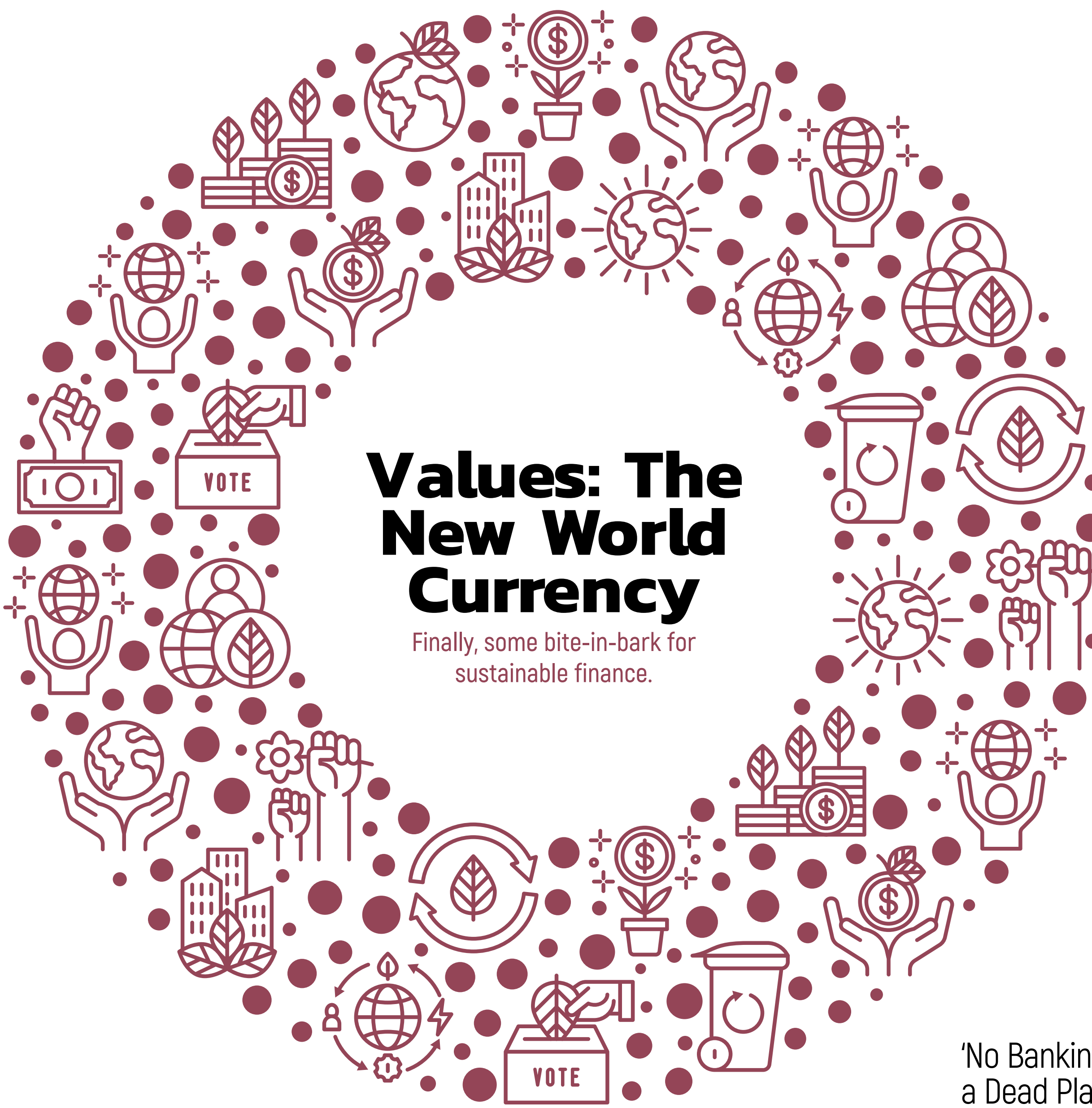
Exclusive Interview with Chartered Banker, Rizleen Mokhtar, former Executive Vice President of Credit Risk at AmBank Group

Unfazed by the Future

BANKING INSIGHT

IDEAS FOR LEADERS | JUNE 2021

PP 17327/05/2013(032407)



Values: The New World Currency

Finally, some bite-in-bark for sustainable finance.

'No Banking on a Dead Planet'

MANY MARKETS, ONE COMMON LANGUAGE

NOVEL WAYS OF THINKING IN FINANCE

A PUBLICATION OF

AICB
ASIAN INSTITUTE OF CHARTERED BANKERS

ISSN 2231-6247


AICB
ASIAN INSTITUTE OF CHARTERED BANKERS
Bank Risk Management
Identify, assess and manage risk in an evolving banking landscape
Bank Risk Management (BRM) is a certification that provides a comprehensive body of knowledge to those who aspire to be risk specialists. It focuses on the types of risks faced by banks and how these risks may be identified, assessed and managed. The application of risk management tools and techniques is presented to enhance the understanding of managing risks in a volatile banking environment.
To enrol, please visit www.aicb.org.my
Asian Institute of Chartered Bankers 197701004872 (35880-P), Levels 11 & 12, Bangunan AICB, 10 Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
Toll-free 1300-88-6833 E enquiries@aicb.org.my

Editor's Note

Banking's Next Shot in the Arm?

And the trophy for breakout star of 2021 goes to: sustainable finance.

As the biggest investors in the world double down on commitments (and budgets) for environmental, social, and governance (ESG) investing, the once-elusive business case for sustainable finance is today a booming USD51.1 billion market.

The only asset class to buck the downward trend in the current economic crisis, it looks like sustainability as a sector has finally grown into its boots, proof that doing good and delivering returns are compatible and achievable goals.

In fact, the burgeoning sustainability landscape changes significantly with each passing day. Our editorial for this issue attests to it – we overhauled articles and features twice in the preceding weeks to ensure we gave readers the most current data and perspectives before hitting the printing press.

We lead with *Values: The New World Currency*, which explores the tectonic shift towards a human-centred economy, which global experts and leaders concur will be a cornerstone for global recovery. The corporate world is abuzz with shareholder activism, impact investing, and values-based decision-making. We must take our positions today in this nascent economy.

Our smorgasbord of banking briefs, including the AICB's collaborative works with UK-based Chartered Institute for Securities & Investment and University of Cambridge, bring readers abreast on the major trends impacting boards and executives.

Taking the bull by the horns is *Pre-empt a Green Swan*, which delves into the transition risks of 'brown to green'. Financial stability and resilience can only be enhanced when we factor these material risks in the analysis and counter them head-on.

For too long, many in the sector have narrowly defined success solely through the lens of monetary gain. In *No Banking on A Dead Planet*, French sustainability leader Minh Cuong Le Quan, drops the penny to remind us of the ripple effect banking has on the world and our moral duty to shape humanity's future for good.

Last but not least, our very own Rizleen Mokhtar, CB embodies what it is to be *Unfazed by the Future.* Her personal journey and insights in this interview mirror the reimagining that we must undertake in order to achieve true professionalisation in Asian banking.

Sustainable finance is where we believe banks should look to for the next wave. This transition isn't easy, but wholly necessary.

The phrase 'pull yourself up by your bootstraps' comes to my mind – a rough-and-tough approach that may seem at odds with the 'work smart, not hard' philosophy that's crept into modern-day corporate culture.

But in my book, nothing beats self-reliance. We succeed through our own ability and effort – by thinking independently, embracing our individuality, and leading bravely.

This journey is not for the faint-hearted, but neither is banking. ✱

The Editor

The only asset class to buck the downward trend in the current economic crisis, it looks like **SUSTAINABILITY AS A SECTOR HAS FINALLY GROWN** into its boots, proof that doing good and delivering returns are compatible and achievable goals.

AICB

BANKING INSIGHT

Editor - Prasad Padmanaban
Assistant Editor - Shireen Kandiah
Writers - Angela Yap Siew Peng, Julia Chong, Kannan Agarwal, Dr Amanda Salter

PUBLISHER
Asian Institute of Chartered Bankers
197701004872 (35880-P)
(formerly known as
Institut Bank-Bank Malaysia)
Levels 11 & 12, Bangunan AICB
10 Jalan Dato' Onn
50480 Kuala Lumpur, Malaysia
Tel +603 2602 6833
Toll-Free 1300 88 6833
Email enquiries@aicb.org.my

PUBLISHING CONSULTANT
Executive Mode Sdn Bhd (317453-P)
Tel +603 7118 3200
Fax +603 7118 3220
Email admin@executivemode.com.my

PRINTER
Percetakan Lai Sdn Bhd
No.1, Persiaran 2/118C, Kawasan Perindustrian
Desa Tun Razak, Cheras, 56000 Kuala Lumpur
Tel +603 9173 1111
Fax +603 9173 1969

CONTENTS | JUNE 2021

All Aboard

Building the Right Board to Respond to the Climate Challenge, a webinar jointly hosted by the Asian Institute of Chartered Bankers and UK-based Chartered Institute for Securities & Investment, addressed the discourse surrounding board commitments in the transition to net-zero.

During the 71-minute webinar this January, panellists including Richard Burrett, Fellow at the University of Cambridge Institute for Sustainability Leadership, and Beate Van Loo-Born, Executive Director – Head of Strategic Projects at UBS Zurich, outlined the impact of current board trends at government and corporate levels, existing knowledge on board characteristics and their degree of impact to positively influence climate response. The closing Q&A also addressed global expectations as climate-related issues gain further traction.

In response to an audience question on voluntary or mandatory disclosures by boards, Burrett elaborated: "We are seeing an increasing regulatory burden on institutions in general and financial institutions in particular around climate change. The TCFD (Task Force on Climate-related Financial Disclosures) has had a major impact on the way that many institutions now think about climate change, and the regulators are doing this because they see climate change as a material systemic risk and I think that's an important addition to the shareholder versus stakeholder debate."

"Even if you don't care about your stakeholders, even as a shareholder, the materiality of climate change as an issue is evolving and people are recognising that it does have a material impact." ✱

A University of Cambridge research, *What Board Characteristics Are Driving the Climate Change Response of Firms in the Financial Sector?* revealed:

The importance of the chair in driving the firm's climate response. When the chair possesses a sustainability mindset, this has an impact on whether climate is included on the board agenda and ultimately in the firm's climate response.

Even a climate-literate chair with a sustainability mindset needs to bring other directors along on the journey.

Separation of CEO and chair roles are found to positively influence climate response.

Board diversity, including gender, age, and expertise, positively contributes to a firm's climate response, as does a sustainability mindset.

Watch the recording at *https://member-portal.aicb.org.my/login.*
Visit *https://www.aicb.org.my/events/*upcoming for information on upcoming webinars.

IMF: ASIA'S RECOVERY LIFTS GLOBAL GROWTH ESTIMATE

Stronger performance in advanced and emerging economies in Asia – China, India, Malaysia, Thailand – led to an upgrade in the International Monetary Fund's (IMF) global growth estimate for 2020 by 0.7 percentage points to a contraction of 1.5%.

Its January 2021 *World Economic Outlook Update* reports that the pandemic-led collapse last year has had acute adverse impacts on women, youth, the poor, the informally

NEW COST PARADIGM TO UNLOCK SAVINGS

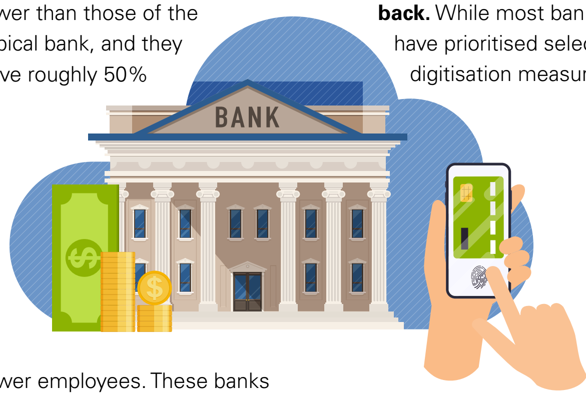
With nonbank insurgents carving inroads in the sector, retail banks must rethink and realign cost structures.

In *Global Retail Banking 2021*, Boston Consulting Group states: "The bank of the future cannot operate with the cost structure of the present and remain competitive.

Our analysis shows that the operating costs of the best banks are already about 40% lower than those of the typical bank, and they have roughly 50% fewer employees. These banks make larger and more sales, and they do so with branches that are less transaction focused."

To unlock cost savings, the consulting house recommends that retail banks take the following steps or will likely struggle to monetise their current investments:

- **Restructure operations around value streams.** The typical bank has fewer than ten value streams, including joining the bank, borrowing, saving, and making transactions. In our experience, front-to-back value stream redesign can typically deliver a reduction in costs of 15% to 25% and an increase in the consumer advocacy or net promoter score of 20 to 40 percentage points.
- **Shift digitisation from front-end to front-to-back.** While most banks have prioritised select digitisation measures (often focusing on front-end functions that will have the most customer impact), they have not put an equivalent effort into cost and risk control (the back-end or internal processes). As a result, customers' digital experience has improved, and they are enjoying new options and features, but banks' fixed costs, which are largely tied to terrestrial assets, remain in place. ✱



employed, and those who work in contact-intensive sectors.

The international financial institution also predicts the world economy is set to grow 5.5% in 2021 and 4.2% in 2022 on the back of a vaccine-powered strengthening of activity and additional policy support in several major economies. Expect a divergent recovery in 2021 as emerging markets and developing economies outpace advanced economies by 6.3% vs 4.3%. ✱

RATHI: DIVERSITY & INCLUSION ARE REGULATORY ISSUES

The UK Financial Conduct Authority (FCA) together with the Prudential Regulation Authority are developing a cohesive approach to diversity and inclusion (D&I) – which includes gender, ethnicity, sexuality, disability, social background – for all financial services firms under its jurisdiction.

Nikhil Rathi (photo), CEO of the FCA, said in a speech in London this March: "We care because diversity reduces conduct risk and those firms that fail to reflect society run the risk of poorly serving diverse communities. And, at that point, diversity and inclusion become regulatory issues."

"In our recent guidance on vulnerability, we said that firms – all firms – needed to understand the needs of their customers and be able to respond to them through product design, flexible consumer service and communications."

"I would question if any firm can adequately respond to the needs of these consumers if they do not have the diversity of background and experience required to overcome biases and blind spots."

If improvements are not forthcoming, he said the FCA will weigh how best to flex its statutory muscle, including:

in addition to the five conduct rules under the Senior Managers Regime, a sixth rule is proposed, asking firms, "Is your management team diverse enough to provide adequate challenge and do you create the right environment in which people of all backgrounds can speak up?".	whether D&I should be made a requirement under the FCA Premium Listing Rules, following recent positive steps by exchanges like Nasdaq.

Long-Termism Pays Off in Short Term

Dividend payout restrictions imposed by supervisors in some jurisdictions at the height of Covid-19 tended to increase lending and capital reserves. Based on recent research released by the Bank of International Settlements (BIS), it reports that capitalisation rose with restrictions, which helped banks better leverage additional capital into more lending.

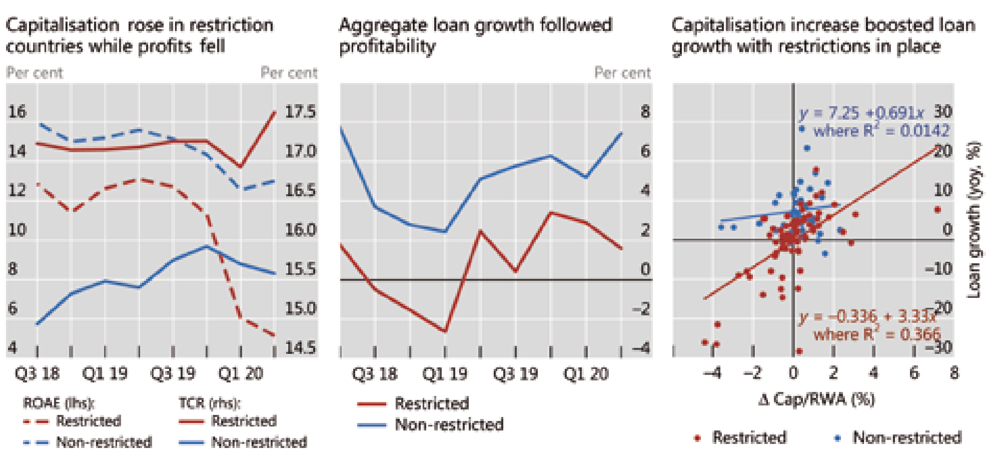
When the payout freeze was first announced, share prices for impacted banks fell and the dividend restrictions did not receive unqualified support from all stakeholders. The BIS writes that its analysis indicates a sector-wide ban on payouts can remove stigma for individual banks that restrict dividends, but punishes prudent banks with sizeable capital buffers that could safely pay out their profits.

However, the prudential measure achieved goals of supporting policymakers by reassuring that credit was sufficient in ensuring continued economic activity.

"In contrast to its impact on the share price," it elaborates, "the decline in anticipated dividends boosted the perceived safety of the banks. A larger decline relative to capital correlated with a smaller increase in CDS spreads. In other words, retaining more profits seemed to reassure debt investors, underlining the divergent interests of creditors and equity holders."

"Payout restrictions appear to be effective at both increasing the capital available to the bank and channelling the additional resources towards lending. An increase in capital of 2% of risk-weighted assets resulted in loan growth that was 6.7 percentage points higher…Thus, these restrictions in the initial phase of the Covid-19 crisis supported policymakers' objectives." ✱

Bank Capitalisation and lending



Source: FitchConnect, BIS calculations.

BUSTING CRYPTOCURRENCY JOHN DOE'S

The US Internal Revenue Services (IRS) recently served a 'John Doe' summons on Circle Internet Financial Inc, a Boston-based digital currency exchange, this April.

Circle is not alleged of wrongdoing but the IRS is hunting for information about an unidentified taxpayer who conducted cryptocurrency transactions of at least USD20,000 between 2016 to 2020 for possible violation of federal tax laws, including failure to report virtual currency transactions.

This is the latest in the US crackdown on cryptocurrency tax cheats. Under the country's federal law, convertible virtual currencies are classified as property for tax purposes.

The tax agency has previously issued John Doe summonses to Coinbase, another US cryptocurrency exchange platform used to buy and sell bitcoin, ethereum, and other digital coins.

A 'John Doe' summons is an IRS-mandated summons to unmask the identities of a class of taxpayers under investigation and is used to pursue account holders at a financial institution.

Most notably, a John Doe summons is what lifted the veil surrounding the hushed world of Swiss banking in 2008, leading to the IRS' USD50 billion offshore sweep of American taxpayers using Swiss accounts.

Unfazed by the Future

Reporting by the Banking Insight Editorial Team

A Chartered Banker's personal take on risk, leadership, and life.

This issue, we switch gears with Rizleen Mokhtar, CB, whose vigour and insights mark our most candid interview to date. From her views on 'credit as an art' to discussing Impostor Syndrome, the former Executive Vice President of Credit Risk at AmBank Group is seemingly unfazed by challenges or a forthright question. She exemplifies the fighting spirit that keeps the engine of finance going and banking reinventing itself.

Q ***Rising from the frontlines of banking to helming the Wholesale Credit Risk division at AmBank, could you set the stage for us and talk about some turning points in your career?***

I joined AmBank in the late 1980s as an executive trainee in the Corporate Banking (CB) division, and in those days there was no dedicated client relationship unit, credit evaluation unit, credit risk units, etc.

Banking officers did everything practically end-to-end, from engaging customers to sniffing out potential deals or offering financial solutions; conducting credit evaluation and running sensitivity scenarios on cash flow models; preparing submissions for credit approval; right through to preparation of offer letters, reviewing facility documentation, and ensuring conditions are in order for loan disbursement. This gave me a holistic learning experience, and enabled me to understand the building blocks and appreciate each facet of the corporate banking process flow.

Now a risk manager, I came to have better understanding of the intent of the recommendations under the Basel Accords, in particular the **RELATIONSHIP BETWEEN CREDIT AND CAPITAL ADEQUACY IN ENSURING SUSTAINABILITY OF THE FINANCIAL INSTITUTION.** This gave me a different perspective when analysing credit proposals. It was no longer just about short-term gratification, it had to also be about long-term sustainable growth.

In those early days, I was fortunate to have been given the opportunity to tackle a wide range of customer profiles, starting with both private- and public-owned midsized firms to eventually the larger top-tier corporate entities, covering businesses in the manufacturing, trading, construction, property development, and energy sectors.

In between, I was also given the opportunity to handle financial institution groups, which gave me a totally different credit experience. One of the turning points in my career came sometime in 2000 when the CB division was restructured into separate, dedicated functions – the 'frontliners' and the credit specialists. I was assigned to the latter (known at the time as credit risk management unit or CRMU) which initially was still under the purview of the business line managing director. Eventually, CRMU was hived off and became part of Group Risk Management (GRM) under the purview of a chief risk officer. This came on the heels of the Asian Financial Crisis, at a time when regulators, both global and domestic, were strengthening risk management practices in financial institutions.

Now a risk manager, I came to have better understanding of the intent of the recommendations under the Basel Accords, in particular the relationship between credit and capital adequacy in ensuring sustainability of the financial institution. This gave me a different perspective when analysing credit proposals. It was no longer just about short-term gratification, it had to also be about long-term sustainable growth.

The other character-shaping event was when I was assigned to handle derivatives documentation. A major component of the International Swaps and Derivatives Association (ISDA) master agreements was negotiating credit and credit-related terms, and the foremost thing to bear in mind was that this was not a lender-borrower relationship. This was a negotiation between two counterparties (in most cases at the time, between two financial institutions in swap transactions) and the one with the better credit standing had stronger bargaining power.

I learnt very quickly that the big, foreign banks thought very highly of themselves, had experienced ISDA negotiators, and there was great disparity between the terms applicable to each side. It was a personal victory for me when I managed to negotiate with two large foreign banks through their teams out of Hong Kong for equal footing on some very crucial close-out terms. This experience really honed my critical thinking skills and made me ‘tougher’.

Q ***Delving a little deeper, you’ve said that your experience in managing customer relationships helped shape your unique perspective on risk. What’s your thought process when balancing credit risk against the need to grow client relationships – your secret sauce, if you will.***

When I review a credit, whether as an analyst or approver, my first thought would be whether the client profile or proposition suits the bank’s risk appetite and if not, what would have to be addressed to make the transaction bankable and equitable from a risk-return perspective to both the bank and the customer. Credit risk managers tend to make the mistake of trying to eliminate or avoid risks.

There is a quote from French writer, Luc de Clapiers: “There are those who are so scrupulously afraid of doing wrong that they seldom venture to do anything.”

