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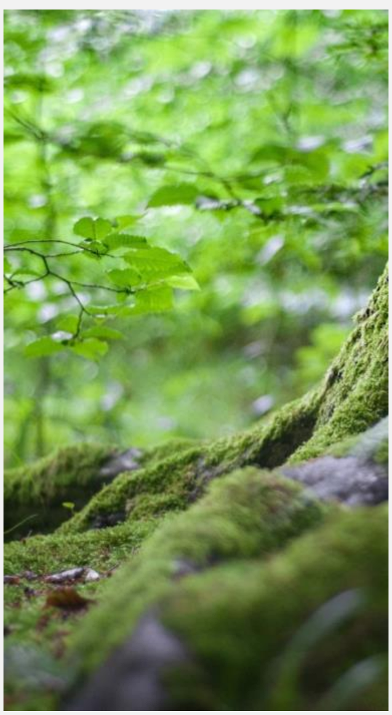

Financing Deforestation Increasingly Risky Due to Tightening Regulatory Frameworks

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The trend to integrate sustainability factors into financial regulatory frameworks is creating compliance, legal and reputational risks for local banks and investors financing forest-risk commodities in tropical countries. International banks and investors exposed to these supply chains may also be affected. Based on public sources and interviews, this report analyses the integration of sustainability in financial regulation on the international level, as well as in the regulatory frameworks of five countries with tropical forests: Brazil, Colombia, Peru, Indonesia and Malaysia.

Key Findings

- **At the global and EU levels, the integration of sustainability in financial regulation is mostly driven by the potential impact of climate change on financial stability**. Stress-testing is the main instrument. Attention to biodiversity is growing while TCFD reporting on climate change risks may become mandatory soon.
- **Countries with emerging markets are taking the lead in integrating sustainability in financial regulations.** Four out of five countries researched have taken steps to minimise the negative impacts of finance on society and the environment, even if only for Islamic banks in the case of Malaysia. Colombia is preparing similar steps.
- **Brazilian regulations aim to prevent financing of companies involved in illegal deforestation, other environmental problems and forced labour.** Peru sees social conflicts over resources as the main sustainability risk for banks. Indonesia demands banks to invest in sustainable management of natural resources and land use. Malaysia wants banks to verify whether clients are involved in deforestation. Colombia sees forest protection as one of the main goals of its regulatory framework, including for the financial sector.
- **The new regulations are creating compliance, legal and reputational risks for local banks and investors**. In some countries, like Brazil, Peru and Indonesia, banks may face penalties from financial regulators or civil liabilities.
- **If supervisory actions do not follow regulations, legal risks for the regulators themselves may arise**. In Brazil, public prosecutors and other compliance agencies are demanding supervisory action from financial regulators in courts.
- **International banks and investors may see impacts from the following**: 1) New financial regulations affecting their investments in, and lending to, agricultural and livestock companies in countries with tropical forests; 2) Exposure to local banks and investors; and 3) Financial regulators in the home countries of international investors and banks demanding them to investigate climate and biodiversity risks – strongly linked to commodities as palm oil, soy and beef.

Emerging economies lead in integrating sustainability criteria in financial regulations

Banking regulators from emerging economies have considered environmental and social (E&S) risks and opportunities earlier than their European counterparts. Since the creation of the Sustainable Banking Network (SBN) hosted by the International Finance Corporation (part of the World Bank group) in 2012, many emerging economies have joined it. This network now consists of banking regulators and/or banking associations from 37 countries.

Regulators from Europe became aware of these challenges only after the famous "tragedy of the horizons" speech in September 2015 by Governor Mark Carney of the Bank of England. This event led to the establishment of the Network for Greening the Financial System (NGFS) in December 2017. It currently has 50 members and observers, all of them financial regulators or supervisors. The main financial regulators in Brazil, Indonesia and Peru are members of SBN, while the Colombian financial regulator is a member of both. Bank Negara Malaysia is a member of the NGFS.

