Board Matters Quarterly

Issue 4, 2022

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The Board Matters Quarterly offers thought-provoking perspectives and insights into leadership and governance issues for boards and audit committees, supporting them to navigate the increasingly complex business environment.

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Why sustainable finance is becoming the future of mainstream financing instruments

Sustainable finance can be defined as any form of financial service that incentivizes the integration of long-term environmental, social and governance (ESG) criteria into business decisions to provide more equitable, sustainable and inclusive benefits for clients and society. Examples of sustainable finance include green, social and sustainability-linked debt instruments such as bonds, *sukuk* or loans.

The imperative:
There won't be a sustainable future without sustainable finance

In 2018, the Intergovernmental Panel for Climate Change (IPCC) issued a landmark report warning of the catastrophic and irreversible effects of climate change if global warming is not limited to a maximum of 1.5°C above pre-industrial levels . Critically, the latest IPCC 6th Assessment Report published in 2021 suggests that without immediate, rapid and large-scale reductions in emissions and a shift to promoting well-being, limiting global warming to 1.5°C will soon be beyond reach.

We need to combat climate change, achieve the United Nation's (UN) sustainable development goals, and create fairer societies. This will require a trillion-dollar growth in the market for sustainable lending, investment and insurance. Meeting this demand is a great moral responsibility for the finance industry, but also a historic business opportunity.

Companies in every industry will need help to transform. People in every community will need fair and inclusive access to financial services that help them respond to climate risk. The transition to a sustainable future is for everyone, and everyone should be able to benefit. None of this will happen without the capital, skills and knowledge contained within the global financial services industry. In fact, there will not be a sustainable future without sustainable finance. Leaders across the global financial services industry are stepping up to play their part. They see the moral responsibility, as importantly as they see the business opportunity.

The case for Malaysia

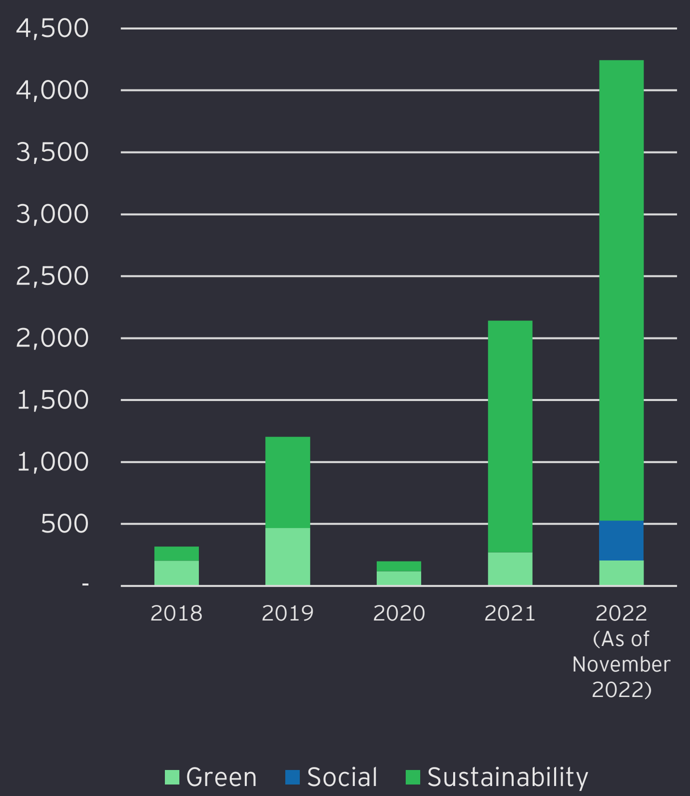
> Sustainable finance in Malaysia is thriving, driven by government commitments, supportive regulatory and policy frameworks as well as the significant participation of institutional investors.

As of the end November 2022, Malaysia recorded approximately US$4.2 billion in new sustainable bond or *sukuk* issuances, more than double from a year ago. The highest growth was seen in sustainability-labelled *sukuk* driven by the financial sector and government issuances where the use of proceeds include both green and social projects. 76% of the issuances are by corporate entities, while the remaining 24% relates to Malaysian government issuances.