In essence, risk managers in their zeal to protect the bank’s position are often guilty of trying to tighten the terms of the transaction to the extent that it may not make sense for a customer to accept the offer.

It is therefore important for credit evaluators to understand the risk profile of the customer, determine the acceptable level of risk that the bank is prepared to take and ultimately craft the structure, terms and pricing that would make sense for both lender and borrower.

In any type of business, hazards are always present. A good credit risk manager would be able to identify the hazards or risks that can be controlled and offer appropriate mitigation solutions; while for those risks that cannot be controlled, whether such risks can be rationally accepted and the contingency plan if all hell breaks loose!

Credit is obviously an art – not a science – and there is no ‘one size fits all’ formula. The ideal credit risk managers are those who (i) have strong credit fundamentals; (ii) can balance risk mitigation with sound commercial understanding of the customer and transaction; (iii) can spot opportunities which the relationship manager, or even the customer, overlooked; and (iv) have the flexibility to adapt to constantly evolving circumstances.

Q ***As a member of the AICB Industry Curriculum Committee’s (ICC) Business Credit module, you share the responsibility of ensuring the Chartered Banker programme is continuously and rigorously enhanced to reflect current industry priorities. Could you share some of the Committee’s work thus far?***

The ICC’s mandate is to review the existing curriculum for relevance with current regulatory environment and best practices. As an example, old-school banking placed great importance on collateral whereas in today’s world, regulators require that emphasis be given to repayment capacity under various stress scenarios.

With this in mind, the ICC members had robust discussions and debates on the weightages assigned to the various topics in the syllabus, both in terms of the study material content as well as the examination questions. There was the need to incorporate more recent financial accounting standards, particularly those that pertain to risk identification, risk measurement, and classification of impairment, as well as remove references to regulations which were obsolete and update with new directives, standards, and guidelines issued by the regulatory authorities.

We also looked at the relevance of the case studies presented in the curriculum and suggested inclusion of lessons learnt from more recent events in the banking and financial sector, both global and domestic.

Q ***European Central Bank President Christine Lagarde has said, "There are still too few women in management worldwide, particularly in the economic and financial spheres, including central banks." How do we broaden support for more women leaders in the sector?***

I was actually surprised to find that among the G20 countries, there was only one female central bank governor. Same can be said of the EU, where all the heads of central banks are men except for Mdm Lagarde who is President of the European Central Bank. Among the 10 ASEAN nations, only two central banks – Malaysia and Vietnam – are currently helmed by a woman. In Malaysia, there is no lack of strong, competent, visionary women in the banking sector. The fact that we have had central bankers (twice, in fact), chairpersons, and members of the board of directors as well as chief executive officers who are women attest to this. So, I am of the view that the structural support and opportunities for women to elevate to leadership positions exist in the industry, although there is always room for improvement.

Sometimes a woman can be her own worst enemy – not for lack of ambition or expertise but lack of confidence in her own potential. You may have heard of 'Impostor Syndrome', the internalised fear or self-doubt of one's own skills and accomplishments. More women than men tend to have this problem, preventing them from seizing the possibility of progress. Incidentally, I was made to understand that some women are able to thrive in leadership positions despite having Impostor Syndrome. What it took for them to overcome this and be effective leaders is something I really want to read and learn more about!

There is also something to be said about forming effective informal networks, a 'sisterhood' if you will, of like-minded, progressive women – providing a support system to boost morale, overcome insecurities and open doors to new horizons. Like this phrase made famous by US Vice President Kamala Harris, "..standing on the shoulders of those that came before..".

Men also have a role to play. You know that saying, "Behind every successful man, there is a strong woman." I believe the converse is also true. It takes a strong man to recognise a woman's potential for advancement and not be insecure of it. It takes an even stronger man to influence changes in the culture of the workplace, tear down the walls of 'boys clubs', and give a woman not only a seat at the table but the right to have her views heard and respected. It is disheartening when male colleagues chide a woman who puts forth a contrarian view as 'being difficult', whereas when a man does so, he is merely 'speaking his mind'. I conclude this by quoting the late and infamous US Supreme Court Justice Ruth Bader Ginsburg: "Women belong in all places where decisions are made."

Q ***Each era celebrates its own leadership archetype – there was Lee Iacocca in the 80s and we've Elon Musk today. But in reality, building a team calls for authenticity – it isn't about who you aspire to be, it's shaped by who you are. What does your style of leadership look like?***

This is a difficult one for me to answer, simply because I believe I am still evolving and have not yet found that one distinct leadership style that I can call my own. I do agree that building a team calls for authenticity – without it, a leader will only get people who follow out of duty or obligation; not because they are inspired, motivated or influenced by you.

When I was first thrust into the position to head a department, I found myself in the awkward situation of having to lead my peers, some even a whole generation older! I established early on that the 'boss-subordinate' dynamic was not going to work. Realising that some of them had more experience and depth than I did in certain areas of banking, I decided to go the 'captain of the team' route, i.e leverage on their strengths, learn from them, and have rigorous discussion on the merits and demerits of a case to arrive at a consensus.

I was honest with them – I didn't profess to know everything nor have a solution to every problem. I engaged my team to bounce off ideas and held brainstorming sessions so that we can put everything on the table for consideration. I also made sure that they know I had their backs, would not 'throw them under the bus', and was frank with them on matters on which we disagreed.

As a result, I had this camaraderie with my direct reports and I really believe there was trust and mutual respect on both sides.

Having said this, I am of the view there is no one optimal leadership style. When I have to deal with a more junior, less-experienced team/staff, my style and how I interact with them would be different.

It doesn't make me less authentic. It's about knowing the right tool to use in the appropriate situation. ✱

VALUES: THE NEW WORLD CURRENCY

By Angela Yap Siew Peng

- FINALLY, SOME BITE-IN-BARK FOR SUSTAINABLE FINANCE.

Investors are cranking up the heat on the world's biggest companies.

On 1 May, Berkshire Hathaway Inc, the massive Omaha-based investment holding company chaired by billionaire Warren Buffett, clashed head-on with shareholders at its annual meeting.

At the centre of this controversy are two landmark shareholder proposals, billed as the "litmus test for ESG (environmental, social, and governance) investors".

The first proposal came from a trifecta of institutional investors – California Public Employees' Retirement System (CalPERS), Federated Hermes, and Caisse de Dépôt et Placement du Québec (CDPQ) – who demand that Berkshire declare physical, transitional, and other financial risks in efforts to address climate change and transition to a low-carbon economy. To date, Berkshire is the only major US or European stock that does not disclose its risk exposure to climate change and whose board has repeatedly rejected these pleas.

Stressing its "unusually decentralised" business model, Buffett – the market's most vocal opponent to ESG – has repeatedly said "I don't believe in imposing my political opinions on the activities of our businesses" and gives vast independence to its subsidiaries as long as they deliver on the numbers.

"We are not going to shy away from holding Berkshire accountable just because it's run by Warren Buffett," said Simiso Nzima, CalPERS' Head of Corporate Governance.

The second proposal was for Berkshire to report its diversity, equity, and inclusion (DEI) efforts across its 400,000 workforce. This was mooted by As You Sow, an American non-profit for shareholder advocacy, on behalf of a small retail investor.

> At the centre of this controversy are two landmark shareholder proposals, billed as the "**LITMUS TEST FOR ESG (ENVIRONMENTAL, SOCIAL, AND GOVERNANCE) INVESTORS**".

Unsurprisingly, both proposals were rejected, given that the 'Oracle of Omaha', as Buffett is known, controls almost one-third of votes and continues to hold enormous sway over retail investors.

What is surprising this round is that 25% of shareholders' votes went against Buffett and his management team, surpassing the usual 3% or less opposition. Media outlets including *Reuters* comment that this is "greater discontent than Berkshire shareholders historically demonstrate", leading to questions on whether the 90-year-old Buffett could possibly be out of sync with the times.

TURNING THE BEND

Whichever camp you're in, it's undeniable that shareholder activism is on the rise and investors are demanding that ESG targets be placed squarely on the shoulders of boards and top of the corporate agenda.

Even equities and fixed-income investors – traditionally hands-off, holding when they see upside and selling when it reaches peak value – are moving in surprising ways.

Asset managers Aviva and Amundi have announced plans to vote against boards of companies that lack a climate strategy or disclosure policy. This includes multinationals such as Exxon-Mobil and General Motors.

BlackRock, the world's largest asset manager with USD8.67 trillion in assets under management, has pledged that it will demand disclosure on portfolio companies' compatibility with (i) a net-zero economy, (ii) board involvement in energy transition strategies, and (iii) talent strategies to improve DEI as appropriate by region.

This January, its chairman, Larry Fink, warned in his influential annual letter to CEOs that "…companies ignore stakeholders at their peril – companies that do not earn this trust will find it harder and harder to attract customers and talent, especially as young people increasingly expect companies to reflect their values."

This is a major win for sustainability buffs, who've long critiqued Fink and BlackRock for fence-sitting.

WOKE CAPITALISM

These writings on the wall point to a new world order. One where the future of markets, economies, and alliances will be based on values rather than ideology, history, geography, or past patterns.

Welcome to the human-centred economy, where 'wokeness' – millennial-speak for awareness and action on social justice – is currency.

It's not unheard of. In Scandinavia, they call it social capitalism. As an ideology, it's making headway; as a system, its human-centric policies are designed to fix the inequalities of the current economic system.

These thoughts are echoed in *Covid and the New World Order: Actionable Insights from Global Technology Thought Leaders*, a white paper co-edited by Dr Jane Thomason, Industry Associate at University College London, which seeks to proffer a "rethinking of the economic system, to rethink what we value and to rethink how we live".

The report's array of global thinkers has this to say about the financial system: "The pandemic has helped crystallise our collective realisation that the current global economic order, and our financial markets, are not equipped to address the wider environmental and social issues that face humanity.

"We can no longer be complacent, and we have both the theories – a wealth of research around alternatives to a profit-first economic model that still preserve capitalism, such as doughnut economics – and the technologies to implement them for a sustainable future.

"We also need to build the financial markets of the future: markets that recognise the value not only of financial factors but also environmental and social factors, in determining the value of companies and their activities, and in allocating capital.

"It is only through a broadening of our definition of value through internalising the social and environmental consequences of economic activity instead of treating them as externalities as they currently are – that financial markets will shift to allocate value more holistically and to drive the behaviours that we need from companies and their economic activities."

HIT RESET

If you think such wokeness is by chance, think again.

Like a sleeping volcano, public discontent has been bubbling below the surface. Pre-pandemic, the line between business and social action was already blurring, with most governments being perceived as impotent in wresting big issues like climate change or racial equality. In response, citizens took matters into their own hands and voted with their feet.

From Asian Lives Matter protests and Xinjiang cotton boycotts to NFL players 'taking the knee', these modern-day *hartal* (economic strike action) are increasingly common. Cases of ESG-related derivative litigation (where a shareholder files a lawsuit against an executive officer or director) are also on the rise, pushing the boundaries of the legal system to instil social justice, though these cases are more often than not dismissed by the courts.

So before one dismisses the current ESG wave as another 'do gooder' phase, here's how it supersedes previous efforts in both strategy and unified action.

In terms of shareholder activism, 435 climate- and DEI-related shareholder resolutions have been filed this proxy season in America alone. One of the biggest groups is Climate Action 100+, an organisation with over 500 investor members (including CalPERS, Federated Hermes, CDPQ) with a collective USD54 trillion in assets. Its members have collectively filed 37 shareholder proposals to push big-cap corporates to align or merge climate strategies with business plans. They've also released a corporate net-zero benchmark to evaluate board governance on the matter.

In Asia, Harvard Law School's *Annual Review of Shareholder Activism* released on 25 January ranks Japan's Softbank, Nintendo, and Toshiba as the largest global targets of corporate activists pushing for change in the conservative society.

Closer to home, the pressure is top-down with no signs of abatement. Malaysia's Employees Provident Fund (EPF) – which the World Bank cites as having "transitioned from a relatively small public retirement fund…in 1949 to become now one of the largest pension funds among developing countries" – is in step with global sentiments. Its former CEO Tunku Alizakri Raja Muhammad Alias had previously announced the pension fund's target to have a fully ESG-compliant portfolio by 2030 and aims "to be a climate-neutral portfolio by 2050, with net-zero greenhouse gas emissions".

Malaysia's path of least resistance – as opposed to the confrontational approach in America – is likely to be the prevailing strategy in other Asia-Pacific nations, a top-down approach which minimises resistance and speeds up adoption rates in favour of ESG.

GLIMMERING GREEN PUDDLES

In his 2019 podcast *Why It's Time to Finally Worry About ESG*, Harvard Business School's Prof Robert Eccles explains the start-sputter-and-start-again history of sustainable investing:

"Historically, I think companies came to sustainability long before the investment community, to give them credit. A lot of it had to do with sustainability reporting that started in the late 1990s. It was not a side show but it was definitely not mainstream...They picked the low-hanging fruit – carbon emissions, turn off the water and lights at night and stuff, but it really wasn't integrated into the business.

"When you talked about sustainability on the investor side, people thought about socially responsible investing, where you were excluding stocks and industries that you didn't like, or companies that you didn't like, or even countries, like South Africa under apartheid, and there was the belief that if you put in these values based on exclusions, then you were going to lose returns.

"I think what changed was, as people began to realise that these ESG issues mattered to financial performance, both the corporate community and the investment community started to see things differently."

"So, I think we're at the tipping point. I think it's a top priority," Prof Eccles concludes.

As the pie grows, so will the dangers multiply. Here's what banking and finance should keep in mind as it shifts its gaze to greener pastures:

+ Over the next five years, as sustainable investing morphs into a projected EUR7.6 trillion asset class, investors will be increasingly vulnerable to greenwashing. Firms that mislead investors in their ESG disclosures pose a systemic risk, distorting the low-risk and resilient nature of ESG-compliant assets that have weathered the market through the pandemic. To avoid such co-opting, regulators stand *en garde* with a slate of compliance rules, such as the EU-led Sustainable Finance Disclosure Regulation and relevant sustainable finance taxonomies in the respective jurisdictions.
+ Sustainable finance is more than just climate change. Organisations must enhance and achieve other goals on the sustainability spectrum, such as social inequality, social justice, and diversity and inclusion, which have thus far been eclipsed by the global emphasis of climate targets and the Paris Agreement.
+ All financial actors must up their risk management game. Advanced risk management processes may already be in place at the largest institutional and big-cap firms, but many smaller pension funds or investment companies lack the sophisticated processes needed to address risks arising from ESG investments. This puts both the firm and the clients they represent at the losing end. Whether through valuable knowledge exchange platforms or bringing in specialists to set the levers, regulators, financial institutions, corporations, civil society, and citizens must work shoulder-to-shoulder to rein in excesses.

DOUBTING THOMAS

For a long time, banking – home to many a Doubting Thomas – pooh-poohed values-based investing. It was presumed ESG investments were limited to a return trade-off, i.e. it just wasn't possible to do good and make a decent profit. But that was many moons and one pandemic ago.

On 9 April, BlackRock's newest ESG fund – the Blackrock US Carbon Transition Readiness ETF – raked in USD1.25 billion, making history as the biggest launch ever in the ETF industry, proving that "sustainable strategies do not require a return trade-off and have important resilient properties".

Sustainable funds have also shown greater resilience throughout 2020. In the first quarter of 2020, *Morningstar* reported 51 out of 57 of their sustainable indices outperformed broad market counterparts, and MSCI reported 15 of 17 of their sustainable indices achieved the same.

Where rubber meets the road, sustainable finance seems to be revvin' up some serious smoke.

But if you're still unconvinced…I suppose only time will tell how well a Doubting Thomas fares. ✱

Sustainable funds have also shown **GREATER RESILIENCE THROUGHOUT 2020**. In the first quarter of 2020, *Morningstar* reported 51 out of 57 of their sustainable indices outperformed broad market counterparts, and MSCI reported 15 of 17 of their sustainable indices achieved the same.

■ *Angela Yap Siew Peng is a multiaward-winning entrepreneur, author, and writer. She is Director and Founder of Akasaa, a boutique content development firm with presence in Malaysia, Singapore, and the UK and holds a BSc (Hons) Economics.*

RISING TEMPERATURES, MELTING ICE CAPS, AND THE BANKING SECTOR

By Nik Shahrizal Sulaiman

■ **Stronger ESG adoption is driven by financial, economic and regulatory factors.**

Lately, the topic of ESG has taken centre stage in our business conversations. From business columns to webinar discussions and social media chatter, many opinions have been shared to describe the urgency of the issue.

But what exactly is ESG and how important is it really to our businesses and specifically the banking sector? For the uninitiated, ESG stands for 'environmental, social and governance' and the term is typically used in the context of how a business plays a role in sustainability and how it protects the environment and the community.

In the banking sector, there has been an increased focus on the issue of climate risk within the larger ESG agenda. On 30 April 2021, Bank Negara Malaysia (BNM) issued a guidance document titled *Climate Change and Principle-based Taxonomy* with the objective of creating a standardised set of classifications and reporting of climate-related exposures to support risk assessments in the banking sector. The intention is that by providing this guidance, it would help the industry to plan the transition towards sustainability and eventually help shift investments where they are most needed.

But how important is ESG or specifically climate risk in the context of the banking sector? Is this just a fashionable buzzword which will disappear when a new trend comes along or does this represent a fundamental shift in terms of how we look at the role and purpose of banks within the wider community? To answer this question, we must first consider this from the perspective of history and science.

THE INDUSTRIAL REVOLUTION

The industrial revolution which started in the 18th century was probably one of the most important events in our modern history. It ushered a new age of prosperity and innovation, unparalleled in the context of economic development. Rapid industrialisation, which began in Britain, gradually expanded all over the world, and with it came rapid consumption of energy such as coal, petroleum and other forms of fossil-based energy.

However, this progress has not been without cost. An unprecedented volume of carbon dioxide has been released into the atmosphere as a result of human activities since the industrial revolution

The intention is that by providing this guidance, it would help the industry to plan the **TRANSITION TOWARDS SUSTAINABILITY** and eventually help shift investments where they are most needed.

and because carbon dioxide traps heat, this has resulted in the greenhouse effect which contributes to global warming. Many peer-reviewed studies have been published in this area of study, which provide in-depth analyses on the adverse effects of global warming, such as melting polar ice caps, rising sea levels, volatile weather patterns and natural disasters.

Indeed, our country is not immune to this risk. According to various sources cited in the BNM's *Climate Change and Principle-based Taxonomy,* Malaysia has experienced an increase in surface mean temperature of 0.13°C to 0.24°C for every decade from 1969 to 2016. In addition, more than 50 climate-related disasters have been reported in the past 20 years, resulting in over RM8 billion in monetary losses and affecting the lives and livelihood of more than three million people in Malaysia through displacements, injuries and death.

WHY SHOULD BANKS CARE ABOUT CLIMATE RISK?

Even though the responsibility to protect our environment should not be restricted to a single group of stakeholders, the banking sector nevertheless plays an important role in this agenda. This is because the banking sector provides the economy with capital and consequently, how the capital is directed and managed has a direct impact on how much carbon emissions the economy produces.

In addition, the banking sector's role in climate risk mitigation is also important to our national aspiration. As a signatory to the Paris Agreement, Malaysia has made a commitment to reduce our greenhouse gas (GHG) emissions by 45% by 2030 (from its 2005 level). On this note, there have been encouraging developments from the Malaysian banking community. Several banks have recently announced the gradual phasing out of financing activities in coal plants, whilst others have committed towards net-zero carbon emissions in the future. Even though these commitments are a step in the right direction, more can be done by our banking industry to take this agenda further.

In order to elevate the climate risk agenda in the banking industry, it is critical for this initiative to be driven at a strategic level and not restricted to certain functions within the bank. As such, it is **IMPORTANT TO CREATE A ROBUST GOVERNANCE STRUCTURE** to enable the board and senior management to provide adequate oversight over the climate risk agenda.

TONE FROM THE TOP AND GOVERNANCE

In order to elevate the climate risk agenda in the banking industry, it is critical for this initiative to be driven at a strategic level and not restricted to certain functions within the bank. As such, it is important to create a robust governance structure to enable the board and senior management to provide adequate oversight over the climate risk agenda. For example, in some banks around the world, climate-related committees are created at the board level to secure board oversight over climate-related risks and opportunities. This oversight is then augmented by a management-level committee made up of experts from various front-office functions, sustainability, risk and other departments. The committees meet frequently throughout the year and climate risk becomes a fixed agenda item during every meeting.

Having a clear and robust governance structure helps the management with the necessary buy-in to drive the agenda throughout the rest of the organisation, which is then cascaded at the operational and business level. Without strong support from the top, such an initiative is likely to be short-lived and lacking in substance. It is also important for organisations to have

quality information and relevant metrics to facilitate the decision-making process.

THE IMPORTANCE OF SUSTAINABILITY FRAMEWORKS AND DISCLOSURES

Currently, there are many guidance and reporting frameworks on the topic of sustainability or ESG. Examples include frameworks and standards issued by the Global Reporting Initiative, the Sustainability Accounting Standards Board, the Climate Disclosure Standards Board, and the Task Force on Climate-related Financial Disclosures (TCFD) among others.

Each of these frameworks has a slightly different focus depending on their objectives. For example, the TCFD was established by the Financial Stability Board in December 2015 to develop climate-related disclosures that "could promote more informed investment, credit [or lending] and insurance underwriting decisions". The TCFD recommendations are organised into four key themes covering different areas such as governance, risk management, strategy and metrics/targets, supported by various key climate-related financial disclosure requirements in relation to the areas above.

In the UK for example, the Financial Conduct Authority announced that premium-listed commercial companies are now required to adopt the TCFD reporting for companies with reporting periods beginning on or after 1 January 2021. In addition, the UK Chancellor of the Exchequer, Rishi Sunak also announced that the TCFD-aligned disclosures will become mandatory across the entire economy by 2025.

Even though these frameworks are currently not mandatory in Malaysia, clear benefits can be reaped from early adoption. Firstly, it adds an element of structure to the bank's ESG or climate risk initiatives. Secondly, it will provide better quality reporting and disclosures to a broad range of stakeholders. Thirdly, given the rate of adoption across the world, it will just be a matter of time before investors and other stakeholders will expect our own banking sector to adopt the TCFD-aligned disclosures as well. Together with the new taxonomy issued by the BNM, these will help our banking sector make a bold transition towards this agenda.

RISK MANAGEMENT, CARBON METRICS AND DATA

Once a specific framework or standard has been selected, banks can then conduct a gap analysis to assess the areas requiring further enhancements. This may involve relooking at various processes, such as strategy setting, risk management practices, data collection, business resilience and others to ensure that they are aligned with the framework requirements.

