provide both a Foundational Framework as well as metric-based Technical Screening Criteria (TSC) for six focus sectors and three enabling sectors under the Plus Standard, which were identified based on significant contributions to GHG emission and the economy of the AMS. The ATB will be the ultimate approval body for activities, tier, TSC and TSC review. The TSC will be adjusted over time, where Tier 2 and Tier 3 classified as Amber is expected to gradually sunset over time for all activities and migrate all activities to Tier 1. The ATB may establish TSC Review Bodies (TRB) for reviewing and proposing enhancements to TSC. With the overarching guidance provided by the ASEAN Taxonomy for Sustainable Finance, the AMS can develop national level taxonomies, similar to CCPT and SRI Taxonomy in Malaysia, but at the same time still ensuring consistency and facilitating capital mobility within ASEAN.

The ASEAN Capital Market Forum (ACMF) has presented the Roadmap for ASEAN's Sustainable Capital Market, with priorities to promote common disclosure standards and facilitate capital mobility within ASEAN. The harmonisation of sustainability investment frameworks and disclosure requirements will increase cross-border investment in sustainable projects within ASEAN. All ASEAN Member States (AMS) will have an equal opportunity to access financing for sustainability, subject to their willingness to adopt and implement frameworks and disclosure requirements. For example, Malaysia's SRI label bonds framework is developed in line with ASEAN Green and Social Bond Standards. The ACMF also suggests introducing a "Green Lane" to expedite cross-border label bond issuances and distribution of funds without compromising regulatory standards. In addition to the bond markets, the ACMF also recommended strengthening the ASEAN Collective Investment Schemes (CIS) framework and streamlining the review framework for ASEAN Common Prospectus to facilitate cross-border flows.

ASEAN also focuses on capacity building in the region by working with other international organisations and donor countries. The ASEAN Central Banks (ACBs) and capital market regulators are already working on a common platform to discuss and share their knowledge with regional peers. The ACBs and capital market regulators should facilitate for joined training activities among the AMS. For example, the Centres of Excellence (COEs) in Malaysia and Singapore can be offered to other AMS to join to build Sustainability talent.

**Data is a key factor in climate financing. The initiative to develop a common data platform that features sustainability data such as climate financing data could benefit businesses and investors to access business opportunities and identify collaboration partners to work together.** The ASEAN Exchange (AE) currently provides investment tools such as broker reports and financial data for listed companies of their members. To accelerate the adaptation of Environmental, Social, and Governance (ESG) practices, the AE can consider providing an ESG database, which will benefit investors in making investment decisions based on ESG principles.

# Conclusion

In conclusion, the transition to sustainability and ESG disclosure is no longer optional; it is a necessary and critical tool for businesses to remain relevant and competitive in today's market. This report presents key takeaways based on some of the major challenges faced by various capital market stakeholders, along with potential policy recommendations. The insights in this report were gathered primarily through stakeholder interviews. While the business opportunities that arise from the transition to sustainable business model are massive, business and governments should also be aware of the potential risks that come with abrupt changes during the transition.

To ensure a smoother transition, it is necessary to have a clear policy direction with specific timelines and more education and awareness programs. Institutional investors play a crucial role in advancing the ESG agenda, and their stewardship role must continue. Given the challenges in the ESG transition, a phased approach is still the best way to move forward. Nevertheless, Malaysian companies must also recognise that transition pressure will come not only from domestic regulation but also from international regulations, supply chain pressure, and foreign investment and trade requirements.

The study proposes three key strategies to transition towards sustainable practices in Malaysia. These include promoting policy coherence, facilitating ecosystem motivation, and fostering network cohesion. To achieve this goal, Malaysia needs to adopt a coordinated approach that involves institutions, industry, universities and civil society. By addressing the identified challenges and implementing the recommended strategies, Malaysia has the potential to become a leader in sustainable development.

