

## PRINCIPLE-BASED SUSTAINABLE AND RESPONSIBLE DEVELOPMENT FOR MALAYSIAN CAPITAL MARKETS

In recent years, there has been increasing awareness of corporate social responsibility ("CSR") and a global shift towards sustainable market practices- especially in light of the various climate emergencies that necessitate immediate global response. The recent pandemic has, nonetheless, hampered efforts to attain certain global goals such as the UN Sustainable Development Goals ("SDGs")[1], with funding gaps for financing sustainable development are expected to increase exponentially[2]. It is no longer sufficient for such sustainability agendas to merely become part of national policies that rely on public financing. Greater support and commitment from private investments are required for the viable implementation of such agendas[3]. Hence, we witness the emergence of practices like Sustainable and Responsible Investment ("SRI")-- essentially encompassing any investment decision that embraces Environmental, Social and Governance ("ESG") considerations on top of economic returns[4].

To preface, Malaysia has always been well-poised to implement these initiatives. This can be attributed to the intersection of certain ESG principles with the underlying tenets of Islamic finance, which becomes a matter of considerable significance due to Malaysia's global domination in the Islamic Capital Market (ICM)[5]. Coupled with the efforts of the Securities Commission Malaysia ("SC"), there has been an obvious shift towards achieving sustainable development and climate goals in the past few years. From the active participation of our SC in the ASEAN Capital Markets Forum (ACMF) which champions sustainable finance, to our membership of the International Network of Financial Centres for Sustainability (FC4S), whereby international financial centres strive to achieve the UN SDGs and the Paris Agreement[6]- these are just some of our many international commitments in pursuit of sustainable economic growth[7].

### **Facilitative Regulatory Frameworks- the SRI Sukuk**

Locally, the SC has spearheaded various initiatives to foster a facilitative SRI ecosystem in the Malaysian Capital Markets. One of its earliest and most notable efforts to date includes

the establishment of the SRI Sukuk Framework in 2014. Leveraging Malaysia's position as a global leader in the sukuk market[8], this framework facilitates the issuance of Shariah-compliant financing instruments exclusively for projects which benefit the environment and society. Some of the more notable issuances under this framework include the social impact sukuk issued by Khazanah in 2015 to widen the availability of quality education and the world's first green sukuk from Tadau Energy for a solar project in 2017[9].

### **The SRI-Linked Sukuk**

In June 2022, the SC introduced an SRI-Linked Sukuk Framework as part of the Commission's bid to support a transition into a low-carbon or net-zero economy[10]. Some industry experts believe the introduction of this framework to be a timely one since it serves as a much-needed impetus for the diversification of ESG sukuk issuance in Malaysia[11]. Unlike its predecessor- the SRI Sukuk, the proceeds from an SRI-linked sukuk are available for general purposes, not just exclusively to fund eligible SRI projects[12]. Additionally, the features of an SRI-linked sukuk differ since its financial and/or structural characteristics may vary depending on whether the issuer meets its prescribed key performance indicators ("KPIs") and sustainability goals[13]- yet another trait that an SRI sukuk does not share. The cumulative effect would be heightened flexibility under the new framework and greater accessibility to private financing for a more diverse range of sustainable projects[14]- further reinforcing Malaysia's commitment towards the sustainability agenda.

### **A Principles-Based Approach**

With the introduction of these initiatives to expand the SRI segment in the Malaysian Capital Markets, it naturally follows that further guidance on what qualifies as SRI becomes imperative. In response to this pressing need, the SC developed a Principles-Based SRI Taxonomy which sets out common guiding principles on the classification of economic activities to support sustainable investments[15]. Taking cognisance of its significance to our capital markets, various measures were taken to ensure the domestic suitability of the SRI Taxonomy. Firstly, its development was a joint effort between the SC- in its capacity as the regulator with various industry players[16]. The SRI Taxonomy also took into account other relevant taxonomies and national blueprints to ensure compatibility and the alignment of principles so far as possible[17]- although SC did highlight the need to consider and prioritise the state of readiness of the wider Malaysian Capital Markets[18].