For example, on the topic of risk management, the risk appetite statement may need to be refined and updated to formalise the bank's approach on managing climate risk. Some policy documents may need to be updated to describe the bank's policy on specific sectors. In addition, climate risk metrics can also be created to measure the carbon footprint across various sectors, with specific targets to reduce the overall carbon emissions in the bank's portfolio. New sets of data may need to be collected to enable climate risk stress tests and scenario analysis.

Overall, there is a long list of initiatives that can be undertaken by our banking sector to further this agenda, however these need to be coordinated and driven at both the strategic and operational levels to ensure that key objectives are met.

ADAPTING TO THE NEW PARADIGM

In conclusion, the climate risk agenda will continue to be an important topic for the banking sector. This is not only driven by a moral imperative to protect the environment. Looking at various trends around the world, the decision towards stronger ESG adoption is also driven by financial, economic and regulatory factors.

As the global economy evolves in line with this new paradigm shift, it is important for our banking sector to relook its business model, adapt to ESG and benefit from the new opportunities that this new paradigm offers. ✱

■ *Nik Shahrizal is a Partner with PwC Malaysia. He holds the CFA and ICAEW qualifications and graduated with an MBA from Judge Business School, Cambridge.*

MONEY IS MEMORY, TAKE TWO

By Angela Yap Siew Peng

With digital currencies on the rise, an old economic theory takes on new dimensions.

Back in 1998, leading American monetary economist Narayana Kocherlakota posited that 'Money is Memory', a singular idea that continues to inspire economic thinking.

His paper of the same title, published in the *Journal of Economic Theory,* argues that money is a primitive form of memory and its circulation in the economy is akin to a "superledger" (as Agustín Carstens of the Bank of International Settlements puts it) that carries within it a history of all transactions – from big kahuna deals of who bought which submarine to mundane affairs of who paid for that bag of lemons, what you still owe the grocer, and if you've got enough pennies for a soda on the way home.

This is the central idea behind Kocherlakota's theory. Money is more than just a medium of exchange; it is intrinsically a source of "high quality information storage and access". If there were a way to tap into the memory of money, he warned that this could be exploited by parties other than the central bank (the only authorised issuers of money) and "the government's monopoly on seignorage might be in some jeopardy as information access and storage costs decline".

For a long time, the theory that 'money is memory' was seen more as a philosophical endeavour than practical reality. Today, that has all changed with fintech, specifically distributed ledger technology (DLT), the foremost technology underlying the creation of central bank digital coins (CBDC).

DIGITAL CASH

CBDC, the new electronic currency that most governments are experimenting with, is very much talked about but often misunderstood. The most important misconception that needs to be cleared is that although the idea of a CBDC was inspired by bitcoin, the former is not a

cryptocurrency.

Here's why. As CBDCs are digital fiat currency, its issuance and record-keeping would be centrally controlled and tracked by monetary authorities. Permission to make changes in the digital ledger would be entrusted to authorised individuals (or validators) who each hold a private cryptographic key; a change to the ledger can only be made when consensus is achieved. This mechanism is known as 'trust by reputation' or 'trust by default of a legal contract'.

In contrast, publicly traded cryptocurrencies like bitcoin are permissionless. Changes to the ledgers are done through consensus algorithm, i.e. 'trust in math'. As long as the numbers and protocols check out, the ledger will record the change.

The countless rallies and crashes of Bitcoin (about eight, at last count) is proof of the underlying volatility in blockchain architecture and reason why cryptocurrencies cannot attain the level of public confidence in CBDCs. The finish line to a global implementation of CBDCs however is still a way off.

READY, STEADY, GO?

Although the majority of central banks are still unlikely to issue CBDCs in the foreseeable future, we must give heed to signals that policy coordination and technical design choices of proposed CBDCs will only intensify in the coming months.

In *Ready, steady, go? – Results of the Third BIS Survey on Central Bank Digital Currency,* the Bank of International Settlements (BIS) reports this January:

- Of the 60+ participating central banks, 86% are exploring the benefits and drawbacks of CBDCs.
- In recent months, major central banks have published a multitude of in-depth assessments of related policy issues and tested a variety of designs for CBDCs.
- On 20 October 2020, the Bahamas launched its Sand Dollar, the world's first CBDC which is globally convertible into traditional Bahamian dollars using a prepaid Mastercard.

- Consequently, central banks collectively representing a fifth of the world's population are likely to issue a general purpose CBDC in the next three years.

Already, the BIS has followed up with what is perhaps the first economic analysis on using a permissioned DLT as the basis for a new monetary system using CBDCs. In the February 2021 paper, *Permissioned Distributed Ledgers and the Governance of Money,* authors Raphael Auer and Hyun Song Shin of the BIS and Cyril Monnet of the University of Bern, write:

"While the concept of money as memory has been well-known in theoretical circles, the advance of cryptography and digital technology has opened the possibility of taking the idea of a complete digital ledger more literally, and building a monetary system around such a ledger. However, with a public ledger the issues that loom large are who should have the authority to update the ledger and how. This is all the more so given the incentive problems that arise to misrepresent ownership of funds.

"Under traditional account-based money overseen by an intermediary, for instance a bank, this authority is delegated to intermediaries. The bank updates the ledger by debiting the account of the payer and crediting the account of the receiver.

"However, in monetary systems without a central intermediary, the ledger must be updated by other means, such as a DLT, as exemplified by bitcoin. DLT is a record keeping device in the spirit of Kocherlakota's analysis of money as memory…Application of permissioned DLT are being explored for securities settlement systems, trade finance solutions, 'stablecoins', and CBDCs."

PROPOSED ARCHITECTURE

Although the Bahamas has launched its retail CBDC and China its pilot, regulators are still studying the most appropriate technology for a CBDC.

Attempting to understand the architecture of CBDCs can be confusing as the term 'blockchain' and DLT are often used interchangeably. To understand the difference, TradeIX, an award-winning fintech for global trade and supply chains, explains:

On the surface, distributed ledger sounds exactly how you probably envision a blockchain. However, all **BLOCKCHAINS ARE DISTRIBUTED LEDGERS**, but remember that not all distributed ledgers are blockchains. Whereas a blockchain represents a type of distributed ledger, it is also merely a subset of them.

"On the surface, distributed ledger sounds exactly how you probably envision a blockchain. However, all blockchains are distributed ledgers, but remember that not all distributed ledgers are blockchains. Whereas a blockchain represents a type of distributed ledger, it is also merely a subset of them.

"Think of blockchain and distributed ledger in the same way you might think of Kleenex and facial tissues. The former is a type of the latter, but it has become so popular that it becomes ingrained in people's minds as what the product is.

"The most important difference to remember is that blockchain is just one type of distributed ledger…Removing the intermediary party from the equation is what makes the concept of distributed ledger technology so appealing. Unlike blockchain, a distributed ledger does not necessarily need to have a data structure in blocks. A distributed ledger is merely a type of database spread across multiple sites, regions, or participants."

In fact, there are many options on what the underlying technology of a CBDC should be, however on the basis of security, central banks and other security experts are not in favour of blockchain.

Bruce Schneier, security technologist and lecturer at Harvard Kennedy School, explains why in a recent article by *Wired* magazine: "What blockchain does is shift some of the trust in people and institutions to trust in technology. You need to trust the cryptography, the protocols, the software, the computers and the network. And you need to trust them absolutely, because they're often single points of failure.

"When that trust turns out to be misplaced, there is no recourse. If your bitcoin exchange gets hacked, you lose all of your money. If your bitcoin wallet gets hacked, you lose all of your money. If you forget your login credentials, you lose all of your money. If there's a bug in the code of your smart contract, you lose all of your money. If someone successfully hacks the blockchain security, you lose all of your money.

"In many ways, trusting technology is harder than trusting people. Would you rather trust a human legal system or the details of some computer code you don't have the expertise to audit?"

FORK IN THE ROAD

What then is the optimal technology for a CBDC? Whilst the jury is still out on that, results from the BIS' Auer-Shin-Monnet study on DLT "suggest that a centralised ledger is likely to be superior, unless weaknesses in the rule of law and contract enforcement necessitate a decentralised ledger".

> In many ways, trusting technology is harder than trusting people. **WOULD YOU RATHER TRUST A HUMAN LEGAL SYSTEM** or the details of some computer code you don't have the expertise to audit?
>
> **Bruce Schneier**
> Security Technologist and Lecturer at Harvard Kennedy School

The central question is about control over entries into the digital ledger – should the power to make changes to the database vest in a central authority or be designated to a network of validators.

In a centralised ledger, a central authority or administrator (e.g. government, bank, institution) is entrusted with the duty to control the contents of the ledger – what transactions get posted and in what credit/debit amounts. The risk is high when there is a single point of failure.

By contrast, in a decentralised ledger and DLT, such central authority or administrator is absent and the ledger is distributed across several nodes (devices) in a shared network. Updates are done independently as each node contains an identical copy of the ledger. Any modification by one party will be reflected in all other ledgers throughout the network.

Although DLT presents attractive benefits, it is not risk free. It takes time for an update to reflect in all nodes and such a lag can cause severe casualty in financial services, such as high-frequency trades where real-time data is critical down to the nanosecond.

A permissioned DLT also needs to incentivise validators to perform their job of validating transactions properly in order to maintain the integrity of the ledger. This may require a transaction fee as payment for the job, which adds to the cost of using centrally issued digital cash – taking it further away from financial inclusion goals and money's role as a public good.

But the most crucial is how we strike a balance in the trade-off between user privacy and traceability. Identification is key to ensure the integrity of payment systems, prevent fraud, and AML/CFT efforts. Yet, in a world of increased data hacks and other privacy breaches, what new safeguards must be in place to protect privacy and ensure recourse in the event of a security breach?

Such questions run to the heart of banking stability and financial resilience. As vanguards of their economies, central banks have the Herculean duty of determining if CBDCs will have a role to play in their future economies and, if so, what necessary redesigns must take place in order to preserve the stability of value of all types of money. ✱

■ *Angela Yap Siew Peng is a multiaward-winning entrepreneur, author, and writer. She is Director and Founder of Akasaa, a boutique content development firm with presence in Malaysia, Singapore, and the UK and holds a BSc (Hons) Economics.*

A NEW OPPORTUNITY FOR BANKS?

By Chartered Banker Institute, UK

WITH SOCIAL, EMOTIONAL, AND PROFESSIONAL FATIGUE NOW SETTING IN ACROSS THE COUNTRY, HOW CAN THE INDUSTRY BUILD ON THE RISE IN APPROVAL TO MAKE LASTING CHANGES FOR THE BETTER?

Since 2012, public confidence in the banking industry has been recovering from the aftermath of the 2008 financial crisis, from 27% approval in 2012 to 56% approval in 2020, according to Gallup. As well as this, the 2020 Edelman Trust Barometer, which surveys more than 13,000 respondents globally, found that the public's trust in the sector reached an all-time high of 65% amid the pandemic.

FIGHT OR FLIGHT

With financial organisations juggling a fast-shifting set of logistical, social, and economic challenges, the display of public confidence is a good news story for the industry, and for society in general. But exactly what is the reason behind the surge in trust, in particular during a time of such unprecedented uncertainty? For Christopher Box, Financial Services Consulting Leader, PwC, it's not entirely surprising. "I think it's partly a reflection of times of uncertainty, when there is usually a flight towards institutions," Box suggests.

"That says to me that people want to trust during a period of uncertainty. Organisations currently have an opportunity because lots of engagement scores were consistently high across financial services, but now is the critical time because we have reached the point where fatigue is starting to set in." The authorisation of payment holidays and facilitation of government support packages have also played a part in public perception of the sector. "At the heart of the government's response has been the banks, which together have authorised payment holidays and issued various support packages worth over GBP57 billion," Richard Kibble, UK Head of Banking, Deloitte, said at the end of 2020.

"This hasn't gone unnoticed by customers with more than three-fifths of customers saying they were pleased with their banks' response to the crisis. Moreover, customers are voting with their feet, with more than one-third of those who switched or opened bank accounts as a result of the pandemic saying they were motivated by their new bank's societal impact."

CRUNCH TIME

Michael Conway, Partner and AI Practice Leader, IBM, believes the way in which the industry responded to the logistical challenges when Covid-19 first hit the UK showed that supporting customers was the first priority for organisations. "There was a crunch period at the beginning," Conway says.

"If you think about the dynamics of how banks help their customers, there's the supply of help, which is typically agents or branch staff, and then there's the demand of customers. With the government rolling out new financial measures and instruments almost daily that banks were having to administer, the demands from customers wanting to understand these things was going through the roof.

"There are some things that just **DON'T NEED THE HUMAN TOUCH** – for example, if you've lost your card – and, frankly, customers want a quick, any-time response to those types of questions.

Michael Conway
Partner and AI Practice Leader, IBM

"And yet, customer support in branches and the staff in the banks contact centres was reducing due to sickness and self-isolation. There was a problematic dynamic of customers needing help and the banks not being able to supply it, so banks had to shift to remote working remarkably quickly."

There followed a seismic shift in the industry's day-to-day operations, which opened the gates to a new wave of innovation aimed at providing customers with the support they needed.

One example was TSB's Smart Agent live-chat technology, developed in partnership with IBM and launched in just five days. The functionality enabled customers to communicate with bank staff remotely for the first time with common banking questions, allowing staff in branches and contact centres to prioritise vulnerable customers and those who required essential services.

THE OTHER AI

Conway says that, amid this transformation, there is a huge opportunity for harnessing AI – augmented intelligence, as he explains it – to further personalise the customer experience. "We want to help customers when they want help in the quickest way possible," he says.

"There are some things that just don't need the human touch – for example, if you've lost your card – and, frankly, customers want a quick, any-time response to those types of questions. It's about freeing up that time for the human-led intelligence to really come to the fore. That's better both for the customer and for the institution.

"Digital-first is something that we've been speaking about for a number of years, but it's coming to centre stage now that the customer demographic that didn't previously use digital banking services now does. Digital can be the enabler for customers getting what they want, when they want it, with AI helping to ensure the right support is there when required."

FROM THE INSIDE OUT

While banks are finding more efficient ways of communicating with customers, the industry has a number of challenges

to consider as we start to move towards a new way of working. This includes gaining and maintaining the trust of employees – a vital step during any period of transformation and one which, Box says, must come from the inside out.

"I think a lot of what was done eight or 10 years ago was to satisfy regulators and the media," he says.

"I believe that what organisations are trying to do now is genuinely reconnect with both employees and customers. Organisations realise that taking employees on whatever transformation they're going through is critical if they want that transformation to be successful. People need to buy into it. It's a bit like a pandemic; people need to see the path and they need to see what is going to be better as a result of any change.

"In our banks today, the message has become more simplified. It's become much less about messages on mouse mats and posters on the wall and much more about asking 'how do we behave?' and 'what do we really stand for as an organisation?'. And that, I think, resonates with employees."

PAY BACK

As is necessary during any period of transformation, financial viability and operational efficiency have to be key considerations. But failing to prioritise customer need while implementing changes will never precede positive transformation. "There's definitely a more balanced scorecard now, one that says this can't just save costs," says Conway.

"It's got to be good for the customer, good for us as an institution, but also radically change the way that we operate.

"I think this period has served as a reminder to focus on the 'why'. Previously, organisations would often get so caught up in the 'what' and the 'how' that they would forget about the 'why'. When you're rolling out financial products within five days to help customers in dire financial straits, the 'why' is so apparent in your mind that you get stuff done really, really quickly.

"That sort of focus on the end result for customers will help banks deliver change and transformation far quicker in the future."

A CLEAR HEAD

Christopher Box agrees on the importance of clarity.

"You've got to be clear on why you're looking at this as a topic as an organisation," he advises.

"If you genuinely want to increase trust between organisations and employees and between organisations and customers, then being clear on what you want to achieve is really important. You're better off doing nothing than paying lip service to this. And that's the question CEOs need to pause and reflect on.

"All organisations need to close the gap between what they say and what they do. The worst thing that organisations can do is purport to say and do one thing, and actually do something completely different, because then they set themselves up for failure."

One of the key principles for creating lasting change, Box says, is not to over-promise. "You've got to be confident that you can deliver on what you say you're going to do. That 1% of the time when people or organisations are under extreme pressure, when they are inconsistent with what they purport to do, can have a massively disproportionate impact in terms of perceptions of trust."

AUTHENTIC LEADERSHIP

While clarity of messaging will continue to play a vital role in maintaining and building on public trust in the sector, it's honest leadership that, for Box, will get the industry through the challenges ahead.

"If there has ever been a time in our lives for authentic leadership, this is it," he says. "I think employees want it and expect it more than ever, but what does that actually mean? For me, it means trying to use words that resonate with employees, trying not to over-engineer the key messages, trying to be honest with people. You're seeing it now at a societal level with government. People want honesty."

The other challenge for banks, and other financial institutions, is defining their place in, what Box calls, the trust ecosystem and finding opportunities to step into areas where trust and authenticity are lacking.

"Studies have shown there is a current distrust of the media because of the rise in fake news, and a distrust in traditional organisations like government. I think part of that void could be filled by corporates and organisations. If you can, as a CEO, address it in an effective way, it could make a massive difference commercially and help to differentiate you when attracting people to your organisation.

"We'll soon start to see some of the more detailed analysis of what didn't go well. Organisations need to think about what their longer-term strategy is, especially as we start to get into, dare I say it, some of the recriminations that will inevitably follow the pandemic. We need to build on the good that was done at the beginning." ✱

■ *This article previously appeared in the Chartered Banker magazine, UK, spring 2021 edition.*

'NO BANKING ON A DEAD PLANET'

By Angela Yap Siew Peng

Ça va bien? Hold your horses.

Minh Cuong Le Quan

Minh founded the Climate Change Unit at international non-profit, Geres. He subsequently chaired a global carbon-finance cooperative, **DESIGNING ITS UNIQUE FINANCING MECHANISM FOR IMPROVED FINANCIAL INCLUSION** of Asia in the carbon trading market.

French agronomist and sustainability leader Minh Cuong Le Quan has advocated for environmental justice in Asia, Africa, and Europe for close to 30 years.

His award-winning projects are known for putting people and their communities at the heart of market-based solutions. These pioneering ideas have garnered Minh and his team accolades, including the prestigious Clinton Global Initiative Award, the EU Energy Globe Awards, Ashden Awards for Sustainable Energy, and recognition as best-in-class solutions by bodies such as the US Environmental & Protection Agency.

Minh founded the Climate Change Unit at international non-profit, Geres. He subsequently chaired a global carbon-finance cooperative, designing its unique financing mechanism for improved financial inclusion of Asia in the carbon trading market. His perspective that environmental stewardship is inseparable from social justice goals has been presented to international panels, including the carbon market fora and technical bodies of the United Nations Framework Convention on Climate Change.

As CEO of Staterre, a France-based accelerator for change, he advises companies on transition and climate adaptation strategies. He also lectures on environmental stewardship at French business schools.

We share excerpts from our interview with the climate expert.

Q ***Achieving net-zero by 2050 under the Paris Agreement calls for decarbonising our planet in the next 30 years – companies must do away with fossil fuels and other sources of emissions or match every tonne of carbon dioxide (CO_2) emission with a ton removed from the atmosphere. What challenges will industries, including banking, face en route to sustainability?***

The financial sector must wake up to the realisation that we are in the midst of a collapse.

Net-zero pledges have become the norm, but for me, it's not a sufficient target.

Net-zero means that in 30 years, I'll

stop dumping pollutants into the air. That's like saying, "In 30 years, I'll stop being violent with my wife." First of all, the timeline is way off – the state of the climate system and the current inertia require that bolder changes take place within the current decade. Secondly, it is neither visionary nor ambitious.

We are on a dying Earth and climate change is just one symptom of a sick world. There are many other symptoms, like pollution of our oceans and biodiversity loss. Nearly one-third of species on Earth are on the IUCN Red List of Threatened Species and we've lost 50% of total insect mass over the past 40 years.

Business and finance have a great role to play. The financial sector is the machinery, the pipes that direct the flow of monies to fuel the economic engines, and the people in control of these pipes must be 'hit' by the realisation that these pipes are not laid in the right direction. Therefore, whatever objectives or targets we set are irrelevant unless we address or redefine the key driver that has brought the world to where it is today: greed and materialism.

For change to happen, people must realise that finance is just an instrument, a tool in the pursuit of happiness, personal development, and well-being of society. It is not an end in itself.

Q *But greed and materialism are a universal trait – we all have it in differing degrees. How do you change that?*

Firstly, it's about key performance indicators (KPIs). Making the carrots bigger toward meaningful goals is one way to set the stage. As soon as KPIs change, business leaders, managers, and their incentives will move in the same direction. This can be seen when the KPIs of a director include data on diversity of staff, gender equality, or environmental performance.

Changing KPIs have immediate effects on the way business is done, including investment funds that have steered their fund managers to divest from fossil fuels and destructive/extractive industries by changing their KPIs. Change can happen fast, if KPIs are changed.

Secondly, we must change how and what we value as success. Currently, we attribute the greatest value to extractive or destructive industries like fossil fuels and logging, when what we need is to substitute our benchmarks and determine value based on 'impact' measures.

There is the budding sector of impact investing, which in my view should be the norm. Instead, it's seen as this 'funny little thing' on the fringe of finance, as an extra-financial parameter or indicator instead of the core of financial performance.

Impact measures include a polluter-pay principle or reparations, the principle that people who do damage need to not just stop, but also repair and make amends. There are leadership cases, one of which is Microsoft, whose aim is not net-zero, but full responsibility for their history of emissions. This principle should apply for whatever we've done throughout the history of nations, of companies, and of individuals.

Q *Does impact investing effectively move the needle? Will it eventually, down the line, be just another box to tick in the regulatory checklist?*

The trend we've seen in Europe and other countries which have implemented impact investing is that the pioneers' values are pure; then as the field grows, you have other kinds of players trying to step in and dilute the values of impact investing. As we speak, huge forces are at play to influence the EU taxonomy, current and future.

Then the correct implementation of impact investing is a matter of governance and wider participation to ensure that the goals are preserved. How stringent or pure impact investing remains is a matter of openness and how we devise its criteria: Do we involve only decision makers, politicians, special interest groups, or do we involve society at large by including civil society and human rights activists?

Discussions involving a wider range of participants give greater credibility to impact investing. This is where we touch on democracy, on the participation of people who will press for policies and decision-making power in order to achieve the goals of impact investing. The key issue here is that market-driven forces are reined in when merged with the vision embodied in human rights and environmental activism.