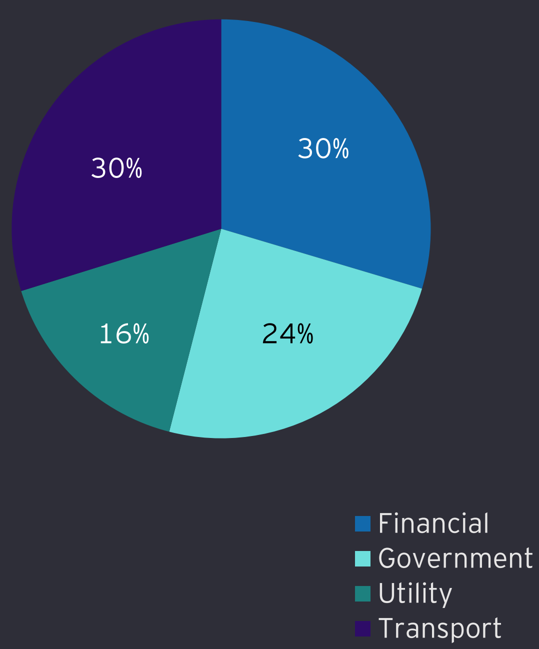
The surge in sustainable bonds or *sukuk* is consistent with global and regional trends, supported by strong investor demand as more investors have committed to net zero and aligned their strategies to the 2030 Sustainable Development Goals. Earlier this year, MBSB Bank's maiden Sustainability *Sukuk Wakalah* issuance was oversubscribed by ten times, demonstrating strong investor demand.

One of the major challenges of sustainable finance is the convergence of financial and non-financial information. Currently, there is a lack of agreement on and availability of actionable environmental, social and governance (ESG) data. The lack of standardization in disclosure regulation around the world means that corporate ESG disclosure is inconsistent. However, in November 2021, the International Financial Reporting Standards (IFRS) Foundation announced the formation of the International Sustainability Standards Board (ISSB), which intends to develop "a comprehensive global baseline" for sustainability disclosure standards to help meet the information needs of investors. In March 2022. the ISSB published its first two Exposure Drafts on IFRS Sustainability Disclosure Standards, namely: [1] General Requirements for Disclosure of Sustainability-related Financial Information (IFRS S1) and [2] Climate-related Disclosures (IFRS S2). This promising progress can lay the foundations for consistent and comparable corporate ESG disclosure.

Amount of sustainable bond or *sukuk* issuances in Malaysia per year (US$'mil)



2022 sustainable *sukuk* Issuances by sector (%)



Drivers moving forward

> As a country, Malaysia has committed to becoming a carbon-neutral nation by 2050, reducing 45% of economy-wide carbon intensity by 2030

and increasing the total installed capacity of renewable energy to 31% by 2025 and 40% by 2035. These commitments will require signification transitions in the energy, transportation, and infrastructure sectors to a low-carbon economy. These transitions will require substantial capital, and sustainable finance will likely be channeled towards these sectors. By 2030, the ASEAN green / low-carbon economy is estimated to provide potential annual business opportunities of nearly US$1t .

In addition, efforts and initiatives by local regulators will further support financial institutions to integrate ESG considerations in their financing and expand on sustainable finance offerings. Some of the notable initiatives by the local regulators include:

Bank Negara Malaysia

- Financial Sector Blueprint 2022-2026
- Climate Change and Principle-based Taxonomy
- Policy document on Climate Risk Management and Scenario Analysis
- Value-based Intermediation (VBI)
- Discussion Paper on the 2024 Climate Risk Stress Testing Exercise
- Jointly formed the Joint Committee on Climate Change (JC3) with Securities Commission Malaysia

Securities Commission Malaysia

- Financial Sector Blueprint 2022-2026
- Climate Change and Principle-based Taxonomy
- Policy document on Climate Risk Management and Scenario Analysis
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Bursa Malaysia

- FTSE4Good Bursa Malaysia Index
- Sustainability Reporting Guide and Toolkits
- Task Force on Climate-related Financial Disclosures (TCFD) Application Guide (issued under JC3)

What does this mean for boards?