Members of SBN and NGFS interpret their mandate in relation to E&S risks differently. The SBN members, apart from considering the materiality of E&S risks, generally see financial regulation also as a tool to achieve development and environmental policy objectives, such as improving financial inclusion, stimulating SME companies, avoiding deforestation and reducing GHG emissions. Most members of the NGFS, on the other hand, interpret the mandate of financial regulators more narrowly, limited to ensuring the stability of the financial system. They are less interested in the impact of finance on sustainability than in the impact of sustainability issues on the financial system. Therefore, the NGFS is initially focusing on climate change amid the understanding that both transition risks (stranded assets) and physical risks related to climate change might impact financial stability. To assess these risks, they are proposing to introduce climate stress tests for banks. The NGFS is also looking at the portfolio management of Central Banks and widening its scope to include biodiversity as well.

A significant share of the SBN members (12 out of 37 countries) now have a banking regulator which integrates sustainability criteria. These include: China (1995, 2012, etc), Brazil (2008, 2011, 2014, 2017), Bangladesh (2011), Nigeria (2012), Peru (2015), Vietnam (2015), Indonesia (2017), Pakistan (2017), Nepal (2018), Paraguay (2018), and Ghana (2019). Regulators in two more countries (Georgia and Sri Lanka) launched a roadmap, announcing that regulations on banking and sustainability are expected soon.

Driven by the need to tackle pollution around its booming industrial centres, China has gained an increasing amount of experience with integrating sustainability criteria in financial regulation to support environmental policy objectives. Its first regulations originate from the 1990s, and studies show these favourably impacted both air quality and default rates. As one of the founding members of the NGFS, China now is sharing these experiences with European counterparts.

International bodies also take initiatives to integrate sustainability criteria in financial regulation

In late 2016, the G20 commissioned the Financial Stability Board (FSB) to create the Taskforce for Climate-related Financial Disclosure (TCFD). The goal of the TCFD, supported by both developed and emerging economies, is to make corporations disclose, in a standardized manner, how they manage climate risks and opportunities, including physical and transition risks. Specific guidelines for different industries have a large impact on climate change. However, guidelines mostly focus on GHG emissions rather than on the protection of the habitats that capture GHG, such as forests, mangroves and clean oceans. Specific guidelines for agriculture and the food industry fall short of voluntary commitments made in the sector. However, the guidelines for the financial sector are a landmark in terms of global standards for environmental risk governance and disclosure, mentioning climate scenarios and stress tests as fundamental tools to be applied to financial institutions' portfolios. The TCFD guidelines are expected to become mandatory soon, as recently announced by Mark Carney, governor of the Bank of England.

In December 2016, the European Union (EU) created the High-Level Expert Group on Sustainable Finance (HLEG). The HLEG published an extensive report, followed by an ambitious Action Plan. Since July 2018, the Technical Expert Group on sustainable finance (TEG) has deepened the Action Plan. The TEG has 35 members from civil society, academia, business and the finance sector. It has published reports on four topics, which will soon lead to new EU regulations:

- An EU classification system – the so-called Green Taxonomy – to determine whether an economic activity is environmentally sustainable;
- Corporate disclosure of climate-related information (following the TCFD-guidelines);
- An EU Green Bond standard, with green projects required to be aligned with the Green Taxonomy; and
- Methodologies for EU climate benchmarks and disclosures for benchmarks that aim to ensure that EU Climate Transition and EU Paris-aligned benchmarks contribute to better transparency and help prevent greenwashing.

Proposed EU regulations focus strongly on climate change mitigation and adaptation, along with protection of water resources, healthy ecosystems, pollution prevention and control and transition to a circular economy are covered. The interim taxonomy technical report from June 2019 sets a cut-off date of 2008 for no conversion of high carbon stock land. Health and safety issues at the workplace are also covered, but other social issues -- such as impacts on local and indigenous communities -- are not.