On this score, transparency of information is critical. It enables us to rank and benchmark financial institutions, to see who is best in class, what the best practices are, and hopefully, inspire change.

For instance, Reporters Without Borders, an international non-profit organisation safeguarding the right to freedom of information, tracks acts of violence against environmental journalists. In the past five years, at least 10 journalists have been killed and over 50 environmentally linked press freedom violations have been registered. There is much work to do to improve this metric.

But I'm pleased that we have this level of transparency and the information to do this ranking. It also becomes a reason for people with savings, investors, and fund managers to divest from certain holdings in their portfolio.

Q *Mechanisms like carbon financing aren't new. In fact, it failed about 10 years ago in what I would call Round 1 of sustainable finance. Today's new targets and fresh pledges are Round 2. What failed then and how is it different today?*

What happened is that there was a choice between regulation or market mechanism. The EU was pushing for regulation, of putting caps and a carbon tax; whilst the US wanted a market-based cap-and-trade mechanism. To attract the US into the Kyoto Protocol, the EU and nations in favour of regulations relented.

It's important to note that market mechanisms like carbon financing work for simpler asset classes, such as addressing acid rains through the trading of sulphur dioxide emissions. This worked in the US, which is why they wanted to impose the same market mechanism for CO_2 emissions upon the rest of the world. But CO_2 is much more complex and the market mechanism failed around 2010.

The emissions trading market completely collapsed with the crumbling of the EU Emissions Trading Scheme, in part due to the over-allocation of quotas as well as the economic recession. This over-allocation was due to cronyism and political connivance between politicians and big industry in France and Italy, which resulted in the inefficient distribution of quotas in the carbon market.

Today, countries like China have taken stock of this experience and set up a carbon market that seems much healthier. Let's see how it goes.

The key issue for me is that the carbon market is still a mechanism based on greed, not regulation. We need a stronger stick to address CO_2 emissions.

Q *What does this 'stronger stick' entail?*

Where there is bad behaviour, we need to analyse where it comes from. Part of it stems from within – the core values of individuals, organised groups, and the way society functions. It's self-development, it's spirituality, it's education in a way that nurtures human values. In other words, values-based education.

We need to invest in equality and values-based education; that's where state budgets are really critical, not only in fund size but also in the quality of education, so that individuals have the opportunity to nurture these values within and become responsible citizens.

Where education has failed, there is regulation. At the societal level, it reins in human greed and keeps bad behaviour in check. Where we detect trespasses, there must be retribution.

At the moment, compared to other criminal activities, we are too soft on environmental crimes; punishments are not severe enough. There's a lack of retribution for bad environmental behaviour, but I think this will tighten. One day there will be very severe punishments for crimes against the planet.

Q *Are the green principles in Europe suitable for Asia?*

The fundamentals – human rights and environmental stewardship – are universal. Then there are specifics that are based on people's priorities and the balance between different forces at play in different countries or groups. There must always be regional or national adjustments.

However, Europe is not in a good place to give lessons, especially France. In a new report by Oxfam, Reclaim Finance and Finance Watch on major banks financing fossil fuels, four French banks are in the Top 15.

> Change can come from anywhere. Just as a toddler's question can pierce the adult mind, **THE SPARK OF AWARENESS CAN HAPPEN IN THE BIGGEST,** most rigid organisations. If banks have a hard time changing due to certain constraints, they can at least support their people within who want to do something better and with more meaning.

Q *Banking has moved toward embracing sustainability but there's still a lot of resistance. What must happen to bridge this divide?*

Crisis after crisis, I've seen many people from the financial sector hit by the realisation that the sector does not address their fundamental needs. They move out of the financial services industry to the NGOs in quest of more meaning and purpose in life. This lack in the financial sector needs to be addressed.

People move out of banking when they don't find meaning or can't see where they have an impact. If financial institutions are bent on change, they must find a way to encourage people with such drive to stay on, to support these 'stars in the night sky'.

Change can come from anywhere. Just as a toddler's question can pierce the adult mind, the spark of awareness can happen in the biggest, most rigid organisations. If banks have a hard time changing due to certain constraints, they can at least support their people within who want to do something better and with more meaning.

What matters is that people gather under the same tree. Whether it is for shade, for collecting low-hanging fruits, or just for the pleasure of finding like-minded friends – no matter the motivation, people must move from the barren lands to gather under the tree and aggregate.

Ultimately, there is no banking and finance on a dead planet. ✱

■ *Angela Yap Siew Peng is a multiaward-winning entrepreneur, author, and writer. She is Director and Founder of Akasaa, a boutique content development firm with presence in Malaysia, Singapore, and the UK and holds a BSc (Hons) Economics.*

PRE-EMPT A GREEN SWAN

By Julia Chong

Focus on material sustainability issues to mitigate sustainability risks and achieve alpha.

Whilst alarmist reports make for good headlines, they are an incomplete reflection of the work that has been done to forestall a potential climate-related financial crisis. Reining in sustainability risks has been on the agenda for some time, but garnered little attention from media stalwarts.

Take, for instance, non-profit Ceres' announcement that lending linked to fossil fuels and energy transition could translate into more than USD100 billion in losses for US banks and systemic financial risk. What this soundbite – carried by major newswires throughout the world – fails to reflect is the other side of the story.

COMPLY OR EXPLAIN

In every way, sustainability policies today are the result of years of behind-the-scenes work by supervisory authorities.

The EU's Sustainable Finance Disclosure Regulation (SFDR), which came into effect on 10 March 2021, is a landmark new regulation issued by the European Supervisory Authorities to achieve the goal of a carbon-neutral Union by 2050. The Regulation is a legislative tool designed to reorient capital towards sustainable businesses in order to achieve global climate goals whilst ensuring financial institutions actively combat 'greenwashing' i.e. conveying a false impression or misleading information to investors that the products are environmentally friendly.

An important aspect of the SFDR, specifically Recital 10, is that it is now mandatory for financial institutions to make pre-contractual and ongoing disclosures with regard to sustainability risk to end investors in accordance with regulatory technical standards.

The European Banking Authority (EBA) define sustainability risk as an environmental, social, or governance (ESG) event or condition which could cause an actual or a potential material negative impact on the value of the investment. This provides greater protection for end investors as firms must now disclose sustainability characteristics and risks at both entity and product level in accordance with EU-issued technical standards. Otherwise, firms must explicitly state that the product or entity does not take into account sustainability risks. This is known as a 'comply or explain' regime.

Most European banks have in place policies and/or established frameworks to address this risk and actively inform investors how controls are in place to take into account sustainability impacts. Rothschild & Co Merchant Banking, for instance, discloses to investors how sustainability risk may occur as part of its ESG investments:

"This policy therefore approaches sustainability risk from the perspective of the risk that ESG events might cause a material negative impact on the value of our products' investments. To give an example, if a Merchant Banking fund has significant exposure to digital services businesses which collect and process

Figure 1: ABN AMRO Sustainability Risk Policy for Lending

Process | Tools

1. RISK DETERMINATION

Screening for bank-wide embargo — **Exclusion List Global**

Identifying transaction's sustainability risk — **Sustainability index**
- Potential ESE (Environmental, Social and Ethical) impact and country-related issues
- Stakeholder attention (transaction/client) and transaction characteristics

Low, medium or high risk?

2. ASSESSMENT — **Questionnaires, Sector policies, Other tools**

Low Risk	Medium risk	High risk
- No further action	- Sustainability risk assessment - Gap analysis of client performance vs transaction risk	- In-depth sustainability risk assessment - Gap analysis of client performance vs transaction risk

Below, on or above par?

3. APPROVAL — **Action plan formats**

On/above par	Below par
- Standard conditions	- Conditions and exceptions - Performance-enhancing measures

4. MONITORING AND REPORTING — **Reporting formats**

On/above par	Below par (medium risk)	Below par (high risk)
- Standard monitoring	- Progress report	- Progress report - Supervision report

large volumes of personal data, then Merchant Banking might consider that there is a data security risk which, if a breach were to occur, could cause a material negative impact on the value of the relevant business (i.e. a governance risk to the value of the digital services business). To give a further example, if a Merchant Banking fund has significant exposure to a company which is people intensive, then any breach of applicable labour laws and employment rights could result in an adverse impact on Merchant Banking's investment (i.e. a social risk to the value of the company)."

Others like ABN AMRO Bank N.V. have outlined an umbrella Sustainability Risk Policy that zooms in at the activity level to fully incorporate the policy in each of the bank's relevant activities. For example, its Sustainability Risk Policy for Lending (**Figure 1**) outlines the sustainability risk management process for ABN AMRO's lending activities in order to ensure that lending transactions are managed according to its sustainability risk appetite and the 'Three Lines of Defence' model (risk taking, risk oversight, risk assurance).

"A VERY THIN LINE"

What warrants greater attention is: *The Green Swan: Central Banking and Financial Stability in the Age of Climate Change,* a 155-page book by the Bank of International Settlements (BIS) and Banque de France.

+ Inspired by Nassim Nicholas Taleb's now-famous 'black swan', the green swan concept in this book draws similarities with the former except:

There is certainty about the need for ambitious actions despite prevailing uncertainty regarding the timing and nature of impacts of climate change;

Climate catastrophes are even more serious than most systemic financial crises as they could pose an existential threat to humanity; and

The complexity of climate change is of a higher order than for black swans.

In a January 2020 podcast, Luiz A Pereira da Silva, BIS Deputy General Manager and co-author of *Green Swan*, describes two types of sustainability risk – physical and transition – and ways to preserve financial stability in the era of climate change:

"We are, of course, already seeing many of the physical risks associated with climate change. Take, for example, the widely noticed wildfires in Australia, or some of the consequences of hurricanes in the Caribbean…of course, for communities, these events entail large cost.

"Now, if we start rushing into very sudden changes, for example, regulations to offset these events – which is needed, but we do it in a way that is abrupt, that causes people to change portfolio allocations of their assets in a very fast, rapid way – we run into the risk of transitions that are not controlled.

"In an ironic sense, if we are successful in changing some of the regulation for the common good, to reduce the risk of climate change, we might run into the paradox of creating [for] ourselves some financial consequences that might be negative.

"So, everybody has to consider walking a very thin line between the urgency of making changes that improve and combat climate change, while at the same time considering all the consequences of this and trying to make sure that we move in the right direction, with safety and for the common good."

Such gradual moves, says Pereira da Silva, requires more novel approaches to risk modelling: "What we are increasingly perceiving is that all these phenomena related to climate change are very complex. They contain nonlinearities, they contain a number of different locations, and therefore, they are very uncertain."

"Now, most of the models that we use and sometimes models that include climate related events to forecast financial stability, they are usually backward looking. And now we understand that none of them contain climate related risks of the magnitude that we have today. So, we need to use more and more novel approaches, forward-looking scenarios that instead of just trying to replicate the past, extrapolate from the knowledge that we are accumulating with climate scientists, and that show that the dynamic effects of what is happening, the accumulation of greenhouse gas effects into our environment is changing dramatically and with a lot of uncertainty, the way in which we see the future. So, it's much more complicated than just extrapolating the tendencies of the past."

Some quarters, including former Secretary General of the Basel Committee Bill Coen, argue that climate change is being used as a justification to rollback established banking standards. Pereira da Silva refutes this logic and points out that addressing sustainability risk does not diminish financial stability, but instead improves it.

"What we are adding now is an additional dimension that needs to be carefully thought through. So that you begin thinking of what are the dimensions in terms of the composition of assets that your financial system has that entails more or less climate related risks, and the financial stability consequences of holding these assets," he said.

LONG-TERMISM

It's necessary to note that although climate-related systemic risk has received the most attention of all the ESG trends, other factors such as gender and racial diversity, biodiversity, food security, human rights, and global pandemics are part of the larger picture. Similar to the 'Do No Significant Harm' principle in the EU Taxonomy (see *Many Markets, One Common Language* on page 70), these factors are interdependent with varying degrees of materiality.

The importance of materiality is exemplified in *Corporate Sustainability: First Evidence on Materiality*, a seminal 2019 paper by Harvard Business School's Professor George Serafeim and coauthors, which discovered that firms with good ratings on material sustainability issues financially outperform firms with poor ratings on the same issues. Designing an index that differentiates between material sustainability issues and immaterial ones, the research indicated that the former yielded strong results with estimated alpha ranging from about 3% to 5% annualised. They conclude that these findings have "implications for asset managers who have committed to the integration of sustainability factors in their capital allocation decisions".

A 2019 research report commissioned by the Global Alliance for Banking on Values, an independent network of banks and banking cooperatives, found that banks which consistently scored high on material ESG issues delivered higher risk adjusted returns compared to those banks that performed poorly on the same issues, while the opposite was found for immaterial ESG issues. These results suggest that a focus on material sustainability issues is likely to coincide with enhanced financial returns.

If the deal is then sealed that sustainable investments will pay off in the long run, what remains to be seen is whether financial institutions will commit themselves to ESG principles in the short- to medium-term transition toward a sustainable future.

In this respect, Pereira da Silva's words exemplify the approach that all financial players should take in order to avoid a potential green swan: "Central banks cannot do it alone. They have to coordinate the actions of others because the fight against climate change is a collective action issue. Everybody in society should pull in the right direction." ✱

■ *Julia Chong is a Singapore-based writer with Akasaa. She specialises in compliance and risk management issues in finance.*

DATA ETHICS: TIME TO GET YOUR HOUSE IN ORDER

By Dr Amanda Salter

Landscaping what's fair and responsible use in emergent banking tech.

The technophiles among us are well aware of the recent high-profile cases of algorithms and artificial intelligence (AI) gone wrong.

Take the ignominious Apple credit card. Launched in 2019 in the US and backed by a leading global bank, the offering was panned by consumers who noticed that, as a result of its credit-rating algorithm, women were offered significantly lower lines of credit than men who had similar income and assets. The subsequent media storm sparked an ongoing investigation by the state regulator, who stated that "any algorithm that intentionally or not [emphasis added] results in discriminatory treatment of women violates [the] law".

The fracas highlights the common fallacy that technology, algorithms, and data are clean, objective, and neutral. This perception is patently untrue. All algorithms and data carry the biases of the people and the cultures that collect, process, analyse, and present that data.

A solid, long-term data ethics programme can forestall harmful and costly impacts, mitigating risks so that banks won't be caught with their pants down.

EVOLUTION & ITERATION

Researchers Luciano Floridi and Mariarosaria Taddeo, in a 2016 Royal Society *Journal* article, classify "data ethics as a new branch of ethics that studies and evaluates moral problems related to data (including generation, recording, curation, processing, dissemination, sharing and use), algorithms (including artificial intelligence, artificial agents, machine learning and robots) and corresponding practices (including responsible innovation, programming, hacking and professional codes), in order to formulate and support morally good solutions (e.g. right conducts or right values).

The nascent field of data ethics is constantly evolving. There are many societal and technological drivers behind the need for data ethics, from the rise of big data to the Internet of Things, and of course, AI itself.

We could argue that right now, our capabilities are only limited by our ambition and our expectations. But to misquote a phrase by Dr Ian Malcolm, the iconic scientist in the sci-fi classic *Jurassic Park*, just because we can do something doesn't mean we should – ability doesn't mean prerogative. In the emerging field of AI there is often no clear-cut right or wrong answer, and the mere presence (or absence!) of data can

create new ethical or moral dilemmas which need to be addressed.

Many organisations around the world are working hard to draw clear lines in the shifting sands. Much progress has been made in the last three years, summarised below.

In 2019, the Organisation for Economic Co-operation and Development published a set of five principles for the responsible stewardship of trustworthy AI. All are intrinsically linked to data governance and relevant to financial services:

- AI should benefit people and the planet by driving inclusive growth, sustainable development, and well-being.
- AI systems should be designed in a way that respects the rule of law, human rights, democratic values and diversity, and they should include appropriate safeguards to ensure a fair and just society.

The nascent field of data ethics is **CONSTANTLY EVOLVING**. There are many societal and technological drivers behind the need for data ethics, from the rise of big data to the Internet of Things, and of course, AI itself.

- There should be transparency and responsible disclosure around AI systems to ensure that people understand AI-based outcomes and can challenge them.
- AI systems must function in a robust, secure and safe way, and potential risks should be continually assessed and managed.
- Organisations and individuals developing, deploying or operating AI systems should be held accountable for their proper functioning in line with the above principles.

Asia-Pacific countries which have signed up to these ethical principles include Australia, Korea, Japan, and New Zealand. Other principles and guidelines echoing similar sentiments have also been published by such disparate global groups as the Open Banking Standards

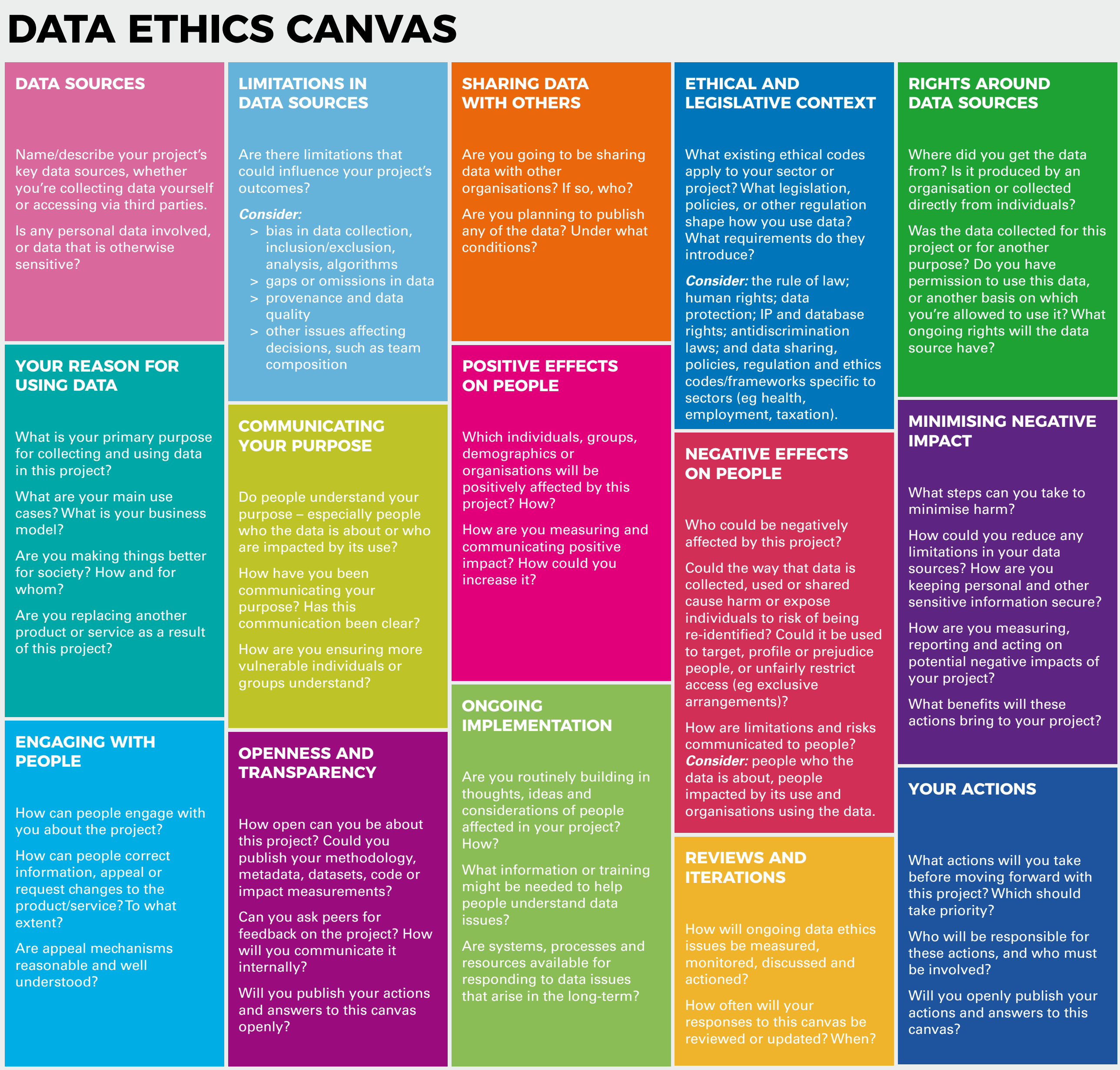


Figure 1: The Data Ethics Canvas, ODI

in the UK, the Institute of Electrical and Electronics Engineers, and the Open Data Institute (ODI).

The ODI also published the Data Ethics Canvas (see **Figure 1**) in 2019. This tool helps projects and organisations identify and manage ethical data issues and gives a framework for putting good practices in place around the ways data is collected, used, and shared.

Closer to home, the Japanese government's enthusiasm for all things AI, robotics, and big data meant they were one of the natural early movers in the field. Japan first published the Draft AI Research & Development Guidelines in 2017, followed by a set of seven core human-centric AI principles in 2018 that aim to reduce risks associated with such systems by establishing transparency and accountability processes for corporates who make decisions using AI.

Singapore followed suit, establishing an Advisory Council on the Ethical Use of AI and Data in 2018. Infocomm Media Development Authority, a statutory board under the city state's Ministry of Communications and Information, went on to publish the Model AI Governance Framework, the second edition of which was launched at the 2020 World Economic Forum Annual Meeting. Both DBS and HSBC have featured in a compendium of use cases which demonstrate how the framework could be effectively implemented in a banking context.

In 2019, the Hong Kong Association of Banks working with the Hong Kong

Monetary Authority (HKMA) launched an Ethical Accountability Framework for fintech development, including supporting models for data impact and process oversight. The HKMA also runs training programmes tailored to help banks adopt the framework and models in the development of fintech products and services.

BE ON THE FRONT FOOT

So, what do banks need to consider in light of the principles of good data ethics? The list of banking practices that would be potentially impacted by a data ethics assessment include, in no particular order of priority:

- AI-driven approaches to social listening;
- Algorithms used for internal day-to-day decision-making, e.g. consumer or business access to lending, financial products, or customer service;
- Customer profiling, risk assessment, and credit scoring;
- Predictive models of customer behaviour;
- Personalised pricing engines and tailored recommendations for products and services;
- Consumer facing robo-advice, e.g. chatbots for retirement or investing;
- Fraud detection;
- Account data aggregation, including shared uses for open banking;
- Data mining to generate insights or trends; and
- Workflow automation that speeds turnaround times for day-to-day processes.

Banks need to question the ethics of each of these applications of algorithms and data, and reexamine them in light of data ethics principles. This may well result in the tightening up of data governance or processes, leading to reduced risk further down the line. Many banks have appointed Chief Data Officers to lead the way and there is a need for dedicated resources to keep on top of the changes in technology and data governance practices to ensure banks stay on the front foot.