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# Appendix 1

## Various sustainability standards

| Standard Setters  | Supranational Organisations  | Indexes/Rating Agencies/Verifier   | Others  |
|---|--|--|---|
| <ul style="list-style-type: none"><li>• Sustainability Accounting Standards Board (SASB)</li><li>• Global Reporting Initiative (GRI)</li><li>• Science Based Targets Initiative (SBTi)</li><li>• Task Force on Climate-Related Financial Disclosures (TCFD)</li></ul> | <ul style="list-style-type: none"><li>• UNGC</li><li>• UNFCCC</li><li>• OECD</li><li>• UNEP FI</li></ul> | <ul style="list-style-type: none"><li>• Dow Jones Sustainability Index</li><li>• FTSE4Goods</li><li>• Veera</li><li>• Gold Standards</li></ul> | <ul style="list-style-type: none"><li>• UN PRI (Investors)</li><li>• Regulation</li><li>• Stock Exchanges</li></ul> |

Source: Adapted from TCFD Learning Hub



## Appendix 2

### Selected empirical research on ESG practices and firm performances.

| No | Author   | Title   | Key Findings   |
|----|--|---|--|
| 1  | Wan Masliza Wan Mohammad, Shaista Wasiuzzaman (2021) | Environmental, Social and Governance (ESG) disclosure, competitive advantage and performance of firms in Malaysia<br>( <i>Cleaner Environmental Systems</i> )                                 | The findings of this research indicate that ESG disclosure improves the firm performance of the listed companies in Bursa Malaysia<br><br>The analysis confirmed that an increase in ESG disclosure by one unit would increase firm performance by approximately 4 percent in Malaysia   |
| 2  | Siew Peng Lee, Mansor Isa (2022)                     | Environmental, social and governance (ESG) practices and financial performance of Shariah-compliant companies in Malaysia<br>( <i>Journal of Islamic Accounting &amp; Business Research</i> ) | The study finds a positive relationship between ESG practices and financial performance, suggesting that ESG practices can enhance firm value.<br><br>Double ESG–Shariah screening can enhance the ESG relationship with performance.  |
| 3  | Atan, R., Alam, M.M., Said, J. and Zamri, M. (2018)  | The impacts of environmental, social, and governance factors on firm performance: Panel study of Malaysian companies<br>( <i>Management of Environmental Quality</i> )                        | This paper examines the impact of ESG factors on the performance of Malaysian public-limited companies (PLC) in terms of profitability, firm value, and cost of capital.<br><br>There is no significant relationship between individual and combined factors of ESG and firm profitability (i.e. ROE) as well as firm value (i.e. Tobin's Q).<br><br>Moreover, individually, none of the factors of ESG is significant with the cost of capital (weighted average cost of capital, WACC), but the combined score of ESG positively and significantly influences the cost of capital (WACC) of a company. |
| 4  | Sadiq, Muhammad (2020)                               | The Impact of Environmental, Social and Governance Index on Firm Value: Evidence from Malaysia<br>( <i>International Journal of Energy Economics and Policy</i> )                             | The study investigates the relationship between ESG practices and the consequences related to their disclosure on the firm's value based on 122 listed companies in Bursa Malaysia for 2011 – 2019.  |

|   |   |   |  |
|---|---|---|--|
|   |   |   | <p>This study finds that ESG disclosures can play the role by which a firm can reduce the negative effect of weakness and improve the positive effect of strength.</p> <p>The results are consistent with the approach that indicate that ESG strength increases firm value, whereas ESG disclosure and ESG concern decrease the firm value.</p>   |
| 5 | Ismail, N., Anridho, N., Isa, M. A. M., Rahman, N. H. A., & Ismail, N. (2022) | Corporate Sustainability and Firms' Financial Performance: Evidence from Malaysian and Indonesian Public Listed Companies<br><i>(International Journal of Economics and Management)</i> | <p>This result implies that companies engaged in ESG aspects have a higher shareholder value.</p> <p>A good economic condition encouraged companies to integrate ESG aspects and rewarded investors with good financial returns (ROE).</p> <p>The empirical evidence confirms the stakeholder's theory and agency theory.</p> <p>The implication of this study is to strengthen the development of sustainability from ESG practice and in line with the current agenda of sustainable finance for policymakers.</p> |