In October 2018, the International Organization of Securities Exchange Commissions (IOSCO) launched its Sustainable Finance Network (SFN). This network unites stock exchange regulators from 50 different countries. According to the representative of the Brazilian Securities Exchange regulator, the SFN plans to issue its first global report soon, which will likely include a stocktaking of already existing regulations and a few first recommendations. SFN already issued a report on emerging economies in June 2019.

In 2019, the International Organisation of Pension Supervisors (IOPS) developed a public consultation process on supervisory guidelines on the integration of environmental, social and governance (ESG) factors in the investment policies of pension funds. It has just launched the result of this work, with recommendations for open and closed pension funds on integrating ESG aspects in their investment policies and reporting.

The Organisation for Economic Cooperation and Development (OECD) in 2017 published Guidelines for institutional investors on how they are expected -- following the OECD Guidelines for Multinational Enterprises -- to conduct due diligence of the companies in which they are investing. Similar Guidelines for banks were launched in October 2019. These guidelines incorporate recognized sustainability standards for banking finance activities, tackling the two most sensitive issues for ESG risk management: the coverage/scope of due diligence and the depth of analysis.

Finally, one of the strongest signs of the increasing attention to sustainability issues in the global financial system thus far was the IMF Financial Stability Report published by the International Monetary Fund (IMF) in early October 2019, which "connects the dots between sustainable finance and financial stability."

Labour prosecutors in Brazil bring banks to court to live up to financial regulations

The Brazilian banking regulator Banco Central do Brasil has integrated sustainability criteria into regulations since 2008. The first regulations focused on "rural loans," which are government-subsidized credits to the farming sector distributed by commercial banks. A relation between rural credit and deforestation rates appears to exist. An unpublished study by Agroícone found that the Brazilian municipalities with the highest increases in deforestation rates (both legal and illegal) from 2014 to 2015 (all of them either located in the Amazon or Cerrado regions) also had a high share in rural loans.

BCB regulations explicitly prohibit lending to farms which violate the following sustainability-related laws and regulations:

- Violations of environmental regulations in the Amazon region (Resolução CMN 3.545/2008), especially regarding activities in embargoed areas (Resolução CMN 4.422/2015);
- Violations of forced labour legislation (Resolução CMN 3.876/2010).

In addition to these restrictive regulations, regulations on rural loans that provide positive environmental impacts are integrated in the so-called "Program for Low-Carbon Agriculture" (ABC program). The program finances activities that either increase productivity of crops or livestock (reducing the use of land) or reduce GHG emissions directly. However, ABC represented only 1.58 percent of total rural lending in the last harvest year. The values disbursed have been reduced every year since 2015, with the current year (2019/2020) being about one-quarter of 2015/2016, according to BNDES data. This year is the last of the ABC program, and in preparation for the new cycle, discussions on its improvement continue.

Several other regulations require banks to pay attention to ESG risks in their normal lending and investment activities. Since 2011, banks have had to consider environmental and social risks into capital requirements by Circular BCB 3.547/2011, later replaced by Circular BCB 3.846/2017.

The most important regulation on how banks should deal with environmental and social (E&S) issues is Resolução CMN 4.327/2014, requiring banks to implement a structure for the management of E&S risks. A main shortcoming of the regulation is that it does not provide guidance concerning appropriate E&S due diligence. For instance, several public agencies publish databases with the names of companies that have been registered as breaching legislation on various E&S issues. However, Resolução CMN 4.327/2014 does not require banks to use these databases published by other government agencies. In several cases, banks continue to finance companies listed in these databases. This lack of guidance generates heterogeneity and uncertainty in the market, especially with regards to relevant social risks. The experience with regulations on rural loans in Brazil shows that the clearer the guidelines, the higher the level of implementation by banks.

Finally, Resolução CMN 4.557/2017 addresses how banks should deal with sustainability risks at the portfolio-level, requiring also stress tests.