UK Finance, the trade body for its banking and financial services sector, published a report in March 2019 that summarises three types of risk associated with the above practices – legal and regulatory risk, operational risk, and reputation risk. In its report, *Ethical Use of Customer Data in a Digital Economy,* unfair algorithmic bias, opaque restrictions of customer choices, skills shortages, and data security stand out as the most challenging risks to address.

> Banks need to question the ethics of each of these applications of algorithms and data, and reexamine them in light of data ethics principles. This may well result in the tightening up of data governance or processes, **LEADING TO REDUCED RISK FURTHER DOWN** the line. Many banks have appointed Chief Data Officers to lead the way and there is a need for dedicated resources to keep on top of the changes in technology and data governance practices to ensure banks stay on the front foot.

AN OPEN GATEWAY, NOT CLOSED BORDER

Despite the risks of running headlong into an Apple Card-like scandal, the reward for banks that get it right is huge. A 2020 report by the Netherlands' Ministry of Economic Affairs & Climate Policy projects that by 2025, the AI global market would be worth up to EUR360 billion, and the Asia-Pacific region is anticipated to overtake North America as the primary player in the same timeframe.

In this light, banks should not view data ethics as a containing or limiting factor. There are many side benefits of applying data ethics well in the context of AI and big data and visionary Asia-Pacific banks can grab the opportunity to lead in this. Here are some potential ideas:

- Deriving win-win business models where both bank and customer benefit fairly from the value of data;
- Innovative ideas for new consumer- and business-facing products and services;
- Empowering customers by giving them access to and visibility of the data held on them, helping to educate and improve decision-making;
- Driving quicker decisions that are fair and in customers' interests;
- Potential to attract investment from ethical investors;
- Facilitating the building of trust with consumers; and
- Expertise in ethical technology and data ethics products could be provided to a hungry competitor market.

As banks enter a new era of big data and AI, we cannot shirk our responsibility to protect the public even as we chase down our gains. The power and peril of ever-increasing quantities of data is that the smallest decision made can have the power to materially impact peoples' lives.

Banks who take the lead on data ethics make a statement that they put people, planet, and society's best interests first. A focus on data ethics drives responsible and inclusive behaviour by ensuring that no one is unfairly disadvantaged by the data or algorithms that we steward. Proper consideration of data ethics is a gateway that can open up new responsible routes to benefits in this new territory. ✱

■ *Dr Amanda Salter is Associate Director at Akasaa. She has delivered award-winning global customer experience (CX) strategies and her recent guest lecture at the University of Cambridge shared insights from architecting impactful CX. Dr Salter holds a PhD in Human Centred Web Design, BSc (Hons) Computing Science, First Class, and is a certified member of the UK's Market Research Society and Association for Qualitative Research.*

DIGITAL TRANSFORMATION POSES POTENTIAL RISKS FOR STABILITY AND THE FINANCIAL INDUSTRY

By Prof Hans Genberg

Reining in the risk of regulatory arbitrage.

Digital transformation is changing how and by whom financial services are provided, bringing benefits to consumers in the form of expanded and simplified access to financial services. However, this transformation is also affecting the financial services industry in ways that could lead to greater risks to systemic financial stability.

THE ARRIVAL OF BIG DATA AND ARTIFICIAL INTELLIGENCE

Transformation of the financial sector and the provision of financial services are driven by 'big data' and the computer-aided ability of financial institutions to analyse these data to provide improved services to customers. By big data, we mean very large structured and/or unstructured data sets containing tens of thousands of observations on bank customers, insurance policyholders, and users of online payment platforms etc., as well as textual data that can be digitised and used for the computer-aided analysis of newly issued financial regulations,

A survey of AI in financial services conducted jointly by the Cambridge Centre for Alternative Finance and the World Economic Forum found that 70%–80% of the firms surveyed had **ALREADY IMPLEMENTED OR WERE IN THE PROCESS OF IMPLANTING SOME FORM OF AI SOLUTION** in their business models.

newspaper reports to search for indicators of economic uncertainty, and reports by investment banks that may reveal information about market sentiment. The evolving analytical techniques that enable financial institutions to take advantage of big data are commonly known as machine learning or artificial intelligence (AI). These are sophisticated methods to discover intricate, often non-linear, relationships between variables that can inform decisions on customer creditworthiness, asset allocation decisions, risk management, and forecasting.

AI IS WIDESPREAD IN THE FINANCIAL SERVICES INDUSTRY

The use of AI in the financial services industry is widespread. A survey of AI in financial services conducted jointly by the Cambridge Centre for Alternative Finance and the World Economic Forum found that 70%–80% of the firms surveyed had already implemented or were in the process of implanting some form of AI solution in their business models. Not surprisingly, fintech firms were in general more active users of AI, although only by a relatively small margin. While these developments will change the nature of financial services and how they are provided by incumbent financial institutions and new start-up fintech companies, they are not likely to pose an existential threat to the traditional financial services industry as a whole. The arrival of new institutions, so-called 'Big Tech' firms, may do so.

THE CHALLENGE FROM BIG TECH

Big Tech institutions are firms like Alibaba and Tencent in the People's Republic of China; Amazon, Google, and Facebook in the United States; Uber in Europe; and Grab in Southeast Asia. These companies did not start as financial services companies, but by taking advantage of their vast networks of customers and the consequent huge amount of data generated by the actions of these customers, they have entered into the financial services business. Big Tech companies are a source of numerous direct benefits for consumers, especially in emerging and developing economies, where they have contributed substantially to the financial inclusion of previously unserved segments of the populations.

Particularly important has been their engagement with small- and medium-sized enterprises (SMEs), which traditional financial institutions have not served adequately. In lending, Big Tech firms can use their wealth of data on the payments and receipts of SMEs to assess creditworthiness and, hence, be in a better position to grant loans.

Big Tech companies are also a source of indirect benefits for consumers as they provide technology infrastructure for traditional financial institutions and encourage innovation, diversification, and efficiency. With their size, extensive customer base, and access to customer information, Big Tech companies constitute a competitive threat to traditional banks that goes beyond that of fintech start-ups. While incumbent financial service providers can and do replicate many of the innovations of fintech, it is much more difficult to replicate the business model of Big Tech companies because of the advantages the latter can extract from their vast information databases on just about all aspects of their customers' behaviour.

FINANCIAL STABILITY RISKS

Financial liberalisation and financial innovation have traditionally preceded stresses in the financial system. The basic mechanism is as follows.

Big Tech companies are also a source of indirect benefits for consumers as they **PROVIDE TECHNOLOGY INFRASTRUCTURE FOR TRADITIONAL FINANCIAL INSTITUTIONS** and encourage innovation, diversification, and efficiency. With their size, extensive customer base, and access to customer information, Big Tech companies constitute a competitive threat to traditional banks that goes beyond that of fintech start-ups.

Financial deregulation and financial innovation create opportunities to expand credit extension and engage in new financial ventures without adequate understanding or appreciation of the underlying risks. The extension of credit leads to economic expansion, which makes the increased debt burden of the borrower seem tolerable, and the riskiness of new financial products are not well understood because, by definition, there is no or very little past data to guide decisions.

The result is overextended borrowers and over-leveraged lenders, and when the tide turns, turmoil and even havoc ensue. These mechanisms apply also to the digital transformation of finance.

The emergence of new types of institutions providing financial services is akin to financial liberalisation, as some of the activities of these institutions lie outside the perimeter of the regulatory system. Innovations brought by fintech and Big Tech can introduce products whose risk characteristics are not well known and that can have systemic stability consequences, the rapid growth of peer-to-peer lending by fintech firms being one example. Machine learning and artificial intelligence may also amplify systemic risk as risk management functions in financial institutions are employed to optimise compliance with the existing regulatory framework. If the

optimisation algorithms lead to solutions that are similar across institutions, the result may be a financial system that is increasingly procyclical when shocks materialise.

Regulators must be vigilant and ready to adapt to the new financial landscape. New entrants that are not yet included in the perimeter of the regulatory system must be monitored, and potential systemic consequences of new sources of risk to individual institutions must be continuously assessed. As some activities of unregulated institutions are indistinguishable from the same activities in regulated institutions, there is a risk of regulatory arbitrage taking place. It is, therefore, imperative that regulatory frameworks be adjusted to focus on activities rather than on institutions.

POST-PANDEMIC IMPLICATIONS

This is being written in the midst of the coronavirus disease (Covid-19) pandemic, which has created unimaginable human suffering and great economic upheaval. As it unfolds, it is hard to imagine that the world will return to what it was just over a year ago. How might the above analysis and conclusions be affected?

A salient feature of the digital transformation of finance is that virtual AI-assisted financial intermediation is challenging financial intermediation and payment services that are based on personal contacts. The social-distancing behaviour that has been mandated or highly recommended during the pandemic, and that may well continue voluntarily in a modified form in the future, increases the competitive advantage of the virtual business model. Entities that have broad access to potential customers, either through their social media presence or their internet-based commerce engagement, will be particularly strongly positioned to expand in this environment. These are the Big Tech firms, because of their ability to take advantage of scale, there is a risk of greater concentration in the financial intermediation industry and, hence, a greater risk of monopoly pricing, cybersecurity challenges, and too-big-to-fail problems. Regulatory authorities must be vigilant and ensure that the financial services activities of these firms are appropriately regulated. ✱

Regulators must be vigilant and ready to adapt to the new financial landscape. New entrants that are not yet included in the perimeter of the regulatory system must be monitored, and **POTENTIAL SYSTEMIC CONSEQUENCES OF NEW SOURCES OF RISK** to individual institutions must be continuously assessed. As some activities of unregulated institutions are indistinguishable from the same activities in regulated institutions, there is a risk of regulatory arbitrage taking place.

This article was originally published in Asia Pathways, the blog of the Asian Development Bank Institute.

■ *Hans Genberg is a Professor of Finance at the Asia School of Business and is the Senior Director of Banking and Finance Programs of the Master in Central Banking Programme. He has published considerably on issues related to exchange rate regimes, reserve management, and capital markets development, having worked in senior roles at the South East Asian Central Bank Research and Training Centre, the Hong Kong Monetary Authority and at the International Monetary Fund.*
Prof Genberg also has extensive academic experience, having been Professor of International Economics from 1979 to 2008, and Head of the International Economics Department from 1989 to 1998 at the Graduate Institute of International Studies in Geneva, Switzerland.
He holds a PhD in Economics from the University of Chicago.

EYE-OPENERS FROM GAMESTOP'S WILD, WILD RIDE

By Kannan Agarwal

CONSEQUENCES TO THE INTERNET-DUBBED "GREATEST REAL SHORT BURN OF THE CENTURY".

By now, every financier worth his or her salt would have heard of GameStop Corp, the stock which – thanks to a subreddit called wallstreetbets – climbed a whopping 1,625%, resulting in multi-billion losses at hedge funds like Melvin Capital and other short-sell firms.

For the uninitiated, a subreddit (denoted by the prefix "r/") is a forum on the social platform Reddit, where users post questions and engage with other Redditors. Hence, r/wallstreetbets is a forum about…well…what wall street bets. It's a mix of people from all walks of life – from teenagers seeking investing tips right up to divergent views from prominent analysts.

In a recent radio interview on *NPR*, Brandon Kochkodin recounts: "It started with someone laying out the case that was, you know, GameStop's being treated in the market as if the company already went bankrupt. But if you look at the fundamentals, they have cash, they can pay their debt, they can service their debt. This isn't a bankrupt company yet, there's something there still and people are overlooking it.

"If you saw a classic value investor make the arguments that they were making for GameStop on wallstreetbets, you wouldn't flinch. You would look at it, and you'd be like, "Oh, good idea." "

BACKGROUND

When GameStop Corp listed in 2002, it was a successful American video game retailer, opening thousands of stores all over the world. However, its fortunes plunged as video gamers switched to downloading games over the Internet. GameStop stocks dwindled as it shuttered most of its stores.

Around 2014, GameStop was trading around USD50, but hit rock bottom in March 2020 at an average of USD3.60. This triggered wallstreetbets to take a closer look at the company's financials, wondering if the institutional investors on Wall Street proper, who said the company would soon go bust, had missed something.

The most notable of value investors who questioned this was Dr Michael Burry, the CEO of famed hedge fund Scion Asset Management, whose billion-dollar bet against the US housing-market bubble is immortalised in the Hollywood movie, *The Big Short*. There was also Ryan Cohen, known as the man who took on Amazon and won.

Around 2014, GameStop was trading around USD50, but hit rock bottom in March 2020 at an average of USD3.60. This **TRIGGERED WALLSTREETBETS TO TAKE A CLOSER LOOK** at the company's financials, wondering if the institutional investors on Wall Street proper, who said the company would soon go bust, had missed something.

The pivot came when a pseudonymed user, Player896, posted his analysis *Bankrupting Institutional Investors for Dummies, Ft GameStop,* arguing that the video game retailer's fundamentals were solid and institutional investors were shorting the stock at an unprecedented level: "But here is the real kicker. GameStop's short float. 120% has never been seen before. The short theory was that GameStop would not make it to the new console cycle and the shorters would collect their tendies."

GameStop then announced that Cohen would join its board and the stock climbed to USD40 in under two weeks. This prompted high-profile short-sellers like Andrew Left of Citron Research, nicknamed the bounty hunter of Wall Street, to throw the gauntlet and state, "Five reasons why GameStop is going to USD20".

Redditors on wallstreetbets took it upon themselves to "teach Wall Street a lesson". In late January 2021, small investors rallied on wallstreetbets, sending GameStop stock to an all-time high of USD483.

Hedge funds and short-sell firms like Melvin Capital and Citron lost close to USD20 billion by shorting GameStop. Two days later, Left conceded that the majority of Citron's position was covered "at a loss of 100%" and announced on Twitter that it would quit publishing short reports and will focus instead on long or bullish investments.

Left said: "Twenty years ago I started Citron with the intention of protecting the individual against Wall Street, against the fraudulent stock promotions that were all over. Now, after 20 years we noticed something…we've actually become the establishment…it's completely now lost its focus."

"We understand the changing dynamics in the market. So with that, we'll become more judicious when it comes to shorting stocks."

FUNDAMENTALS

The GameStop price action is a unique juncture between finance, social action, and technology. At the time of writing, regulators are actively addressing these emergent dynamics:

Increased scrutiny on several fronts:

- **Institutions.** Regulators and legislators have moved to curb the inordinate sway of non-bank players like hedge funds, open-ended funds, and money markets. Evidently, their control of the stock market through large-sized short positions pose systemic risks to the broader financial sector. The GameStop short-squeeze adds to risk concerns highlighted by the US Financial Stability Oversight Committee, which is mandated to minimise risk through consolidated supervision of designated nonbank financial institutions or break up those that pose a "grave threat" to the financial system. Market watchdogs have also called for greater oversight on par with banks.

- **Anti-competitive practice**: At its hottest point, online trading platforms, like the commission-free Robinhood, temporarily halted trading of GameStop and other meme stocks. This is after it helped fuel the frenzy by offering free GameStop stocks last year to new investors on their game-like investing app. It is now facing regulatory censure and civil lawsuits claiming that it violated customer agreements and industry rules.

  "I am concerned about whether or not Robinhood restricted the trading because there was collusion between Robinhood and some of the hedge funds that were involved with this," said Maxine Walters, who chairs the US Committee hearing on this.

  The US Financial Industry Regulatory Authority has also issued a letter to brokers indicating it would look into whether Robinhood-executed trades sufficiently disclosed investing risks to clients and if its actions exacerbated GameStop swings.

- **Is the Reddit strategy legal?** Through the power of sheer numbers, retail investors got organised and turned the tables on US institutional investors using a tried-and-true hedge fund strategy.

  Forbes interviewed John Reed Stark, former Chief of the Office of Internet Enforcement at the US Securities and Exchange Commission (SEC), who opined: "Whether the banding together by Reddit users to buy a stock is illegal is always going to be a matter of intent, that is, an intent to artificially distort the market for a security. Historically, the SEC has required some sort of deception, fraud, false statement, etc. before charging any sort of unlawful activity.

  "I also can't help but notice at least one odd irony here: that banding together is not limited to Reddit users. Hedge funds band together too. Many hedge fund managers freely share investment ideas with one another, through instant messages, emails and private chats. In fact, according to a *Wall Street Journal* article, some hedge fund trades stem from what are so-called 'idea dinners', where hedge fund managers discuss stocks, markets, and economic trends."

  Wallstreetbets' Keith Gill a.k.a. Roaring Kitty, whose in-depth analysis of GameStop helped spark the price surge, has testified at a congressional hearing which found no wrongdoing on the part of retail investors, who disagreed with Wall Street valuations and gave a detailed analysis why. The SEC could find no wrongdoing as GameStop strategy was publicly announced and, in some ways, even more transparent than hedge funds themselves.

- **Trust and transparency**. Combing through the forum indicates that there are fundamentally sound users on wallstreetbets.

  Mohammad Rajjaque, Programme Director at University

I also can't help but notice at least one odd irony here: that banding together is not limited to Reddit users. Hedge funds band together too. Many hedge fund managers freely share investment ideas with one another, through instant messages, emails and private chats. In fact, according to a Wall Street Journal article, **SOME HEDGE FUND TRADES STEM FROM WHAT ARE SO-CALLED 'IDEA DINNERS',** where hedge fund managers discuss stocks, markets, and economic trends.

of Sheffield and long-time wallstreetbet member, in his article titled *GameStop: I'm one of the WallStreetBets 'Degenerates' – Here's Why Retail Trading Craze is Just Getting Started,* sheds light on the platform's open peer-review and due diligence (DD) process.

"These DDs were scrutinised and discussed by members and any discrepancies in arguments or data were usually identified quickly. Existing members continually reminded newcomers about the risks involved with suggested trades and cautioned that anyone putting more than 2% of their total capital into a risky trade was making a mistake.

"The most important feature of the forum was transparency. Members regularly shared the status of their trade – both losses and profits. Traders like Gill even regularly posted the status of their portfolio, including losses."

Platforms like Reddit have created a sort of brotherhood for like-minded individuals. The critical question that needs addressing is why retail investors are increasingly distrustful of what they call "the establishment" a.k.a. Wall Street proper.

- **Democratisation of finance**. Like how crowdfunding changed political fundraising for President Obama and Senator Bernie Sanders, raising millions of small-dollar donations from citizens, today's retail investors are similarly flexing their collective power.

Its 'success' continues to spark a rally on other stocks touted as "the next GameStop" and has spawned other retail-investor subreddits throughout the world, including Malaysia's very own r/bursabets.

However, as wallstreetbets subscriber base explodes to 9.4 million at the time of writing, it's yet to be seen whether the forum will continue its activist streak or become a victim of its own success.

WHO WILL PREVAIL?

Wallstreetbets isn't just a forum, but a cohesive community populated with lingo that only insiders get.

For instance, the word 'tendies' – short for 'chicken tenders' – refers to winnings; diamond hand emojis (💎✋) mean you're ready to hold a position to the very end, win or lose; poo hand emojis (💩✋) mean someone is feeling scared and selling too soon.

Ultimately, it is the emotional connection and shared values of its users that drove the GameStop rally. In fact, some are still holding on with 💎✋ for no other reason than to "stick it to the hedge funds".

Plus, it seems the tussle over whose analysis is truer will rage for some time yet. When GameStop announced its 4Q earnings on 25 March 2021, established media outlets like *Bloomberg* headlined the stock's USD215 million loss in the 12 months ended 30 January, whilst online sites such as the ever-popular *The Motley Fool* emphasised Gamestop's 175% surge in global e-commerce sales in the holiday-impacted quarter.

Irrespective of which camp one is in, Redditors' promise to drive the shares "to the moon" has undoubtedly spurred reform.

In a recent *Fortune* article, Nathan Anderson, founder of Hindenburg Research sums it well: "While the guns are turned on short-sellers at the moment, I'm encouraged that the right questions are finally being asked. It's early, but I'm hopeful that it leads to a broader understanding of how the system is flawed. Because that's the only way it will ever actually improve." ✱

■ *Kannan Agarwal is a researcher with Akasaa, a boutique content development and publishing firm with presence in Malaysia, Singapore, and the UK. His focus is digital content and Big Data analytics.*

THE ETHICAL ADVANTAGE

THE ECONOMIC AND SOCIAL BENEFITS OF ETHICS TO AUSTRALIA

By The Ethics Centre

Numbers show that choosing what's right is really the best.

At the dawn of the third decade of this century, Australia faces significant challenges – navigating the health and economic impacts of the Covid-19 pandemic, responding to emerging issues around the future of work and introduction of new technologies, preparing for an increasingly risky geopolitical environment and addressing long-standing social and environmental challenges, including climate change and reconciliation with Indigenous Australians.

Addressing these issues will require effort from many organisations, businesses, community groups and government bodies, and will draw on a range of competencies and technical skills. Inevitably, we will need to make some 'big decisions' – and this will require leadership of a quality that enables society to cohere in the face of external and internal pressures that would otherwise cause divisions. In these circumstances, trust will be at a premium – especially for key institutions. In turn, this will depend on the quality of ethical decision-making by individuals, groups and organisations.

There remains significant scope for Australia to lift our levels of ethical behaviour and trust. In 2019, Australia was rated as being only 'somewhat ethical', achieving an index score of 37 on the Governance Institute of Australia's -100 to 100 scale, four points down on the result two years earlier. The banking sector, which all Australians rely on, was considered the most unethical industry.

When asked whether people keep their word or make agreements honestly, everyday Australians say 'yes'... but do not hold this view with great confidence – with an agreement score of around 12 out of 18 on the Household, Income and Labour Dynamics survey. According to the World Values Survey, just 54% of Australians state that they generally trust other people they interact with. While this might be a higher score than achieved by many countries, including the USA and UK, the Australian score is 10 percentage points behind the world leader.

In some respects, Australia's relative ethical performance is no surprise. A steady stream of state and federal political scandals has eroded trust. Royal Commissions have uncovered unconscionable behaviour in religious and other institutions, widespread misconduct in the banking, superannuation and financial services industry, and most recently, alarming activities relating to aged care quality and safety.

Australia's uneven ethical performance is also evident in corporate culture. A 2018 review found that while almost all ASX200 companies disclosed a code of practice, only 6% had leading practice. The rest were either infrequently updated or had little CEO buy-in; two-thirds did not contain even five of 13 recommended topics.