Boards need to fully understand the implications of their organizations' sustainability commitments (i.e., net zero strategies) and how their organizations need to transform to better serve — not stop serving — their customers, with net zero in mind. Directors have to challenge management to be catalysts and enablers of change, not to keep taking the easier road of ceasing support. Below are some of the key considerations:

- How well do you understand your sustainable finance commitments? If your firm has committed, or is considering committing to net-zero strategies, have you discussed the full strategic and financial implications with management?
- How well is your sustainable finance strategy embedded in your multi-year corporate strategy? How frequently do you receive reporting on performance vs. plan and associated risks?
- How well does your organization understand the risks associated with sustainable finance? For example, have you been briefed on the impacts of physical and transition risks from climate change on your operations, customers, products and services, and communities?
- Has your organization's risk management group conducted robust analyses on ESG? Are they embedding ESG into their enterprise risk and risk appetite frameworks?
- How is ESG affecting credit, underwriting and pricing decisions?
- How are new ESG-related products governed to avoid mis-selling or mispricing?

Conclusion

This much is clear: the market for sustainable financial services is global, growing and profitable, and it will be shaped and led by firms that get involved now.

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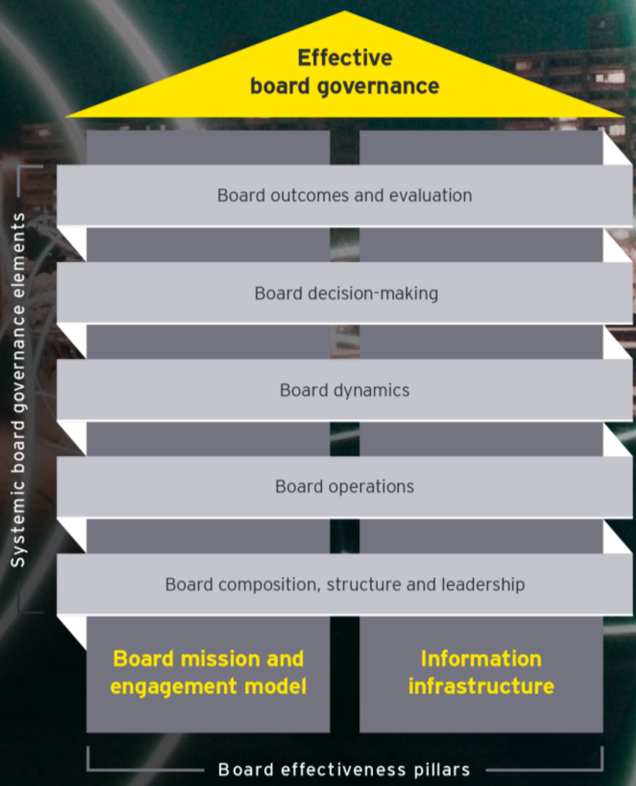
How to achieve board effectiveness in an ever-changing business environment

In a world of constant change, intensified by greater complexity, regulation and crises, enhancing the board's impact and value requires continuous reviews and improvements.

The EY Center for Board Matters has developed a comprehensive approach and framework for understanding and enhancing board effectiveness. The framework includes a series of elements that must be intact for board performance to flourish. Two of these are foundational "effectiveness" pillars that guide the work to be done by the board.

These flow through five "systemic" layering elements that embody the board's operating environment. With a strong mission and engagement model supported by effective information practices, boards have a solid foundation for effective performance. The systemic board governance elements encompass the operating model and principles of an effective board.

The EY Center for Board Matters framework for board effectiveness



Pillar 1:
Board mission and engagement model

The purpose of the board is to essentially impart insights, foresights and oversights on pertinent issues that would improve business process and efficiency while at the same time drive corporate governance. Effective board members must be well prepared and stay abreast of governance issues by engaging with each other, management, advisors and key stakeholders.