Banco Central do Brasil's lack of transparency on enforcement actions is hindering an assessment of the results of these regulations. The supervision department sent questionnaires to supervised entities in order to assess the quality of their policies, action plans and procedures. The results of these first supervisory actions were not disclosed, however, even upon request.

However, over the years, many of the largest Brazilian banks have violated Resolução CMN 3.545/2008 on rural loans in relation to illegal deforestation in the Amazon or have financed illegal deforestation through other kinds of loans.

- Banco do Brasil, the state-run bank which manages about half of rural loans in the country, and BASA, the development bank for the Amazon region, in 2010 were found to be involved in financing illegal deforestation;
- Bradesco has the largest share of rural loans among the private banks. In October 2019, it was reported that of the rural loans linked to illegal deforestation, 54 percent came from Bradesco;
- Spanish bank Santander, which ranks among the largest banks in Brazil as well, received a major penalty from the federal environmental agency in 2016;
- Itaú was also mentioned in the October 2019 report on rural loans related to illegal deforestation.

In 2019, labour prosecutors in Brazil, after two years of unsuccessful negotiations with the seven largest banks and the main banking association Febraban, filed separate lawsuits against all seven banks in labour courts. The prosecutors claimed that the banks violated Resolução CMN 4.327/2014 by financing companies involved in forced labour and/or by failing to assess other labour health and safety issues in a proper way. This claim is based on the following points, according to the lawsuit documents and an interview with the labour prosecutor coordinating the relevant taskforce, Rafael Gomes:

- Regarding forced labour, banks consulted only the administrative list elaborated by the federal government, but ignored the lawsuits on this topic, even when there were final court decisions;
- Apart from forced labour, they did not analyse any other labour health and safety issues. They did not look at child labour, harassment, discrimination or the number of lethal accidents, although they made public commitments, policies and sustainability reports stating that these topics were assessed;
- Many of the banks did not insert clauses into credit agreements demanding compliance with labour health and safety rules and allowing suspension of tranches or acceleration of maturity of the debt in case of violation (Itaú is an exception). They also did not monitor compliance with these clauses (Santander, Bradesco and Caixa are exceptions for forced labor) nor actually apply the suspension of tranches or acceleration of maturity (Caixa is an exception);
- The banks did not demonstrate a single case of credit denial based on non-compliance with labour health and safety standards;
- They did not provide training on labour health and safety for their E&S risk analysts;
- In many cases, the analysis of social risks was based uniquely on statements of the borrower, even when official databases were publicly available;
- Bradesco, Banco do Brasil and Santander were also found providing rural loans (with public funds) to companies involved in forced labour, violating Resolução CMN 3.876/2010. Banco Central do

Brasil did not, however, apply a penalty. Instead, it only declassified the transactions as rural loans. This meant that the banks had to use their own resources to lend with subsidized interest rates. Also, these loans were not included in the minimal amount of rural loans that they were required to offer.

The court has made decisions on five out of seven court cases. The first court decision considered that the prosecutors should have sued the bank at a federal court rather than at a labour court. The second one was partially favourable to the labour prosecutors. The third and fourth court decisions were favourable to banks. Prosecutors are appealing in all cases. In the fifth case, the judgment was favourable to the labour prosecutors and the bank was ordered to review its policy and procedures to include labour health and safety issues. In a sixth case, a settlement is being tried by the judge and the seventh is under secrecy.

A significant part of rural loans is managed by BNDES, the national development bank, and the state-run Banco do Brasil provides about half of rural loans in the country. CRR sent a questionnaire to check whether the banks assess E&S risks such as deforestation in Amazon and forced labour issues, compliance with other environmental rules, impacts on indigenous or other tribal people's lands or environmentally protected areas all over the country, and other labour health and safety issues.

For both banks, the analysis of their agriculture policies indicates that some topics (such as child labour) are included as a general purpose, but they provide no mention of tools and sources for relevant information. Verification of environmental compliance (beyond a check of the permits) also appears limited, except with regards to embargoed areas.