While few would argue a higher level of ethics in individuals or institutions is a bad thing, articulating the benefits of stronger ethics is more challenging. For this reason, The Ethics Centre commissioned Deloitte Access Economics to develop a framework to quantify the benefits of a more ethical Australia: how, and by how much, would individuals, businesses and the economy be better off were Australia to have, say, the best ethical performance in the world? This project is not intended to

In 2019, Australia was rated as being only **'SOMEWHAT ETHICAL', ACHIEVING AN INDEX SCORE OF 37** on the Governance Institute of Australia's -100 to 100 scale, four points down on the result two years earlier. The banking sector, which all Australians rely on, was considered the most unethical industry.

reduce ethics – the very question of what is right and wrong for us as humans – to a mere dollars-and-cents business case, but rather to put a financial analysis alongside the moral case for change, in order to strengthen it.

Reviewing many data sets, research sources and performing three new types of economic modelling, the results are in:

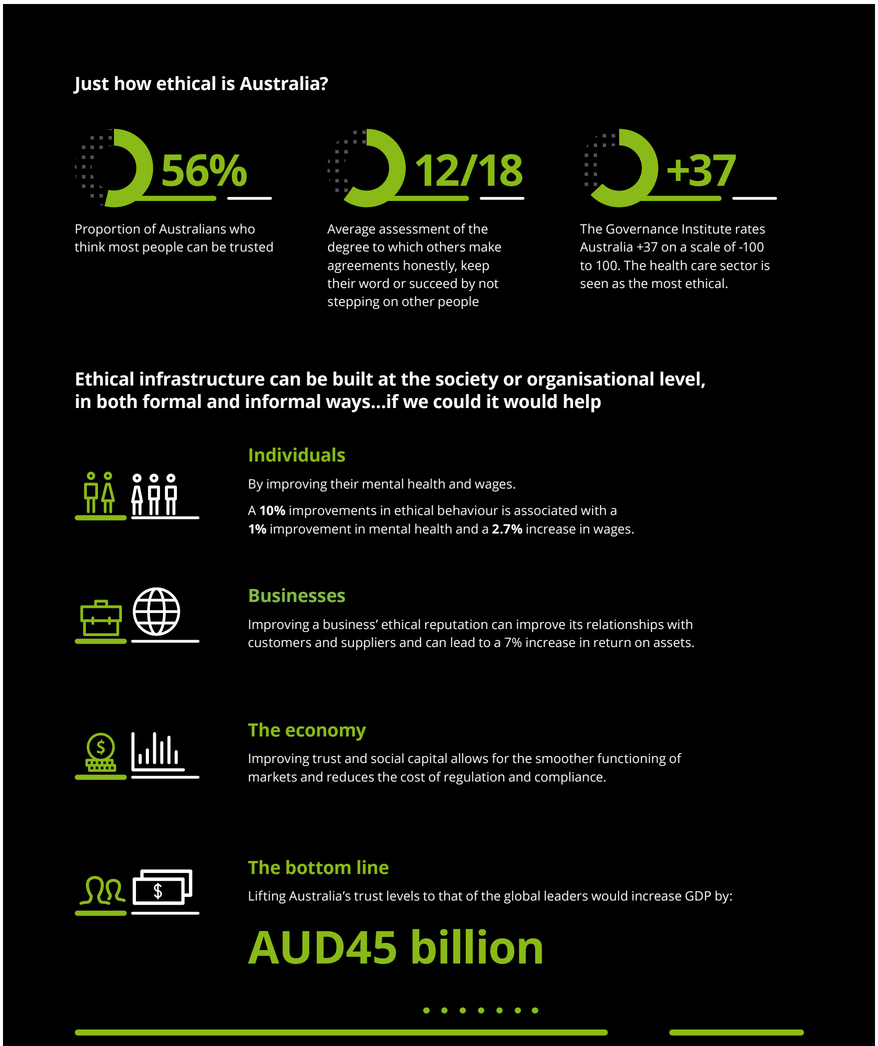
+ Individuals would benefit from improved mental and physical health, avoiding the costs associated with the 'moral injury' caused by unethical decisions. Consistent with this, the impacts are larger for mental than physical health with a 10% improvement in individual perceptions of others' ethical behaviour associated with a 1% improvement in perceptions of their own mental health. The Productivity Commission estimates an AUD130 billion cost associated with diminished health and reduced life expectancy for those living with mental ill-health. Even a 1% improvement in mental health outcomes could have significant implications for the economy and individual well-being.

+ There is also a business case for being ethical. While there are a range of moral reasons for a business being ethical, there is also evidence that unethical behaviour leads to poorer financial outcomes for business. This study supplements the literature in this area by drawing on data from the RepTrak Governance Index (a measure of ethical perceptions), which shows a positive association between return on assets (ROA) and performance on the Governance Index. Increasing a firm's performance on the Governance Index by one standard deviation raises ROA by approximately 7% or around 50% for those firms in the sample.

+ There is also evidence that individuals would enjoy higher wages consistent with an improvement in labour and business productivity. Specifically, a 10% increase in regional measures of ethical behaviour was associated with an increase of 2.7% to 6.6% in individual wages. A 2.7% increase in wages would amount to approximately AUD23 billion increase in aggregate wages across the economy.

+ The economy can benefit from smoother functioning of markets and lower costs of regulation and compliance. If Australia was to improve ethical behaviour, which in turn led to an increase in trust, in line with the world's leading countries, average annual incomes would increase by approximately AUD1,800. This equates to a net increase in total incomes across Australia of approximately AUD45 billion. These annual benefits would grow towards these levels as the country moved towards higher levels of trust.

The Productivity Commission estimates an AUD130 billion cost associated with **DIMINISHED HEALTH AND REDUCED LIFE EXPECTANCY** for those living with mental ill-health. Even a 1% improvement in mental health outcomes could have significant implications for the economy and individual well-being.



SOURCE: The Ethics Centre

These estimates capture the potential economic gain from improving ethical behaviour and do not explicitly account for any costs associated with programmes or initiatives to improve ethics in Australia. There are also overlaps between many of these outcomes such that they are not additive. For example, improvements in business ROA or productivity and employee wages are captured in gross domestic product.

Nonetheless, the results indicate that there are likely to be large economic dividends from improving ethical outcomes. To put it in perspective, a more ethical Australia would achieve an economic improvement about half as big as the nation's economic reform priority list outlined by the Productivity Commission in 2017, where 28 reforms would lift the economy by some AUD80 billion over time.

Ultimately, improving ethics requires a multifaceted and coordinated approach. The complexity of ethical decision-making, and the infrastructure needed to support it, means improving ethics cannot be achieved with a single initiative. Recognising these inherent challenges, there are a number of

These estimates capture the potential economic gain from improving **ETHICAL BEHAVIOUR AND DO NOT EXPLICITLY ACCOUNT** for any costs associated with programmes or initiatives to improve ethics in Australia.

potential initiatives which can help improve ethics in Australia. This report identifies five areas for improvement, supported by 30 individual initiatives.

1. Developing an Ethical Infrastructure Index;
2. Elevating public discussions about ethics;
3. Strengthening ethics education;
4. Embedding ethics within institutions; and
5. Supporting ethics in government and the regulatory framework.

The report concludes with a discussion of how a stronger ethical framework based on these development areas could inform a response to three key challenges in Australia – reconciliation with Australia's First Nations people, climate change and the environment, and technology and artificial intelligence.

Overall, with the individual, business and economic benefits on offer from a more ethical Australia, the business case for change is a sound one. With the challenges facing the country, strengthening ethics is simply a must. ✱

The full report is available at ethics.org.au.

■ *The Ethics Centre is a not-for-profit organisation developing and delivering innovative programs, services and experiences, designed to bring ethics to the centre of personal and professional life. The Centre is committed to injecting a pause into the centre of public life and allowing people to stop, connect with others and explore the ethical dimension of our everyday lives.*

THE CUSTOMER JOURNEY AND ITS ETHICAL IMPLICATIONS

By Bob Souster

The challenges of change.

For many years, banking organisations placed great importance on signing up new customers. The conventional wisdom in marketing suggested that once a person became a customer they would probably stay for life, and in doing so influence others, such as their family and friends, to bank with the same institution. To a large extent this remains true: people do not instinctively shop around for banking products and services in the same way as they might for fast-moving consumer goods and gadgets, nor are they as susceptible to fads and fashions. It takes some effort to persuade a person to switch their bank account from one provider to another.

Customer inertia breeds complacency. Satisfied that many existing customers are here to stay, it is too easy to assume that resources should be focused on attracting new ones. This serves a purpose, as there is much benefit to society in persuading those who do not avail themselves of banking services to do so, yet it is important to accept that banks owe ongoing obligations to their existing customer base. This article argues that this is becoming a more difficult task and will become more difficult as time passes.

> Banks owe obligations to their stakeholders: **THOSE WHO ARE AFFECTED BY AND CAN AFFECT THE BANK**. These include customers, shareholders, suppliers, the community and even the physical environment.

Banks owe obligations to their stakeholders: those who are affected by and can affect the bank. These include customers, shareholders, suppliers, the community and even the physical environment. Yet, to paraphrase the famous author George Orwell, "All are equal, but some are more equal than others". Mindful of the deficiencies exposed by the global financial crisis, many regulators responded by insisting that customers must be prioritised. This is strongly reflected in Bank Negara Malaysia's document, *Fair Treatment of Financial Consumers,* which sets down the outcomes that should be pursued by providers of financial services. In short, customer interests should lie at the heart of everything that a bank does, not just when the customer arrives but throughout the relationship. Increasingly, doing the right thing is doing what is right for customers.

This is no easy task. It was once accepted that customer needs could be predicted by extrapolating a typical customer life cycle. Young customers would need a current account and access to modest levels of credit. Over time, they would then need personal loans, mortgages and investment products. Going into their senior years, customers might need to plan their lives around retirement and inheritance. It is no longer straightforward, if indeed it ever was.

Consider some trends.

+ The perception of the typical family has changed:

Society has become more diverse. Marketers used to write of a typical family of "two adults and 2.2 children", representing an average family living an average life in average circumstances. This no longer applies. Faced with financial pressures, young people may defer their aspirations of home ownership and even defer their plans to have a family at all.

+ The 'job for life' has long gone:
While it was once possible to join a company in a modest job for a modest salary and progress over a period of 40 years until receiving the gold watch given by a grateful company upon retirement, few people can now guarantee that they will stay with a company as a lifetime commitment. The labour market is now more fluid and most employees now accept that they may have to move to achieve their career aspirations. Many leave the employment market altogether to become individual entrepreneurs, capitalising on their own creativity and ingenuity instead of making others rich. Some succeed spectacularly, while others fail in equal measure.

+ Models of rational behaviour do not always apply:
Economic theory suggests that consumers will base their choices on price, income and personal tastes and preferences. Yet demand for products and services will often be determined by a wide range of influences, including subjective bias, rules of thumb and the advice of peers. How many people choose a bank based on the bank chosen by their parents or friends, without exploring the options available to them? In the past, it has been possible for banks to capitalise on this as a ready source of new business. It is also a reason why some less efficient banking organisations have been able to recruit new customers over long periods of time despite the existence of competitors with better products and services.

Customer inertia also plays a part. For example, in return for financial assistance by the UK government after the global financial crisis, Royal Bank of Scotland plc agreed to encourage its business customers in England and Wales to switch to alternative banks, yet many did not do so even when offered incentives of up to GBP2,000. Busy customers may not be inclined to shop around, as time costs money. Banking products are difficult to compare and are sometimes complex, and these factors can inhibit consumer decisions.

These market imperfections are not unique. Information asymmetry and behavioural economics apply in all industries, not just banking, but they have to be understood.

Banks are faced with enormous challenges. While the coronavirus pandemic may have hastened the **MIGRATION TOWARDS ONLINE BANKING AND AWAY FROM PERSONAL TRANSACTIONS**, they should also be conscious of threats such as the dilution of traditional sources of funding (due to low interest rates), changes in demand for conventional credit products and (eventually) the development of digital currencies managed by central banks.

+ The role of technology:
In recent years, a new breed of player has emerged in the world of banking and finance. Heralded generically as 'fintech', these are a diverse set of organisations whose capability lie in the management of big data and applications of advanced communication technologies. Their core competence is lifestyle management, based on analytical capabilities that are highly responsive to changing customer needs. Such is the threat of fintech that many banks have now developed their own fintech models, or in some cases partnered with companies with fintech specialisms, in order to build new business models.

Yet at the same time, technological advancement creates new problems. Not all customers are technologically literate, and some who believe that they can cope with new ways of conducting their financial affairs may fall victim to criminals and scammers who seek to deprive them of their wealth.

IMPLICATIONS

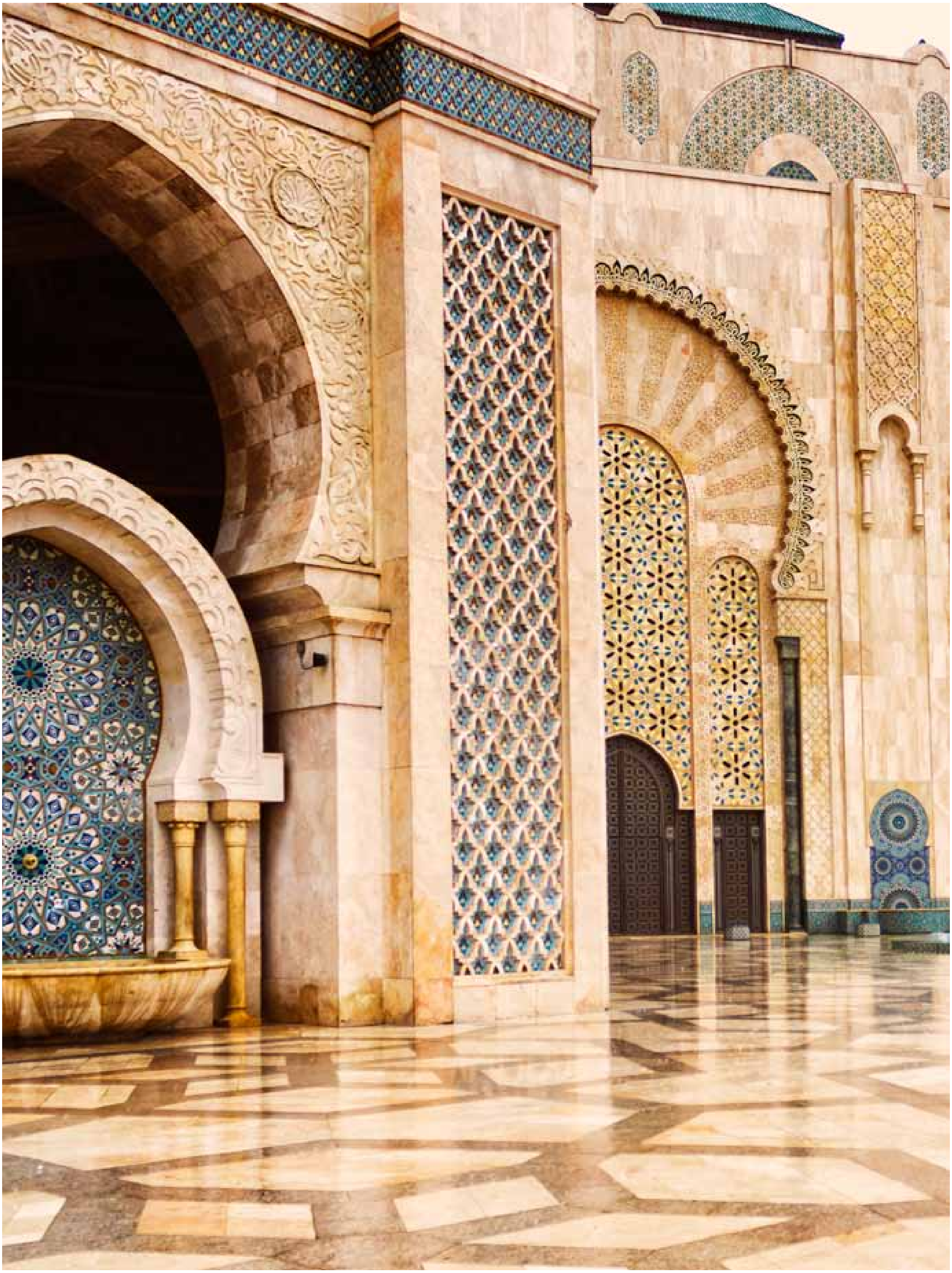
The only constant in a period of rapid change is change itself. The survival and prosperity of any business depends on its ability to change with the shifting demands of society. This implies a need for a holistic approach to customers and a proactive approach to existing and new customers.

Banks are faced with enormous challenges. While the coronavirus pandemic may have hastened the migration towards online banking and away from personal transactions, they should also be conscious of threats such as the dilution of traditional sources of funding (due to low interest rates), changes in demand for conventional credit products and (eventually) the development of digital currencies managed by central banks.

This writer was once asked to write a book on marketing and the commission was politely declined. The reason given was that marketing is about asking what customers want, delivering what customers want and then repeating the exercise continuously over time, so to extend this simple concept over 300 pages was disingenuous.

Doing the right thing for customers is not as easy as it seems, but organisations that are able to adapt to these new realities are those that will continue to prosper. ✱

■ *Robert (Bob) Souster is a Partner in Spruce Lodge Training, a consultancy firm based in Northampton, England. He lectures on economics, corporate and business law, management, corporate governance and ethics. He is the Module Director for 'Professionalism, Regulation and Ethics', a core module of the Chartered Banker MBA programme at Bangor University, Wales.*



ISLAMIC FINANCE LEADERSHIP: LESSONS FROM THE PAST AND STRATEGIES FOR THE FUTURE

By IslamicMarkets.com

An interview with Tan Sri Abdul Wahid Omar on structuring viable and sustainable projects.

As Tan Sri Abdul Wahid Omar had successfully directed Maybank through the 2008 global financial crisis, Daud Vicary, Chairman of the Advisory Board of IslamicMarkets.com, invited him to share his experiences and whether the lessons learned could be applied to navigate through the current global pandemic. Omar admitted that whilst the previous global financial crisis was challenging, it was manageable due to immediate action taken by the Malaysian authorities.

First, the Malaysian banking system was insulated from the knock-on impacts of events that were taking place in financial systems across the United States of America and Europe by way of rigorous risk management strategies put in place. Second, through the learnings from the 1998 Asian financial crisis, Bank Negara Malaysia (BNM) had ensured that the Malaysian banking sector was well capitalised with better asset quality, such that sufficient capital buffers were maintained to absorb any sudden shocks. Third, the government of Malaysia did not solely focus on keeping the financial and banking sector afloat, but also concentrated heavily on the economy by ensuring that all businesses were able to survive the crisis, such that manufacturing capacities were maintained, and jobs were protected.

In contrast, the current global pandemic is unprecedented and very different to previous crises, in that there is an impact on the global economy, with not just corporations, but also economies, societies and families being negatively affected. Omar added that with lockdowns being imposed in many

Tan Sri Abdul Wahid Omar

countries, the global gross domestic product (GDP) is expected to contract 6.1% year-on-year (y-o-y), with most economies looking at an average 5.0% y-o-y decline in their respective GDP levels for 2020. Given this, the challenges posed by Covid-19 are far greater and require an all-encompassing remedy.

Commenting on the relief measures in place, Omar stated that the primary focus is to protect lives and improve the availability of human and financial capital resources. Second, Omar added that governments needed to provide adequate support to keep businesses afloat, to ensure that employment levels are maintained, and income support is provided to those affected. The banking sector needs to embrace the true spirit of Islamic finance and work closely with customers to provide solutions that allow flexible restructuring of facilities, without compromising on banks' liquidity and risk management initiatives. According to Omar, it is crucial for the banking sector to ensure that sufficient capital is maintained to deal with future shocks, given the uncertainty surrounding the duration and extent of the ongoing pandemic.

Vicary then asked Omar to discuss how Islamic finance industry has developed over the years, from having a sole focus on *Shariah* compliance, to one that now encompasses environmental, social and governance (ESG) practices, with a strong focus on sustainability. Omar noted that the development of Islamic finance is a 'journey' that has taken a pragmatic approach through the years. Back in 1983, Bank Islam was established as a stand-alone Islamic bank in Malaysia. In 1998, conventional financial institutions were permitted to other Islamic banking products using a window concept and an interest-free banking scheme, termed as the Islamic banking scheme. The year 2005 saw window operations being moved under wholly owned subsidiaries, with Islamic banking operations needing to establish their own network of branches, separate from their conventional parents' branch networks. Later, the 'leverage model' was seen as more efficient, whereby conventional banks started offering Islamic banking products through Islamic banking windows.

Omar explained that all these gradual changes were supported by developments in the Islamic finance industry ecosystem, which included the **ESTABLISHMENT OF THE ISLAMIC INTERBANK MONEY MARKET,** the International Centre for Education in Islamic Finance (INCEIF), which provides a talent pool for the Islamic finance sector, as well as research institutions such as the International Shariah Research Academy.

Omar explained that all these gradual changes were supported by developments in the Islamic finance industry ecosystem, which included the establishment of the Islamic interbank money market, the International Centre for Education in Islamic Finance (INCEIF), which provides a talent pool for the Islamic finance sector, as well as research institutions such as the International Shariah Research Academy (ISRA). Simultaneously, Omar explained that the continuous revision and upgrade of laws also provided immense industry support and led to the enactment of a comprehensive Islamic Financial Services Act 2013 by BNM.

Omar opined that this approach of 'proper planning and progressive learning' enabled the concept of mere *Shariah* compliance to phase into ESG and sustainability. According to Omar, this was validated through BNM's introduction of Value-Based Intermediation (VBI) principles in 2017, with VBI now focused on developing Islamic finance products that contribute significantly more towards the well-being of people and the environment, without a sole focus on profits.

Responding to an audience query, Omar noted that Bursa Malaysia implemented VBI initiatives through the use of two platforms, one to facilitate commodities trading for Islamic finance contracts, and the other, an end-to-end *Shariah*-compliant equities trading platform which has enabled the listed *Shariah*-compliant stocks to embrace and adopt the VBI approach. Omar noted that 75% of the listed equities were already *Shariah*-compliant.