Evidence of an effective board mission and engagement model:

- The boards' corporate governance guidelines articulate the board's purpose, values and core engagement strategy and practices.
- Every board member can consistently state the board's mission and the company's purpose, strategy and long-term value proposition.
- Board members and management are in clear agreement about the mission-critical company issues that demand board oversight.
- Each board member individually embodies core traditional leadership values and skills, including ethics and integrity, diligence and conscientiousness, executive-level communication skills, and a commitment to progress.
- There is clarity as to the company's core policies, strategies and risk management approaches, and when and how the board engages to oversee them.

Pillar 2:
Information infrastructure

Boards should be specific with management about their information needs so that management is not overburdened with immaterial questions and potentially driven to expand board materials to include tangential information or excessive detail. Boards should never rely solely on management for their education and information. Broader and more strategic engagement, both inside and outside the company, is necessary for boards to obtain the information they need.

Evidence of effective board information infrastructures:

- Board meeting materials include a cover memorandum that succinctly describes in a clear narrative form all items on the board agenda.
- Technical documents, such as financial reporting, equity compensation plans, merger agreements or other material contracts, are fronted with a one- or two-page (max) executive summary of material terms.
- All board materials are presented with draft resolutions clearly specifying the matters the board or its committees are being asked to act on.
- Boards and management are diligent about how they engage with each other to share information, respecting established communications channels and security issues.
- Neither the board nor management feels unduly overburdened with information overload or requests for information, respectively.
- The board regularly hears perspectives from third parties on critical issues and complex matters.

Board composition, structure and leadership

Aside from depicting strong leadership values, diligence and conscientiousness, board members should demonstrate curiosity, continual learning mindset and forward-looking entrepreneurial energy.

> Board committees themselves should select their chairs based on competencies and leadership ability. Any board leader, whether an independent chair or lead independent director, must be dynamic, organized and free of any conflicts of interest.

More boards today are establishing other standing committees to absorb some of the work overload especially on mission-critical board matters. For example, boards are allocating special teams to address matters related to risk and technology, and environmental, social and governance (ESG).

Evidence of effective board composition, structure and leadership:

- The board maintains, in collaboration with management, a detailed board skills matrix in assessing board size and composition.
- The board's corporate governance guidelines and committee charters clearly allocate roles and responsibilities between the board and its committees, including mission-critical issues such as strategy, risk, culture, compliance, technology, cybersecurity, and climate change.
- Board members periodically move across different committees, and committee structure and composition are reasonably fluid based on the company's needs.

Board operations

Board and committee leaders should know what mission-critical issues they need to address and collaborate with management to develop and maintain meeting schedules and orientation programs with appropriate frequency, sufficient time and relevant content. Meeting and orientation agendas should drive scheduled meeting times rather than the other way around.

Evidence of effective board operations:

- Board meetings and core agendas are formalized for the upcoming year or two, reducing scheduling conflicts and director absences.
- Meetings are focused on discussion and deliberation to give focus on agenda items.
- All directors attend all (or most) meetings of the board and committees of which they sit.

Board dynamics

A positive board dynamic is one of the most critical elements in achieving board effectiveness. Many also believe that consistently maintaining a positive board dynamic can be challenging. For this reason, all board members, especially board leadership, need to work to nurture and consistently demonstrate respect and trust for each other.

Board members should be intentional about diversity so they can gain enhanced perspectives that enable better problem identification and solution, stronger innovation and reduced blind spots.

Evidence of effective board dynamics:

- Balanced representations of directors so no single director or group of directors dominates the agenda discussion and deliberations.
- Directors are able to voice out when they see something.
- Boards engage in informal ways to enhance trust and build personal connections.