Both banks require the insertion of clauses concerning environmental and social compliance (including suppliers, in case of manufacturers) in the lending agreements. Both banks also use information provided by the Rural Environmental Registry (CAR), that has some (but incomplete) information about indigenous (and other tribal people) lands, environmentally protected areas and environmental liabilities of rural properties.

However, the state environmental agencies have not yet validated the insertion of information by landowners into the CAR in Brazil. When environmental liabilities occur, landowners must submit an environmental compliance plan (PRA) before the end of 2020, which also needs to be analysed by the State environmental agencies.

Banco do Brasil makes an E&S assessment of each corporate client, which is used by Banco do Brasil to define the lending limit of the client. For information sources, Banco do Brasil consistently uses lists with environmental permits and the list of employers involved in forced labour. Only in the State of Pará (Amazon region), environmental compliance is regularly checked with the State environmental agency. In Brazil, most environmental jurisdiction is organized at the State-level, as a result of an agreement with public prosecutors.

Regarding indigenous lands, Banco do Brasil has its own tool to ensure there are no violations. In terms of environmental performance, Banco do Brasil sends a questionnaire to the client that asks about only waste management and water management (no questions about labour health and safety are included). Banco do Brasil engages with only its clients and requires an action plan regarding E&S issues in Equator Principles transactions. It is important to note that, although Banco do Brasil is one of the few Brazilian major banks that has guidelines for agriculture, the only specific diligence for this sector is the checking of CAR and its new tool launched in September 2019.

Santander is another example of a large bank that has a relevant market share in both rural loans and corporate loans to the agribusiness industry. However, apart from regulatory requirements regarding rural loans, Santander only assesses transactions with clients whose annual revenues are above BRL 200 million (USD 45 million), in the agriculture, forestry and livestock sectors. This leaves deforestation (and other E&S) risks completely unattended for transactions below this threshold.

With respect to the securities exchange, the only relevant regulation (Instrução Normativa CVM 480/2009, as amended by Instrução Normativa CVM 552/2014, annex 24, items 4.1, j, 7.5 and 7.8) requires listed companies to disclose:

- Which permits are necessary for their business activities and the current status of their permits;
- Their environmental policy and the costs incurred for environmental compliance, including costs for environmental certifications or costs of compliance to other environmental regulatory standards;
- Whether the company has a report with environmental and social information (specifying which methodology is used to gather data), and if this report has been audited by an independent entity and is available online;
- E&S risk factors that might influence investment decisions.

For closed pension funds, regulations have existed since 2009, and were recently revised in 2018, requiring the integration of ESG risks in investment policies. The first regulation was Resolução CMN 3.792/2009, replaced by Resolução CMN 4.661/2018 (article 10, 4th paragraph), and complemented by Instrução PREVIC 6/2018. These require that ESG guidelines for investments should be, preferably, industry-specific (article 23, VI). In 2019, the supervisor (PREVIC) issued a “Guide of Good Practices on Investment” and dedicated two pages to ESG integration, giving some examples to pension funds for guidance.

Colombia develops its own sustainable taxonomy

The Colombian banking regulator (Superintendencia Financiera de Colombia – SFC) has not issued regulations with regards to E&S risks or impacts thus far. But it has conducted a first assessment of management of climate and other environmental risks by banks. This assessment concluded that only 57 percent of respondent banks (about half of the total number of banks in Colombia) have environmental policies for their lending activities and only 30 percent include climate risks. As a result of this assessment, SFC announced it will define a sustainable taxonomy for loans and investments, considering international experiences and local priorities, in order to provide a framework for market development. This sustainable taxonomy will align with Colombia’s plan to deal with climate change, the so-called Nationally Determined Contribution. This plan states that one of its main goals is “protection of forests and their productivity.”