### **Outlook for the Malaysian Capital Markets**

Industry experts believe there is potential in the sphere of ESG sukuk waiting to be exploited[19]. As mentioned earlier, there is already some overlap between the underlying themes of ESG and Islamic finance. ESG-related sukuk, such as the SRI and SRI-linked sukuk, is therefore a marriage of the two and poses an attractive option for issuers. If issuers successfully leverage the pre-existing alignment between Shariah and ESG values and properly market it in a manner which resonates with the ethical concerns of conventional

investors, then issuers stand to capture a wider pool of investors[20]. This is especially since many international investors have a CSR budget which may be allocated to purchase a certain proportion of ESG issuances[21]. It cannot be denied that conventional investors might take some time to warm up to Shariah compliant instruments due to the unfamiliar Islamic terminologies and complex structures involved[22]. However, those new to the Islamic Capital Markets should find the benefits of instant portfolio diversification[23] to be an especially attractive prospect and consequently, issuers will also benefit from a diversification of the profile of its investors[24].

Nevertheless, it is expected to be quite an uphill battle before issuances are able to reach their true potential. As identified by industry experts, one of the greatest obstacles would be convincing investors from a returns perspective[25]- a mere heightened interest in the sustainability agenda might not be sufficient to sway investors if there is nothing to evidence a more competitive yield compared to ordinary sukuk or even other conventional bonds[26]. Furthermore, the profit-rate ratcheting feature as seen with an SRI-linked sukuk is most likely something novel for many investors. The product might become less palatable to investors especially if it involves a possible decline in profit rates upon hitting predetermined sustainability KPIs- investors would understandably try to avoid any price uncertainties which could affect tradability on the market[27]. Based on past experiences, issuances with step-down models have been more challenging to distribute, hence the more appealing alternative is to do a step-up, where the profit-rate will gradually increase over time if KPIs are not met[28].

## **Conclusion**

With a growing emphasis on sustainable development worldwide, it would bode well for the Malaysian Capital Markets to evolve and accommodate to the appetites of an increasingly ESG-conscious wave of investors. The development of the SRI segment in particular is instrumental in the nation's transition into a more sustainable and socially inclusive stakeholder economy, which looks beyond short-term financial returns in favour of long-term value creation[29]. Relatively speaking, the Malaysian SRI markets are still in their infancy but the momentum is building for our Capital Markets to provide a conducive environment to support the sustainability agenda, especially when our Islamic finance sphere boasts a strong synergy between its regulator, central bank and financial service players[30]. With everyone working in a common direction, it undoubtedly becomes easier to implement these initiatives but it still remains to be seen just exactly how much more will be done.

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1. The 17 UN Sustainable Development Goals (SDGs) aim to end poverty, improve health and education, reduce inequality, and spur economic growth - all while tackling climate change and working to preserve our oceans and forests. (<https://sdgs.un.org/goals>).
  2. Securities Commission Malaysia, 'Public Consultation Paper No.1/2021- Principles-Based Sustainable and Responsible Investment Taxonomy for the Malaysian Capital Market' (Securities Commission, 17 December 2021) <<https://www.sc.com.my/api/documentms/download.ashx?id=f610a75b-d5e1-4e99-9bdb-393000a2c355>> accessed 30 January 2023.
  3. *ibid.*