Source: Extracted from various journal articles

## Appendix 3

### Tax policies and tax incentives for promoting sustainable practices in selected countries

| Country         | Sustainability Incentives   |
|-----------------|---|
| United States   | The US has well-established green taxes and incentives (both tax and non-tax) for renewable energy, fleet decarbonization and energy-efficiency at both levied at federal, states and localities. Several local jurisdictions have implemented or are considering an ETS or carbon tax. The top focus areas in US sustainability measures are fleet decarbonization/electrification, corporate tax credits for - clean/renewable energy, advanced manufacturing, fleets, renewable fuels, carbon sequestration, energy investment and storage, fuel taxes, rebate and grant programs, green building incentives. There are 33 tax incentives available in the US region.  |
| China Main Land | China Mainland is improving and strengthening ESG- related legislation and supervision. At the national level, there are three environmental protection focus areas: pollution reduction, greenhouse gas reduction and resource conservation. There are multiple tax incentives that address the three focus areas and utilize different mechanisms, including corporate income tax relief and increased VAT refunds or tax exemptions. For pollution reduction, China Mainland launched the Environmental Protection Tax (EPT), which is levied on the emission of four categories of pollutants, namely gas, water, solid wastes, as well as noises. There are 3 cash grants and 11 tax incentives.   |
| India           | India has levied various environmental taxes for a number of years. The Government has recently brought out an amendment of The Energy Conservation (Amendment) Bill, 2022, that paves the way for the government to push its decarbonization agenda through carbon trading, mandatory usage of non-fossil fuel and energy efficiency standards.<br>There are high taxes on petrol and diesel, a "Green Tax" on old vehicles and lower taxes on electric vehicles. A Production Linked Incentive (PLI) scheme has been proposed to boost domestic manufacturing capabilities of the automobile industry, including electric and hydrogen fuel cell vehicles. Overall, there are 17 cash grants, 3 soft loans and 15 tax incentive schemes available in India. |
| United Kingdom  | The UK was a founding member of the EU ETS in 2005, the UK climate change levy caused a behavioural change away from coal-fired power generation and the carbon price under the EU ETS is underpinned by a carbon floor.<br>With the UK's exit from the EU, the UK has introduced its own ETS which has generated a carbon price that is currently slightly above the EU carbon price. Other focus areas include a climate change levy, various fuel duties and other environmental taxes, such as the plastic packaging tax that came into force in 2022.<br>There are 13 cash grants and 10 tax incentives available to support sustainability transition.  |
| Germany         | German sustainability tax programs are well established, mostly at the national level, and more are continuing to emerge. Sustainability taxes and incentives are a political focus in Germany and thus the environment is constantly evolving. There are program adjustments due to technological progress and   |

|           |  |
|-----------|--|
|           | <p>other environmental needs, as well as the strong influence of supra-national EU legislation.</p> <p>There are multiple sustainability incentives available, including grants or rebates for the purchase of qualifying goods and reduced carbon taxes or taxes on fuels in certain qualifying situations.</p>   |
| Malaysia  | <p>Sustainability tax policies are still emerging in Malaysia. There are several green incentives available at the national level, taking the form of income tax credits, accelerated depreciation, grants and rebates.</p> <p>The Malaysian Government has announced a proposal for a carbon tax to be implemented in Malaysia, as well as the development of a domestic emissions trading scheme.</p>  |
| Thailand  | <p>Thailand is considering a carbon tax on products or processes with high carbon dioxide emissions, such as cement, iron, aluminium, fertiliser and the electricity production process.</p> <p>At present, there is a preliminary draft legislation outlining potential funding for waste electrical and electronic equipment.</p>  |
| Indonesia | <p>Green policies are still emerging in Indonesia with no measures currently implemented at the jurisdictional or local level, though some investment tax incentives do apply to green investments.</p> <p>The Indonesian government has stated plans to introduce a carbon tax. Under Indonesia's Proposed Tax Bill that is still being reviewed and discussed by the Parliament.</p>   |
| Vietnam   | <p>Sustainability tax programs, mostly at the national level, have been established in Vietnam for a quite long time with a Natural Resources Tax in place since the 2000s and Environmental Protection Tax since 2010s. However, new measures are still emerging. The Law on Environmental Protection went into force 1 January 2022.</p> <p>Additionally, the Vietnamese government is actively working to implement new measures and will release the detailed guidance on an emission trading system in the near future. The Vietnamese government also enacted incentives and assistance for business activities related to environmental protection to encourage enterprises to seize opportunities from sustainability, clean energy transition and waste reduction.</p>                        |
| Singapore | <p>Singapore has traditionally maintained sustainability tax incentives to encourage businesses to embrace sustainability. Singapore's sustainability tax incentives mainly focus on energy efficiency, adoption of technology or solutions for reduction of carbon emissions and the adoption of alternative sources of renewable energies.</p> <p>Singapore was one of the first Asian countries to implement an economy-wide carbon tax in 2019. In the 2022 Budget, Singapore committed to raising the carbon tax from \$5 per tonne to \$25 per tonne by 2024, with a view to reaching up to \$80 per tonne by 2030. The proposed increase will take effect in 2023.</p> <p>Singapore has 29 cash grants, 3 tax incentives and various form of taxes to achieve their sustainability targets.</p> |

Source: Details are extracted from EY Green Tax Tracker and PwC Green Taxes and Incentives Tracker