Although regulation does not yet exist, the issue of ESG risk is not completely new to Colombian banks. Asobancaria, the Colombian banking association, in 2012 issued the “Green Protocol,” signed by 17 banks. The association revised the Protocol in 2017, when it was signed by 22 banks. A few other banks adhered later, but as Asobancaria has 43 members, only about half of them adhered to the Green Protocol.

The Green Protocol includes three so-called strategies:

1. Promotion of positive E&S impacts of financing and investment activities;
2. Management of the direct E&S impacts of banks (and similar financial institutions);
3. E&S risk management of financed activities, through verification of compliance with environmental regulations, integration of E&S criteria in decision-making process of lending and investments and reporting.

The Green Protocol mentions the definition of indicators for monitoring and reporting, and Asobancaria includes information on them in its annual sustainability report. According to Isabel Mantilla, the head of Sustainability at Asobancaria, the development of a guide for E&S risk assessment for lending to SMEs, including some industry-specific guidelines for agriculture/livestock, will be the next step in the implementation of the Green Protocol.

SFC is also the regulator of the securities exchange market and all types of institutional investors (including insurance companies). Also, SFC has not issued any regulations so far with regards to E&S risks or impacts. However, it has conducted a first assessment of the management of climate and other environmental risks by financial institutions. Among the responding pension funds (75 percent), two-thirds have environmental policies, but none has an environmental risk management system and only one-third considers climate risks as financially relevant. Among the responding insurance companies (80 percent of the market), only 10 percent have environmental policies for investments.

As a result of this assessment, SFC decided in 2019 to define which ESG criteria is appropriate for investments. SFC said that it would also support the TCFD to increase transparency regarding climate-risks in the market. Moreover, it recently submitted a "Guidelines of Good Practices for Due Diligence of Investments of Pension Funds in Private Equity" for public consultation. These Guidelines cover ESG aspects as well, and the final version will be published shortly, according to Mariana Escobar Uribe, an adviser at SFC.

Peru pushes banks to look at risks of the exploitation of natural resources

The Peruvian regulator Superintendencia de Banca, Seguros y AFP (SBS) issued the Regulation for Social and Environmental Risk Management in 2015. This document outlines minimum E&S risk assessment requirements for all financial institutions. The regulation also provides detailed instructions on how to create a questionnaire to evaluate, as well as manage E&S risks.

In 2015, SBS also issued a document titled "Role of Enhanced Due Diligence in the Regulation of Socio-environmental Risk Management for Financial Firms." It defines the scope of projects for which minimum E&S risk management requirements must be implemented. The requirements are only required for project finance and corporate lending above USD 10 million. There are no specific rules for transactions under this threshold, nor for rural loans.

The document's main message is that conflicts with local communities over the exploitation of natural resources may escalate into financial risks: "Social and environmental risk is the possibility of losses due to the occurrence of social conflicts related to the development of projects. Frequent cases of conflict in Peru are those related to water rights between mining companies and communities or neighboring towns; logging rights between native communities and logging companies; the use of water between hydroelectric dams and farmers, and similar ones. In these cases, the conflict generally arises between large companies and groups of citizens who believe that their traditional ways of life or the economic basis of their livelihood are threatened if a specific project is carried out. The exposure of the financial system to this type of risk is widespread."

SBS did not answer questions about the enforcement of the regulation. But Arturo Caballero, the executive secretary of Programa de Inversión Responsable (PIR), a market-led forum for Sustainable Investments, reported that the regulation made an impact: Most Peruvian banks that already operated with transactions above USD 10 million were not yet Equator Principles signatories, except for BBVA and BCP. The regulation forced Interbank, the large commercial bank, and several development banks to improve their E&S risk assessments for these larger transactions. Caballero believes that SBS is enforcing the regulation, but enforcement level might be limited due to changes in SBS management. Regarding transactions under the USD 10 million threshold, Caballero assesses that banks probably do not manage E&S risks yet.