Riba-free Future: Omar explained that although Malaysia's capital markets has made notable progress over the past 37 years (asset size of RM3.1 trillion in 2019), similar to the global Islamic capital markets (asset size of USD2.5 trillion in 2018), Islamic assets are still largely based on a financial system that computed percentage returns per annum, mirroring the conventional system. Therefore, Omar opined that it is time for Islamic financial markets to

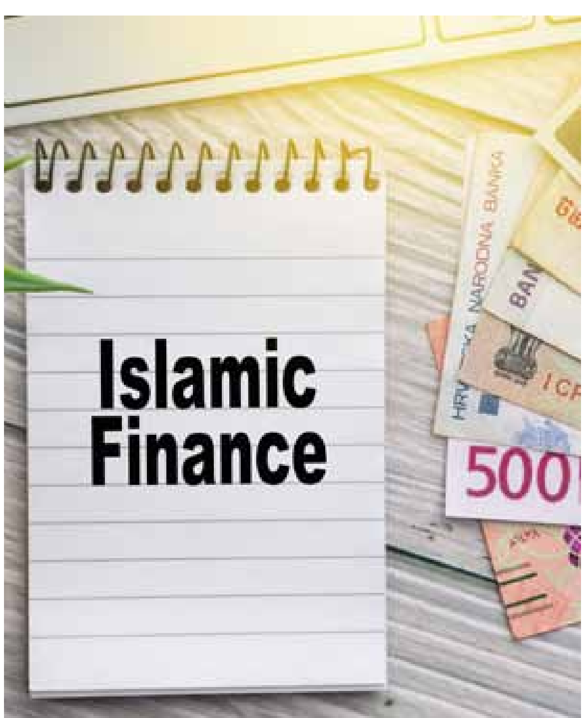
According to Omar, this was validated through BNM's introduction of Value-Based Intermediation (VBI) principles in 2017, with VBI now focused on **DEVELOPING ISLAMIC FINANCE PRODUCTS THAT CONTRIBUTE SIGNIFICANTLY** more towards the well-being of people and the environment, without a sole focus on profits.

develop their own identity through a completely new financial platform, which is truly *riba*-free.

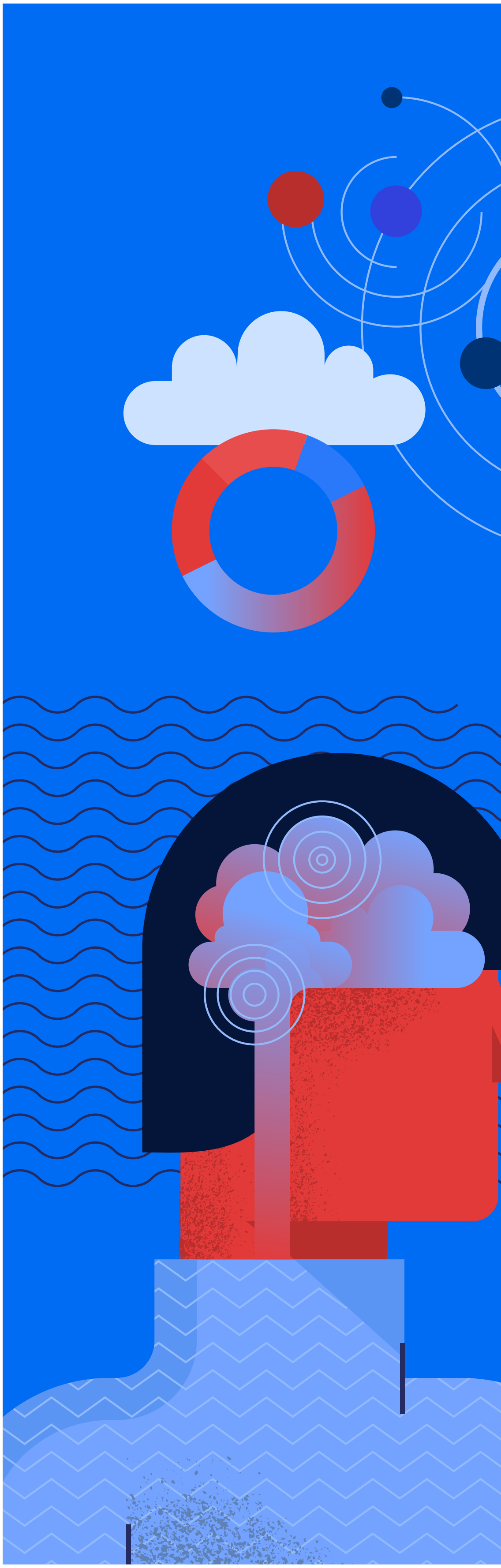
Although still in its early days of conceptualisation, Omar spoke of a platform based on digital gold (like the gold dinar, for example), backed by deposits made in an authorised physical gold depository, and then using this platform to facilitate zero-profit borrowing and lending. Omar added that the introduction of the Central Depository System 20 years ago, coupled with developments in technology such as blockchain or distributed ledger technology facilitated the creation of a better and improved Islamic capital markets platform.

Responding to an audience question on the feasibility of the gold dinar as an asset class, Omar noted that given the current lack of standards and structure pertaining to gold investing, creating a digitised platform for people to invest and trade in gold could potentially see that asset class growing. With regard to a policy framework on securitised token offerings in relation to gold trading, Omar added that policy discussions are currently ongoing and expected to be clarified soon, following which the concept of securitised tokens could be looked further into.

Concluding the discussion, in response to another audience query, Omar explained that whilst Malaysia is clearly the leader in Islamic finance's market development, it is imperative for other hubs to develop across key markets like Dubai, Bahrain, London, and Hong Kong, for example. According to Omar, more Islamic finance centres are required for the global Islamic finance market to be better connected and to create a vibrant ecosystem at an international level. ✱



■ *IslamicMarkets.com is a leading financial intelligence, learning and collaboration platform for the global Islamic economy. With the IslamicMarkets platform, professionals and institutions can access industry-led learning and a wide range of actionable content and tools from sukuk markets to daily market news and the largest network of professionals from across the global Islamic economy.*



NOVEL WAYS OF THINKING IN FINANCE

By Derek Ariss

CRITICAL AND LATERAL THINKING, THE WINNING COMBINATION.

Let's face it. Where would we be if we didn't have problems to solve? Throughout time, the ability of people to think has been crucial. We use thinking to communicate and create new opportunities, to develop strategies, devise tactics, and….yes, to solve problems. As we know, in banking, we solve a lot of problems.

In this article, I introduce you to two types of Deliberate Thinking: Critical and Lateral Thinking. Both thought processes have strengths and combined, they create an essential toolkit in business.

Critical Thinking is to apply reasoning to evaluate information and identify the best answer. It's about separating truth from falsehood, assessing strengths and weaknesses in order to find one best conclusion.

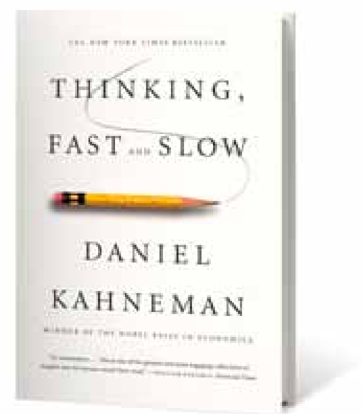
Lateral Thinking is about identifying opportunities from various sources and then using appropriate methods to create unique and original solutions.

Let's first take a closer view at Critical Thinking.

Critical Thinking is about the analysis of facts to form a judgment, to get to the one decision point.

We constantly apply this analytical process in business. We look at data, information, context, evaluate it, and then select the best decision to act upon. In banking, we use deductive and inductive reasoning methods. To do this well, it is essential that the evaluation is factual and unbiased.

How do our minds go about processing information to think critically? Let's look at how we think and at some shortcomings to be aware of in Critical Thinking.



Daniel Kahneman is a senior scholar at Princeton University and a Professor of Public Affairs at Woodrow Wilson School of Public and International Affairs. He was awarded the Nobel Prize in Economics in 2002 and wrote a landmark book titled *Thinking, Fast and Slow*. This book is an excellent reference to understand how we think and some pitfalls that occur when we do Critical Thinking.

In *Thinking, Fast and Slow*, Kahneman discusses two types of thinking modes of our brains. These modes he calls System 1 and System 2 Thinking.

System 1 Thinking is fast and emotionally driven thinking. It's the intuition side of our thoughts. System 1 is often automatic and impulsive. This is where our 'gut feeling' comes from.

System 1 Thinking is used to help us perceive the world around us, recognise objects, and identify threats quickly. It's also critical for our survival, e.g. when you cross the street, and you jump out of the way of an oncoming bicycle. This is System 1 Thinking at work. Without System 1 Thinking, you may have been hit by that bicycle!

System 2 Thinking is different. It is slower, more analytical, and deeper thinking. System 2 Thinking is about being conscious, aware, and reasonable. Thoughts here are deliberate, have depth, and are well placed. It is this thinking that takes a little bit of time. System 2 Thinking allows us to filter through information to get to the correct answer. Imagine it is like a coffee percolator. The thoughts filter through our brain more slowly and take time to process. Often when we are not familiar with something or the information does not come naturally, we use System 2 Thinking to develop the solution. It seems logical that this is the process that we should be using when utilising Critical Thinking. A note of caution. Even when we should be using System 2 Thinking, we tend to prefer System 1 Thinking. For some reason, we tend to have subconscious/conscious preferences.

A classic puzzle used to illustrate the use of these two systems is called the 'bat and the ball problem'. It highlights one of the Critical Thinking pitfalls. In this puzzle, people are asked to solve a basic problem. It goes something like this. (You can try this too and see your result.)

A bat and a ball together cost USD1.10. The bat costs USD1.00 more than the ball. How much does the ball cost?

What did you answer?

Well, the majority of people **instantly** say the answer is 10 cents. This is their System 1 Thinking, "Easy, USD1.10 – USD1.00 = USD0.10."

Unfortunately, in this case, the answer is incorrect.

If the price of the bat was USD1.00 then it would be only USD0.90 more than the ball.

Here is the equation we used:

Price of Bat – Price of Ball = USD1.00 more.
USD1.00 –USD0.10 = USD0.90 more.

However, reading carefully and thinking slowly, we see that actually, if the bat is USD1 more than the ball, the correct answer must be five cents.

Price of Bat – Price of Ball = USD1.00.
USD1.05 – USD0.05 = USD1.00 more.

Even though this is a fun algebraic exercise, it highlights that most people, even when looking at simple problems, don't look deeply enough at the question. This is very much System 1 Thinking stepping forward. We need to be aware that System 1 can jump into our decisions quickly and bias our thoughts, leading us to incorrect conclusions.

This point is significant when we are making critical decisions. The message here may be quite simple and intuitive,

but unfortunately it leads to decisions that may not be ideal. We need to be cautious.

Even when our decisions are well thought out, by using the System 2 'deep thinking', there is another System 1 Thinking wrinkle that often comes up in Critical Thinking. This deals with cognitive biases. Cognitive biases are preconceived ideas we develop around data based on information we have. These are often subconscious, personal, and creep into our decisions through our thoughts. Rightly or wrongly, they create a tendency or inclination in us to prejudge information. The point is these often come from System 1 Thinking and we need to be aware of that when we are using Critical Thinking to make a decision.

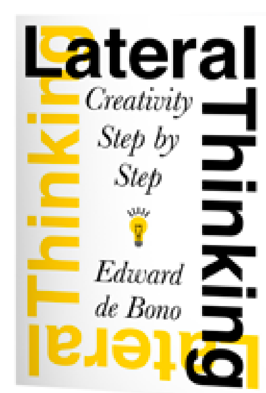
Cognitive bias is a popular and often cited topic because it can unknowingly affect our critical decisions. The easiest solution to cognitive bias is to adhere to factual data and to be aware of data that we may be biased about. How do we do that? We use System 2 Thinking to review any assumptions that are not factually based. This is often easier said than done.

If interested, here is a link where there is a substantial list of biases to look at. These biases impact beliefs, behaviours, and decisions: *https://en.wikipedia.org/wiki/List_of_cognitive_biases*

Therefore, when making critical decisions, we count on a systematic, objective way of filtering information to get to the best decision or the best answer. Noting that we are biased allows us to be aware of determining better solutions.

LATERAL THINKING

The second type of thinking we will examine is Lateral Thinking. Lateral Thinking has a different purpose but is just as important in business as Critical Thinking. Critical Thinking focuses on being able to take information and make the best decision. Lateral Thinking is used in a different manner, where you are trying to find multiple possibilities. From there, you need to select the best opportunity for the problem you are trying to solve.



Edward de Bono developed Lateral Thinking in the late 1960s. It is the use of Lateral Thinking through which one creates new and original ideas to solve problems. These relative solutions are developed by taking a sideways step when looking at

a problem or situation. These steps allow us to look at things from a different point of view, and in turn, 'create' different and original solutions to the problem (See **Diagram A**).

De Bono advises you can find creative solutions to problems by applying Lateral Thinking techniques. Even though these techniques use a systematic process, they result in original, innovative thinking. The outcome of using these techniques is that we develop answers to problems that we may not have considered before.

There are several techniques that De Bono describes, however, the two that I want to highlight today are called Focus and Challenge Technique.

FOCUS TECHNIQUE

This involves sharpening or changing our point of view from the way we usually look at an issue. Using this method involves consciously looking at things from a different perspective. In turn, we will find creative solutions to our problem.

For example, if we walk into a room and describe it while standing, our description would be very different than if we were in the same room but lying down on the floor. Note, the room is exactly the same, but our viewpoint is different. This change of focus technique is the basic principle used in the human-centred design" process, where to solve a problem, web must adopt the customer's perspective to workout an issue. It's the customer's perspective, rather than ours, with a different, valuable point of view that comes up with unique solutions. For example, the fingerprint recognition function in the iPhone was developed from listening to a different point of view. The design for fingerprint recognition came from a customer commenting that accessing their mobile phone by keying in a security code was necessary but cumbersome; perhaps there was a better way? This alternate focus further improved what is an essential function in all of our mobile phones.

CHALLENGE TECHNIQUE

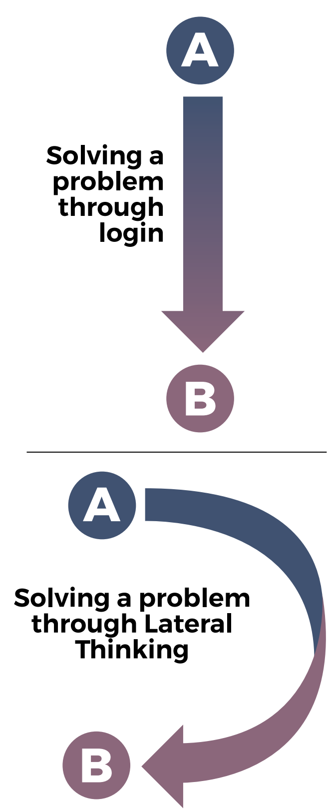
In the Challenge Technique, we break away from the limits of accepted ways of doing things. Here, we list the ways of doing things and then consciously dismiss these norms to find better solutions. Fundamental to this method is the assumption that there are always better ways to do things even when there is no apparent problem with the existing practice. This methodology is often used when organisations create a new business model. Using a banking example, traditionally, it has been assumed that banks always needed to have a physical branch to do transactions. Applying the Challenge Technique, we would ask, "What would a bank and banking experience look like if we didn't have a brick-and-mortar facility?" and, in turn, we can develop the idea of creating a digital bank and mobile banking.

I encourage you to try these simple lateral thinking methods often to identify new opportunities. With practice, these methods will create new options for your business. The techniques may seem basic but practicing them does take effort.

In this article, we have discussed two types of deliberate thinking, namely Critical and Lateral Thinking. In business, we naturally focus on Critical Thinking, finding the right answer. Here, we highlighted that there is value in taking time to think more deeply and remove personal biases in order to arrive at better solutions. We have also taken a brief look at Lateral Thinking, an area of opportunity for businesses to identify great ideas. Lateral Thinking is about the creation of new possibilities and solutions.

When we combine the use of Critical and Lateral Thinking in business, we open ourselves up to a whole new set of opportunities. This winning 'thinking' combination provides us the tools we need to deal with the changing world around us. ✱

Diagram A



■ *Derek Ariss is Head of Innovation Education at Lightbulb Capital and is responsible for building the education practice, focusing on creativity, design thinking, technology, culture, and mindset conducive to innovation in finance. Derek also teaches part of the Singapore Management University (SMU) Certificate in FinTech and Innovation course and an Innovation Culture Catalyst course at SMU. He holds an MBA in International Marketing and Strategy and Bachelor of Commerce (Hons) from the University of Windsor, Canada, and a Bachelor of Science in Psychology and Biology.*

Influencing Financial Behaviour

By Julia Chong

Tipping the scales for values-based banking takes more than just a plan.

Even in the seemingly rational world of finance, you can't win hearts and minds with facts alone. Events like stock market swings, bubbles, crashes, unethical deal-making are proof positive that mankind is driven as much by emotion as it is by rationality.

It's obvious then why tipping the scales in favour of values-based banking is no walk in the park. After all, inciting change to habitual patterns of behaviour is part incentive, part emotion, and although banking is quite adept at economic incentives, historically it comes up short in the 'inspiring change' department.

Figure 1: Principles of values-based banking. **Source**: GABV.

VALUES-BASED BANKING

In order to align the financial system with sustainable development goals, the United Nations Environment Programme established the Inquiry into the Design of a Sustainable Financial System, a leading international platform, whose members include DBS Bank and People's Bank of China, to shift the trillions required for delivering an inclusive, green economy through the transformation of the global financial system.

The Financial System We Need, the Inquiry's landmark report released in 2015, writes about the 'quiet revolution' already taking place, much of which we see today with the renewed push for sustainability in banking through green bonds, value-based banking, fiduciary responsibilities, human rights, and electronic trading.

One of its leading voices is the Global Alliance for Banking on Values (GABV), whose established 6 Principles define the values which financial institutions – whether public limited companies, mutual, or private – should embrace.

Founded in 2009, GABV explains that for the majority of banking institutions, the primary or exclusive driver of business decisions is based on the profitability of the services provided, even if the by-products of those decisions do not deliver sustainable economic, environmental or social development. As a member of the Alliance, each bank would live by the following six principles:

+ **Principle 1.** Triple bottom line approach at the heart of the business model.

Generating reasonable profit is recognised as an essential requirement of values-based banking but is not a stand-alone objective. Values-based banks don't just avoid doing harm, they actively use finance to do good.

+ **Principle 2.** Grounded in communities, serving the real economy, and enabling new business models to meet the needs of both. Values-based banks serve the communities in which they work by financing enterprises and individuals in productive and sustainable economies.

+ **Principle 3.** Long-term relationships with clients and a direct understanding of their economic activities and the risks involved. Risk analysis is used at product origination so that indirect risk management tools are neither adopted as a substitute for fundamental analysis nor traded for their own sake.

+ **Principle 4.** Long-term, self-sustaining, and resilient to outside disruptions. At the same time, values-based banks recognise that no bank, or its clients, is entirely immune to such disruptions.

+ **Principle 5.** Transparent and inclusive governance and reporting. Inclusiveness means an active relationship with a bank's extended stakeholder community beyond its shareholders or management.

+ **Principle 6.** All of these principles embedded in the culture of the bank. These banks develop human resources policies that reflect their values-based approach (including innovative incentive and evaluation systems for staff) and develop stakeholder-oriented practices to encourage values-based business models. These banks also have specific reporting frameworks to demonstrate their financial and non-financial impact.

DEVISING A BEHAVIOUR CHANGE CAMPAIGN

Adopting these values calls for a concerted behaviour change campaign (BCC), that's adopted by multilateral agencies such as the World Health Organisation and non-profit oriented, but rarely explored outside these circles.

A BCC consists of carefully designed strategies to shift social norms and behavioural traits in target demographics toward desired outcomes without direct intervention. An effective BCC will move the target audience from awareness to action.

In the context of values-based banking, BCCs can be deployed to shift consumption patterns towards sustainable behaviour.

If banking is truly looking to take sustainability to heart, it's necessary they invest in BCCs in addition to incentivised economic campaigns such as cashbacks and rewards.

SWINGING THE PENDULUM

The most successful BCCs simultaneously tackle three fronts – social influence, social norms, and vivid examples – which we explore below.

> Social Influence

In his 2000 bestseller *Irrational Exuberance*, Nobel Prize-winning economist Robert J Shiller expounds: "A fundamental observation about human society is that people who communicate regularly with one another think similarly. There is at any place and in any time a Zeitgeist, a spirit of the times [in which]….word-of-mouth transmission of ideas appears to be an important contributor to day-to-day or hour-to-hour stock market fluctuations…"

Shiller's fundamental observation has been reinforced in many financial settings, including the impact of social influence on consumer savings. *The Effects of Social Influence and Financial Literacy on Savings Behavior*, a 2015 research paper by Amer Azlan Abdul Jamal and co-authors at Universiti Malaysia Sabah, indicate that social influence – family involvement, financial literacy, and peer influence, in this descending order of importance – play a major role in nurturing students' savings behaviour in Kota Kinabalu, Sabah.

This is the process of financial socialisation, i.e. acquiring knowledge about money management and developing financial skill sets to influence behavioural intentions. What's crucial here is that a BCC directed at social influence can speed up efforts to shift consumer preferences and choices in favour of green banking products.

> Social Norms

In 2009, to reduce the purchase of plastic bottled water on campus, Princeton University kicked-off its 'Drink Local' programme. Groups of incoming students were given Princeton-branded reusable bottles and briefed about getting involved in sustainability initiatives. Paired with a campus-wide effort to replace over 200 sinks and water fountains with filtered water stations, results showed that students who received the reusable bottles reported reduced bottled water consumption and were more likely to support a campus-wide ban on disposable bottled water on campus.

Figure 2: Snapshot of the Aviva Italy mobile app interface.
Source: *Gamification of Financial Services: Current Trends and Future Possibilities,* Apis.

What clue does this hold for us? Princeton's signalling of pro-environment norms worked by communicating the default value system to students in order to achieve the desired behaviour. Banks can adopt such innovative institutional signalling to gently compel staff and clients and reorient capital/support in favour of values-based banking. This reframes the push for sustainability – making it less mandatory action (e.g. ban on brown sector lending or compliance to green rules) and more voluntary adoption – to reduce resistance and secure greater buy-in. Possibilities are also greater that those on board today will support future green initiatives.

> Vivid Examples

There are many techniques to illustrate desired norms. Gamification – the application of game-design elements and principles in non-game contexts – is the latest. It is a behavioural tool that is increasingly used in business to engage customers and enhance return on investment. Whether a mobile app, website, or in-house customer experience, 'gamifying' as a process has been deployed in finance and investor education to great success.

Numerous studies indicate a positive correlation between motivation and gamification features embedded in digital platforms. Take insurer Aviva Italy's mobile app. For every 300 kilometres driven, it provides a rating of one to 10 as feedback on the users driving skills – cornering, fuel efficiency, acceleration and braking – subtly nudging users toward more environmentally conscious driving patterns. The tech also rewards users in the form of badges which can be shared on social media and, if you wish, used to renew your insurance in-app.