4. EY Global, 'Why sustainable investing matters' (Ernst and Young, 3 April 2020) <[https://www.ey.com/en\\_my/financial-services/why-sustainable-investing-matters](https://www.ey.com/en_my/financial-services/why-sustainable-investing-matters)> accessed 30 January 2023.
5. Securities Commission Malaysia, 'Principles-Based Sustainable and Responsible Investment Taxonomy for the Malaysian Capital Market' (Securities Commission, 12 December 2022) <<https://www.sc.com.my/api/documentms/download.ashx?id=a0ab5b0d-5d7d-4c66-8638-caec92c209c1>> accessed 30 January 2023.
6. The Paris Agreement, signed in 2016, is an international treaty on climate change. This Agreement sets out long-term commitments from all nations to reduce their greenhouse gas emissions and to strengthen their commitments over time. It also provides financing to developing countries to mitigate climate change, strengthen resilience and enhance abilities to adapt to climate impacts. (<https://www.un.org/en/climatechange/paris-agreement>).
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8. Securities Commission Malaysia, 'Capital Markets Masterplan 2' (Securities Commission Malaysia, 12 April 2011) <<https://www.sc.com.my/api/documentms/download.ashx?id=d7ba5bf6-9224-4024-9074-58e2c9f20973>> accessed 30 January 2023.
9. Securities Commission Malaysia, 'Sustainable and Responsible Investment Roadmap for The Malaysian Capital Market' (Securities Commission Malaysia, 26 November 2019) <<https://www.sc.com.my/api/documentms/download.ashx?id=89dea0ab-f671-4fce-b8e4-437a2606507c>> accessed 30 January 2023.
10. Securities Commission Malaysia, 'SC Releases New Sukuk Framework to Facilitate Companies' Transition to Net Zero' (Securities Commission, 30 June 2022) <<https://www.sc.com.my/resources/media/media-release/sc-releases-new-sukuk-framework-to-facilitate-companies-transition-to-net-zero>> accessed 30 January 2023.
11. Chris Wright and Marianne Gros, 'Malaysia shows the way for ESG sukuk issuance' (Euromoney, 3 October 2022) <<https://www.euromoney.com/article/2aomq2ld8h94kriqwodlc/esg/malaysia-shows-the-way-for-esg-sukuk-issuance>> accessed 30 January 2023.
12. Securities Commission Malaysia, 'Frequently-Asked Questions: Sustainable and Responsible Investment Linked (SRI-Linked) Sukuk Framework' (Securities Commission, 30 June 2022) <<https://www.sc.com.my/api/documentms/download.ashx?id=d34d6f67-8f41-4e20-a478-b54fbb817389>> accessed 30 January 2023.
13. Securities Commission Malaysia n (10).
14. *ibid.*
15. Securities Commission Malaysia n (5).
16. *ibid.*
17. *ibid.*
18. Securities Commission Malaysia, 'Public Response Paper No. 2/2022 - Principles-based Sustainable and Responsible Investment Taxonomy for the Malaysian Capital Market' (Securities Commission, 12 December 2022) <<https://www.sc.com.my/api/documentms/download.ashx?id=cdfef1da-833f-4e52-9522-39eaa0de8bfb>> accessed 30 January 2023.
19. Wright and Gros n (11).
20. *ibid.*
21. Mahfuzur Rahman, Che Ruhana Isa, Ginanjar Dewandaru and Nazreen T. Chowdhury, 'Socially Responsible Investment Sukuk (Islamic Bond) Development in Malaysia' (2020) 12(4) *Qualitative Research in Financial Markets* 599, 609.
22. Michael S. Bennett and Zamir Iqbal, 'How socially responsible investing can help bridge the gap between Islamic and conventional financial markets' (2013) 6(3) *International Journal of Islamic and Middle Eastern Finance and Management* 211, 221.
23. *ibid*

24. Securities Commission Malaysia, 'Sustainable and Responsible Investment Sukuk Framework - An Overview' (Securities Commission, 28 August 2014).  
<<https://www.sc.com.my/api/documentms/download.ashx?id=84491531-2b7e-4362-bafb-83bb33b07416>> accessed 30 January 2023; Rahman, Isa, Dewandaru and Chowdhury n (21) 611.
25. Wright and Gros n (11); Rahman, Isa, Dewandaru and Chowdhury n (21) 610.
26. Wright and Gros n (11).
27. *ibid.*
28. *ibid.*
29. Securities Commission Malaysia n (5).
30. Wright and Gros n (11).

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