No regulation yet addresses the integration of ESG aspects into institutional investors' policies and investments. But there has been, since 2015, a securities exchange regulation concerning reporting of ESG issues by listed companies. The regulation specifies the minimal contents of ESG reports and is currently being revised. After the issuance of this regulation, by the Stock Exchange of Lima, together with PIR, issued a Guide for Corporate Reporting on ESG.

In 2019, PIR issued a report on the quality of ESG reporting of Peruvian corporations during the previous year. This report provides a picture of how listed corporations in Peru deal with ESG issues, especially the ones that operate in the financial sector – banks, insurers and open private pension entities. The financial institutions represent 37 percent of the 202 companies listed on the Lima Stock Exchange, making it the most relevant sector.

The main findings of the report with regards to the financial sector were:

- Most ESG reporting concerns issues related to its "internal" stakeholders: employees, shareholders, suppliers and clients. Reporting on the environmental impacts of the financed activities is limited;
- In terms of environmental issues that are the result its financed activities, the financial sector is reportedly worse than any other industry but real estate;
- Only 9 percent of all financial institutions have developed E&S policies;
- 19 percent describe one or more financial products with positive E&S impacts;
- 8 percent of financial institutions have a climate change strategy and offset their own GHG emissions;
- Only one out of 74 financial institutions is a CDP signatory, and only one has climate change targets;
- None of the financial institutions have explored business opportunities arising from climate change.

Indonesia wants banks to finance sustainable management of resources and land

Otoritas Jasa Keuangan (OJK), the regulator for the financial sector in Indonesia, in 2014 issued the Sustainable Finance Roadmap. This document articulated a vision to let the financial sector play a more

prominent role in the sustainable development of the country. In 2017, the Sustainable Finance Regulation created basically two obligations for banks, which entered into force in 2019:

- The elaboration of a **Sustainable Finance Action Plan**, covering three priorities:
    - Increase in the financing of, or investments in, sustainable activities
    - Internal capacity development
    - Integration of sustainable finance principles in risk management
- Annual reporting on sustainability impacts.

In the same year, OJK issued Technical Guidelines for Banks. The guidelines brought clear definitions of:

- Minimal contents of the Action Plans;
- How to implement E&S impact management;
- Which are "sustainable activities" (in order to label loans and investments);
- Minimal contents of sustainability reports.

The Technical Guidelines discuss many international guidelines and policies of the Indonesian government. It gives attention to avoiding deforestation and financing afforestation and sustainable forest management. Banks are expected to finance more of "sustainable management of natural resources and land use." For the palm oil sector, that would be guaranteed by RSPO or ISPO certification.

An important initiative created in May 2018 was the "Indonesia Sustainable Finance Initiative," bringing together eight national banks that manage 46 percent of the banking assets. Their secretariat is WWF, with goals of setting short-term and long-term roadmaps for the sector, building partnerships, developing pilot projects on green business models and initiating sectoral policies.

OJK is also the regulator of institutional investors and the securities exchange. In 2017, OJK's sustainable finance regulation required the following from these actors:

- Institutional investors are required to develop an action plan on the incorporation of E&S aspects into their activities. The regulation does not specify substantial guidelines on content, only on governance aspects and the duration of the plans;
- Companies listed on the stock exchange are expected to report annually on their sustainability impacts.

As sustainable finance regulation is implemented incrementally, these requirements for institutional investors and listed companies have not come into force yet.

Malaysia wants banks to verify whether clients are involved in deforestation

Bank Negara Malaysia (BNM), the Malaysian banking regulator, in 2018 issued its first guidelines on the integration of E&S impacts. However, they only address concerns for Islamic banks. Despite their small market share, Islamic banks play a role in the financing of the palm oil sector. Although most of their financing comes from non-Islamic banks, some of the largest Malaysian palm oil companies also have attracted Islamic finance.