The nifty way of changing consumer behaviour ties in nicely to subtly rebrand the insurer as a sustainability-first advocate and retain customers for the long term.

SOFT INFLUENCE

Armed with this knowledge, banks should consider embarking on their own BCCs in favour of values-based banking, if they haven't already.

Although a seemingly small step in the climate-change agenda, the tipping point comes with the power of numbers, when a sufficiently large pool of users collectively change their behaviour. ✱

■ *Julia Chong is a Singapore-based writer with Akasaa. She specialises in compliance and risk management issues in finance.*

FOOD FINANCING: WHY CREDIT IN THE HANDS OF FARMERS UPLIFTS US ALL

By Dr Amanda Salter

Banking's role in bridging the food-insecurity gap.

Hunger is now officially a weapon of war, on par with money laundering and terrorism financing.

The World Food Programme, awarded the 2020 Nobel Peace Prize for being "a driving force in efforts to prevent the use of hunger as a weapon of war and conflict", is fighting a dramatic rise in hunger due to violent conflict and the Covid-19 pandemic. Food insecurity impacts society at every level. Vulnerable households face malnutrition and loss of income. Businesses face supply chain issues. Countries face food price inflation, reduction in economic output, and long-term consequences of dealing with poor health.

For this reason, the United Nations has set a goal to end hunger and all forms of malnutrition, that all people may achieve food security by 2030. Currently, the world is not on track to meet this, but this can change if financial institutions collectively mobilise the capital at their disposal in favour of food security.

SMALL IS BEAUTIFUL

The British economist EF Schumacher espoused in his book, *Small Is Beautiful: A Study of Economics as if People Mattered,* that championing small, appropriate technologies which directly empower people, has a greater multiplier effect than investments in "bigger is better" conglomerates or what he calls 'gigantism'. This principle is also the foundation for modern economic strategies such as CK Pralahad's Bottom of the Pyramid.

The key to resolving food insecurity

lies with the 570 million smallholder farms worldwide, 74% of which are in Asia with many on or below the poverty line. Access to credit can help a small farm transform and grow from mere subsistence to commercial and market oriented, sustainable scale, allowing us to achieve food security and a key financial inclusion goal. Yet, this sector has been historically underserved financially. A 2019 report by ISF Advisors estimates the financing needs of smallholders globally at USD240 billion a year; USD163 billion is attributed to South and Southeast Asia, and of this, USD115 billion currently goes unmet.

It is imperative that banks take a fresh look at investing in food security, through a shift in their mindsets, products, and risk models to better serve smallholders and small-and-medium enterprises (SMEs) in the agri-food sector who desperately need access to financial services. Here's how:

> Meeting Financing Needs

Smallholders hungry for growth need to invest in assets such as machinery, storage, and technology. However, they often don't have traditional forms of collateral. Banks should expand their definition of acceptable collateral, not limiting to individual savings or a guarantee, but extending to consider registered movable assets, commodities, warehouse receipts, and sales contracts.

Banks' understanding of smallholder customers must evolve from viewing them as individuals to viewing them as households with a lifetime customer value. Savings, personal insurance, and loans for children's education are all important to farmers and can be instrumental to improve their livelihoods.

Banks need tailored models for credit scoring that are specific to this sector. These models could include factors such as projected cash flow, crop, environment, plus an assessment of the commercial prospects of the farmers and the markets they sell to. Banks need to develop smallholder lending expertise and evolve their credit risk models accordingly as understanding of sector specifics grows over time.

There must also be recognition of the role of agricultural SMEs such as cooperatives or farmer associations. These are key points of connection, inputs, credit, and services for smallholders. Lending to SMEs has the potential to generate significant positive

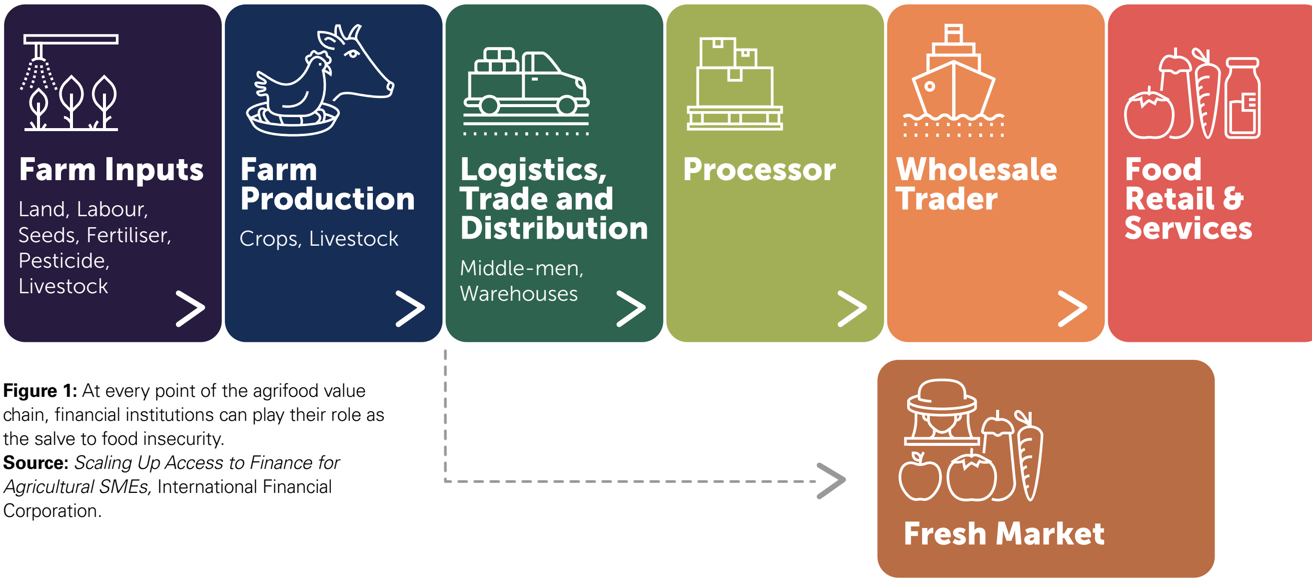


Figure 1: At every point of the agrifood value chain, financial institutions can play their role as the salve to food insecurity.
Source: *Scaling Up Access to Finance for Agricultural SMEs,* International Financial Corporation.

impact for both farmers and other organisations.

> Meeting Protection Needs

Farmers face a significant degree of personal risk, including poor health, poor weather, poor yields, fluctuating prices, and potential government interventions. When disaster strikes, the impact on families can be massive, potentially impacting the next generation at the most basic humanitarian level. A win-win solution is for banks to calculate, structure, and package life or health insurance as part of the loan. This effectively changes the borrower's risk profile and is already a cross-selling solution offered for clients in the corporate and retail segments.

Farmers also face other catastrophic risks, i.e. *force majeure* or acts of God – pests and other natural disasters such as hurricanes, drought, or floods. Well-designed agricultural insurance can lower risk and unlock further credit options.

> Meeting Access Needs

Smallholders are often in rural and remote areas, with minimal access to branches or in-person support. Advances in technology can help to overcome this barrier. Banks need to ensure digital channels for 'know your customer' data capture, loan application, and loan monitoring are in place and working well. Digital payment platforms allow for cashless disbursements and repayments, thus reducing the need for collecting agents and the risks of transporting cash. E-learning platforms can also be harnessed to deliver agronomy-based financial literacy trainings (e.g., how to match cash flow to crop cycles) to ensure farms don't run short of liquidity mid-cycle.

As a useful by-product, this digital customer record also acts as a source of information for banks, and can unlock access to other financial products, as long as that data is used ethically (see *Data Ethics: Time to Get Your House In Order* on page 36).

> Meeting Legal and Regulatory Needs

The power of public-private partnerships cannot be underestimated. Regulators work to align policies and foster close relationships between financial institutions and the ministries of finance, agriculture, trade and commerce.

As food security can be politically sensitive, regulators ensure that management structures are free from political interference as well as provide much-needed knowledge transfer, technical assistance, sandbox environments, and capacity building for lenders who want to create new products to meet agricultural needs.

In addition to strong regulation, a well-functioning judiciary system must ensure timely enforcement of contract rights for all parties in the agrifood value chain (see **Figure 1**), which strengthens sustainable

When disaster strikes, the impact on families can be massive, potentially impacting the next generation at the most basic humanitarian level. **A WIN-WIN SOLUTION IS FOR BANKS** to calculate, structure, and package life or health insurance as part of the loan. This effectively changes the borrower's risk profile and is already a cross-selling solution offered for clients in the corporate and retail segments.

financing practices. Legislation needs to support simple business processes that are smallholder friendly. Policymakers should ensure that equal and inclusive access to finance is on the agenda, given the evidence from the Food and Agriculture Organization that women in agriculture can be unfairly disadvantaged by reduced access to and control of financial resources.

> Strategic multi-stakeholder partnerships

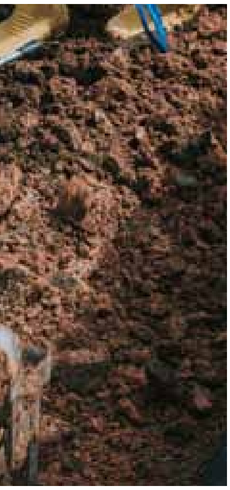
Innovative organisations are increasingly collaborating through scalable partnerships to deliver sustainable growth for smallholders. In these initiatives, private sector, public sector, and civil society work together to mobilise human, operational and financial resources. These blended finance models allow partners to share risk, attract new resources, and use existing resources more effectively. In sustainable programmes, finance is packaged and delivered together with other holistic benefits such as training, better supplies, logistics, and infrastructure.

A good example of this is the ongoing collaboration between confectionary group Mars, the Indonesian government, and the International Fund for Agricultural Development (IFAD). The 2015 phase of the programme aimed to help cocoa farmers in Sulawesi achieve sustainable livelihoods. The programme provided farmers with access to quality seeds, fertiliser, machinery and equipment. Village 'cocoa clinics' were established to enable farmers to access advice and supplies. Mars offered cocoa farmers technical training, and IFAD committed over USD20 million in financing for loans. Outcomes included a rise in cocoa yields, increased household income, increased household asset ownership, and an increase in the number of households that achieved food security.

Spurred on by their success, Mars has undertaken a new collaboration with IFAD and World Agroforestry. The project focuses on smallholders growing oil palm and cocoa in Indonesia and the Philippines, aiming to explore environmentally sustainable ways to link them to global supply chains. Seeing the potential in partnerships like this, forward-thinking banks have started to get involved. One example here is an innovative facility backed by ABN AMRO, BNP Paribas, and Rabobank to provide USD25 million of revolving credit to coffee smallholders.

> Addressing risks of multi-stakeholder partnerships

With any multilateral stakeholder partnership, there are a number of risks that need to be dealt with before success can be assured. Tensions between multiple stakeholder groups can easily appear through misalignment of viewpoints, objectives, priorities, interests, motivations, and responsibilities. Conflicts of interest can arise and need to be quickly identified and resolved. Programmes must work to bring stakeholders together to build mutual understanding, drive consensus, and make decisions. This requires significant investment of time, energy, and resource, but is critical to ensuring smooth operations.



Power asymmetries need to be acknowledged and addressed. Inclusiveness, transparency, and accountability are the keys to address this. By appropriately considering the rights, interests, and needs of all stakeholders, strategies and action plans are more likely to be adopted, leading to more sustainable outcomes. Weaker partners, particularly those who are affected by food insecurity, must be given the right to speak and be heard.

BIGGER PICTURE

In strategising ways to meet the USD240 billion smallholder financing gap, banks need to look at the bigger picture – being customer-centric, developing a deep understanding of the diverse segments within the smallholder/SME market, and identifying new models, platforms and products to meet their specific needs. This involves thinking outside the box, with holistic consideration of the agrifood value chain when identifying opportunities to add value.

In the final analysis, financial services are a means to an end – the real goal is to increase the income, prosperity, well-being, independence, empowerment, and resilience of each household or business served.

In an increasingly complex, chaotic world, one smallholder farm might be the butterfly that could win or lose the battle for food security. Banks must step up and play their part to provide healthy, inclusive, and sustainable financing, thus helping to achieve food security for more people across the world. ✱

■ *Dr Amanda Salter is Associate Director at Akasaa. She has delivered award-winning global customer experience (CX) strategies and her recent guest lecture at the University of Cambridge shared insights from architecting impactful CX. Dr Salter holds a PhD in Human Centred Web Design, BSc (Hons) Computing Science, First Class, and is a certified member of the UK's Market Research Society and Association for Qualitative Research.*

MANY MARKETS, ONE COMMON LANGUAGE

By Julia Chong

Getting to a harmonised taxonomy in sustainable finance.

The sustainable finance landscape lit up in 2020.

According to research house *Morningstar*, assets under management in economic, social, and governance (ESG) funds leapt 29% to hit a record of nearly USD1.7 trillion in 2020. *Reuters* also reports that throughout the Covid-19 pandemic, ESG assets were a bright spot that bucked the capital flight trend into passive products as investors sought resilient investments that will perform better over time. Coupled with the global push to achieve the Paris Agreement climate targets, the creation of a common taxonomy for sustainable finance has gained renewed traction.

MORE THAN A DICTIONARY

A taxonomy for sustainable finance is a comprehensive classification that defines whether or not an economic activity is environmentally sustainable. In the coming years, work in this sphere will be increasingly crucial for global investors, financial institutions, companies, and issuers in order to delineate between green (compliant), light green (transitioning), and brown (incompatible) activities.

+ Such taxonomies are a necessary step to

Accelerate the flow of private capital toward climate-friendly investments;

Reorient existing capital flows and transition to a low-carbon economy;

Enhance investor confidence and awareness of the environmental impact of products or services;

Track and measure the flow of sustainable finance;

Inform future policies, such as inventive setting; and

Eliminate greenwashing.

Some jurisdictions, like China, have moved to establish their own sovereign taxonomies, whilst in others like the EU, their taxonomies apply *en bloc*.

Just as a *lingua franca* – language that is adopted as a common language – facilitates global business, so too will financial markets benefit from a *lingua franca* in sustainable finance. The majors have since moved at record pace to unite on a comparable classification system for sustainable activities, one that will reflect the holistic principles of environmental sustainability and respect the diverse needs and views of each nation.

Note that as more jurisdictions move to regulate sustainable finance through national legislation, there will remain viable institution- and market-based guidelines and taxonomies, such as those set by the Climate Bonds Initiative or Common Principles for Climate Mitigation Finance Tracking, which are widely accepted and generally applied by issuers of green bonds and loans.

Progress in the following jurisdictions reflect the diverse taxonomic approaches:

> *EU*

In June 2020, the European Council issued the most definitive and progressive legislation for a unified classification system in sustainable finance. Dubbed the 'EU Taxonomy', it is formally published as *Regulation (EU) 2020/852 (Taxonomy)* and came into force on 12 July 2020. It plays a critical role in mobilising the needed EUR1 trillion in the next decade to achieve the EU's goal of becoming the first carbon-neutral continent by 2050.

Financial institutions must comply with this Regulation in order to market their products – green/transition bonds, green credit, or green investment funds – as "environmentally sustainable as per EU legislation". However, in line with legislators' intent to not be overly prescriptive and to spur innovation in financial markets, a financial institution or corporate can still opt to issue a self-labelled transition bond as long as it does not reference the EU Taxonomy or carry the words "environmentally sustainable" in its communications describing the product.

The EU Taxonomy harmonises classification standards for all member states, which in turn lowers the risk for green investors by removing cross-border barriers to fundraising and promoting uniformity in assets deemed environmentally sustainable. Activities are

STEPS AND PRINCIPLES FOR PRACTICAL APPLICATION

Banks found that adopting the following steps helped to apply the EU Taxonomy to core banking products.

STEP 01 As far as possible, define the use of proceeds of the loan or credit facility.

STEP 02 When use of proceeds is not specified, classify exposure on the basis of clients' business activities.

STEP 03 Decide into which Taxonomy category the transaction, activity or company falls – Mitigation, Adaptation, Enabling, Transitioning, etc.

STEP 04 Require clients to disclose the necessary information to meet Technical Screening Criteria (TSC) and MSS.

STEP 05 TSC for Substantial Contribution should be strictly met based on evidence.

STEP 06 Subject to a materiality judgement, DNSH and MSS assessments may rely on assumed compliance of clients and assets with relevant legislation. They may also rely on certification schemes and labels and require timing flexibility. Indeed, it may be challenging to conclude assessments before transactions are finalised.

SOURCE: EBF and UNEP FI. Excerpt from *Testing the Application of the EU Taxonomy to Core Banking Products: High Level Recommendations report issued January 2021.*

classified according to these six objectives:

+ Climate change mitigation;
+ Climate change adaptation;
+ Sustainable use and protection of water and marine resources;
+ Transition to a circular economy;
+ Pollution prevention and control; and
+ Protection and restoration of biodiversity and ecosystems.

This taxonomy is also a turning point as it introduces a multi-criterion framework through two principles – Substantial Contribution and Do No Significant Harm (DNSH) – as opposed to the unidimensional model of previous taxonomies. This means that an activity is deemed sustainable only when it proves that it substantially contributes to one of the abovementioned six EU objectives and does not negatively impact the other five EU objectives in the list. In this way, all objectives are interlinked, making it more stringent than any other current qualifying framework.

It also states that activities must comply with Minimum Social Safeguards (MSS), such as the OECD Guidelines for Multinational Enterprises, UN Guiding Principles on Business and Human Rights, and the International Labour Organization conventions.

> *China*

The significance of a China taxonomy is underscored by its potential as the largest market for green goods and services, which Goldman Sachs puts at USD1 trillion.

As early as 2012, the People's Republic issued its Green Lending Guidelines, which mandate banks report twice yearly on the loan balance, energy emissions, and water impact for credit granted under the following sectors: agriculture and forestry, energy and water saving, nature protection, ecological restoration and disaster prevention, waste disposal, recycling and pollution prevention, clean energy, rural clean water projects, green buildings, and green transportation.

Although implementation includes key performance indicators and reporting formats, the early guidelines fall short of establishing any explicit environmental criteria or thresholds. Loans which fulfil the green requirements and hold at least AA rating are eligible for preferred central bank refinancing terms.

In 2015, the People's Bank of China (PBOC) issued its China Green Bond Endorsed Project Catalogue to govern green financial bonds in six qualifying categories – energy savings, pollution prevention and control, resource conservation and recycling, clean transportation, clean energy, and ecological prevention and climate change adaptation.

The Catalogue, also known as the 'China Taxonomy', sets out specific qualifications for green projects or activities, the management of proceeds, and reporting guidelines. It details domestic industrial standards and regulations (including energy efficiency and pollution control) to be enforced on green bonds, but not on green loans.

In 2019, China released the Green Industries Guidance Catalogue, described by some as a "mini industrial plan" to further map out standards and policies to grow the green sector, develop the financial infrastructure to support green investments, and work to harmonise standards for sustainability.

By far the nation's most extensive document to date, the Green Industries Guidance Catalogue is a collaboration between seven government bodies, including the National Development and Reform Commission, the PBOC, and the Ministry of Ecology and Environment.

In 2019, China released the Green Industries Guidance Catalogue, described by some as a "mini industrial plan" to further map out standards and policies **TO GROW THE GREEN SECTOR,** develop the financial infrastructure to support green investments, and work to harmonise standards for sustainability.

> *ASEAN*

Although there are currently no national taxonomies on green finance or for sustainable financing, member nations, including Indonesia, Malaysia, the Philippines and Vietnam, have outlined project categories which qualify for green financing.

In its 2019 *Annual Report*, Bank Negara Malaysia (BNM) called for financial institutions to treat climate risk on par with other types of financial risk as it "can also pose a systemic risk that could lead to a contraction in important financial activities that support the economy."

This view was reinforced by Mr Fraziali Ismail, Assistant Governor of the BNM, last October in a keynote speech which outlined the nation's progress toward its own taxonomy: "We need to find a way to bridge the language and information gap between scientists, government and financiers. What science says about climate effects, what climate action the government is prioritising, what industries are providing and investing in – are quite incongruent at this point.

"In this connection, guidance for financial institutions to classify economic activities that contribute to climate change objectives is provided through our work in developing a principles-based taxonomy. This would be the start to build deeper understanding in climate risk, for financial institutions to better identify, assess and manage the risk. The Bank is now working to finalise the *Climate Change and Principles-based Taxonomy,* which is expected for issuance next year."

Currently, the BNM-issued Value-based Intermediation Financing and Investment Impact Assessment Framework and its Joint Committee on Climate Change with the Securities Commission Malaysia drive the collective response to climate change. Islamic and conventional financial institutions have also stepped up by offering preferential financing rates for hybrid and green-certified properties and assisting oil palm smallholders in obtaining Malaysian Sustainable Palm Oil certification.

Currently, the BNM-issued Value-based Intermediation Financing and Investment Impact Assessment Framework and its Joint Committee on Climate Change with the Securities Commission Malaysia drive the collective response to climate change. Islamic and conventional financial institutions have also stepped up by offering **PREFERENTIAL FINANCING RATES FOR HYBRID AND GREEN-CERTIFIED PROPERTIES AND ASSISTING OIL PALM** smallholders in obtaining Malaysian Sustainable Palm Oil certification.

COMMONALITIES & DIVERGENCES

Work is steadily streaming on all fronts.

In October 2020, the International Platform on Sustainable Finance (IPSF), announced that it had "initiated a working group on taxonomies that will work toward a Common Ground Taxonomy".

The EU-backed IPSF is a multilateral forum for coordinated exchange and action for environmentally sustainable finance whilst respecting national and regional contexts. Its member states – Argentina, Canada, Chile, China, India, Indonesia, Kenya, Morocco, Norway, Switzerland, and the EU – represent almost half of the world's greenhouse gas emissions.

"This Common Ground Taxonomy will enhance transparency about what is commonly green in member jurisdictions and contribute to scale up cross-border green investments significantly," said the IPSF in its first annual report.

In January 2021, the European Banking Federation (EBF) and the United Nations Environment Programme Finance Initiative (UNEP FI) released a joint report, *Testing the Application of the EU Taxonomy to Core Banking Products: High Level Recommendations.* It outlines the practical complexities of applying the EU Taxonomy to core banking products in a pilot comprising 26 major banks, seven banking associations, and five observing organisations.

Banks can expect substantial changes in the coming months and should keep abreast of the latest developments as countries develop and refine their respective legislations for sustainable finance. ✱

■ *Julia Chong is a Singapore-based writer with Akasaa. She specialises in compliance and risk management issues in finance.*