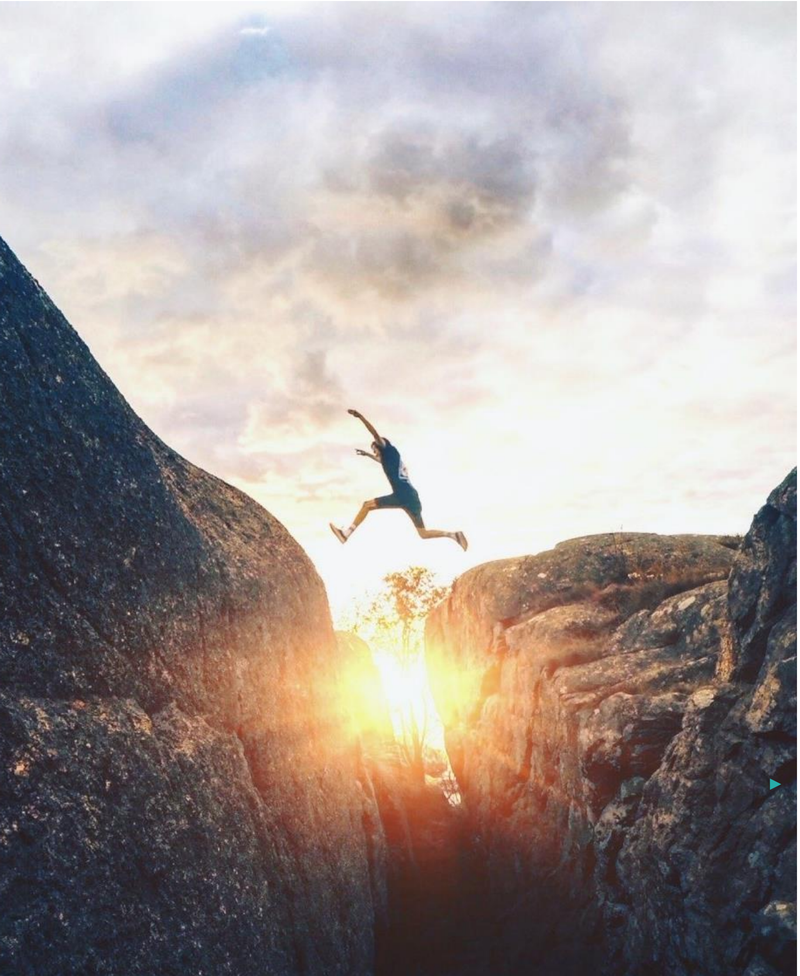
Board decision-making

Boards should be highly conscientious and intentional about when and how they make decisions. Leading boards develop a process to support effective decision-making, based on applicable state and relevant laws and the board's mission and engagement model.

For every matter before them, boards should question and assess how well the decisions they may make align with the company's purpose, culture, strategy, risk tolerance profile, and sustainability goals.

Evidence of effective board decision-making:

- The board maintains a delegated authority matrix, specifying corporate business matters that require board decisions.
- The board establishes transparency around director voting by discouraging informal decision-making discussions.
- Decisions are made with sufficient considerations about the quality of the information, timing, and risks and rewards.



Board outcomes and evaluation

The ultimate outcome of a high-performing board is reflected in the success and prosperity of the business itself. A board should see the evidence of its efforts manifest in company financial performance, including growth through the innovation it fosters and cost reduction from the risks it helps the company avoid.

High quality feedback is what enables boards and directors to see how they can better perform and communicate.

Evidence of effective board outcomes and evaluation:

- The board conducts a self-evaluation annually, enhanced by third-party facilitation when needed.
- The board's collective competencies map to the company's strategic and technical needs.
- The company's disclosures around the board evaluation process enhance trust in the board.

Conclusion

A highly effective board of directors is a great asset to a management team and a critical component of company success. Boards must deliberately manage the board effectiveness pillars to be certain they are working on mission-critical elements of the business and procuring the right information to drive decisions.

Questions for the board to consider:

- How does the board evaluate whether management is "living" the company's purpose and values as described in the company's code of business conduct and ethics?
- On mission-critical issues, how does the board diversify its information sources beyond management by engaging with independent advisors to broaden its perspective?
- Do the board's corporate governance guidelines provide clear standards for director qualifications, continued service, tenure, and removal?
- Does the board calendar make sufficient time for board engagement with management?
- Is every director consistently prepared and represented for board and committee meetings?

This article was adapted from EY Center for Board Matters: How to achieve enduring board effectiveness

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