Guidelines for Islamic banks are among the most comprehensive globally. They include:

- A well-designed framework for assessment of the environmental, social and economic impacts of financed activities, also identifying the positive impacts of loans and investments;

- A description of appropriate information sources and indicators at transaction-level, customer-level and portfolio-level (including industry-specific and crosscutting issues);
- A description of consequences, drawn from impact assessments;
- Criteria for monitoring and for classification of E&S risks and impacts;
- Examples of engagement activities with customers, mapping and communication with stakeholders, and guidelines for engagement with clients;
- Governance models and relevant items for reporting;
- For E&S sensitive sectors that are relevant for the country's economy, the guidelines also note the need for clients to manage E&S risks across their supply chains.

The Implementation Guide (2018) and the Value-based Intermediation Financing and Investment Impact Assessment Framework (2019) are already final. The latter document lists which ESG impacts need to be considered per sector by Islamic banks. For the agriculture and forestry sectors, it mentions issues such as biodiversity loss and deforestation, greenhouse gas (GHG) emissions, and human rights and community relations. The document also lists national and international standards on avoiding deforestation.

The document highlights why these issues matter for (Islamic) banks: "The customers' businesses, if not run properly, can be a source of negative impact such as climate risk, biodiversity loss and deforestation, labour and human rights abuse, pollution, corruption etc. either directly or through their supply chain. If not managed well, the issues presented above can contribute to the degradation and depletion of natural and social capital, which presents a significant threat to the long-term resilience and growth of businesses and wider economy and society with ramifications on financial institutions."

The "Value-based Intermediation Scorecard" (a system for ranking Islamic banks sustainability practices) is still a work in progress, planned to be issued soon, according to Bank Negara Malaysia. Currently, there is ongoing dialogue between the regulator, the Islamic banking market and CSOs working in the field.

BNM in December 2019 published a discussion paper on introducing sustainability-related criteria for all banks operating in Malaysia. The paper, which is open for consultation until the end of March 2020, focuses on climate change-related risks and proposes to introduce a principle-based taxonomy. One proposed principle is for banks "should verify and ensure that the economic activities (which they are financing) are not illegal and do not contravene environmental laws." These laws include "operations involving illegal deforestation."

No regulation yet exists in Malaysia regarding ESG integration into the credit policies of commercial banks and into the investment policies of institutional investors. There is also no regulation on sustainability reporting for listed companies, but the Malaysian Stock Exchange has included ESG reporting into its listing requirements since 2015.

Appendix: Country assessments - summary

Figure 1: Integration of sustainability criteria in financial regulations in the five countries

Type of actors regulated	Country / Criteria	Brazil	Colombia	Peru	Indonesia	Malaysia
Banks	Regulation on ESG integration in credit approval process	General (2014) and specific for rural loans (2008, 2010 and 2015)	No	Yes (2015)	Yes (2017)	Yes (2018 and 2019), for Islamic banks
	Regulation has clear guidance on data sources to be consulted	Only for rural loans and not enough	No	Yes	Yes	Yes, for Islamic banks
	Regulation defines types of credit to be assessed	No, except for rural loans	No	Yes: loans above USD 10 million	Yes	Yes, for Islamic banks
	Regulation mentions that ESG risk can occur in the client's supply chain	No	No	No	No	Yes, for Islamic banks
	Regulation defines green loans or investments	No	No	No	Yes	Yes, for Islamic banks
Listed companies	Regulation on ESG reporting by listed entities	Yes (2014)	No	Yes (2015)	Yes (2017)	No, but included in listing rules (2015)
Institutional investors	Regulation on ESG integration in investment process	Yes (2009, reviewed 2018), for closed pension funds	No, being considered for 2020	No	Yes (2017), entering into force 2020-2025	No
	Regulation requires ESG reporting	No	No	No	No	No
All regulated entities	Regulator has a penalty system in place	Yes, for all	No	Yes, for banks	Yes, small penalties for all	No
	Regulator consults with multi-stakeholder forum	Yes, LAB	Yes	Yes, PIR	Yes, ISFI	Yes (for first guidelines)

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