FAIR FINANCE ASIA

ASIA'S DYSTOPIAN FUTURE?

WHY BANKS NEED TO PUT SUSTAINABLE FINANCE CLEARLY IN THEIR SIGHTS

SOMO

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USE OF TERMS

ASEAN	Association of Southeast Asian Nations, which has ten member states: Brunei Darussalam (referred to as Brunei), Cambodia, Indonesia, Lao People's Democratic Republic (referred to as Laos), Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam (referred to as Vietnam).
Bank financial services, other than lending and underwriting	In this document, it refers to current accounts and saving accounts, financial transfers, and various investment banking activities.
Central bank	Used in this report mostly in its function as a bank supervisor responsible for guaranteeing financial stability and issuing regulations, guidelines, and codes to be implemented by banks.
COVID-19	An infectious disease caused by the most recently discovered coronavirus that caused a worldwide pandemic, starting in China in December 2019.
CO_2	Carbon dioxide
ESG	Environmental, social and governance
EU	European Union
FFA	Fair Finance Asia
FFA countries	Countries in which Fair Finance Asia is active, namely Cambodia, India, Indonesia, Japan, Philippines, Thailand and Vietnam.
FFA-plus countries	FFA countries plus China
GDP	Gross Domestic Product
GHG	greenhouse gas
G20	Forum for the leaders and ministers of the 20 countries with the largest economies, and the EU
IFC	International Finance Corporation

NGFS	Central banks' and supervisors' Network on Greening the Financial System
NDCs	Nationally Determined Contributions under the Paris climate agreement
OECD	Organisation for Economic Co-operation and Development
OJK	Otoritas Jasa Keuangan (Indonesian Financial Services Authority)
Paris climate agreement/commitments	commitments adopted in December 2015 at the Paris Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC – COP 21)
Scenario	An attempt to carefully construct a view of how a particular area or sector might potentially develop in the future. It integrates complex interactions between the most important factors driving change in an area or sector. The purpose is to improve the understanding of how the change will happen.
SDGs	United Nations Sustainable Development Goals
TCFD	Task Force on Climate-Related Financial Disclosures
UNEP-FI	United Nations Environmental Programme – Finance Initiative
UNFCCC	United Nations Framework Convention on Climate Change
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific

SUMMARY AND HIGHLIGHTS OF THE REPORT

Banks play an essential role in financing the economies and societies in the FFA-plus countries, covering Cambodia, China, India, Indonesia, Japan, Philippines, Thailand and Vietnam. This report, 'Asia's Dystopian Future? - Why Banks Need To Put Sustainable Finance Clearly In Their Sights', exposes the problems banks in these countries create when failing to make strategic contributions to the environmental and inclusive sustainable development in these countries in the next ten years. If banks operating in Asia continue with their financing practices, they will themselves be at risk of financial losses according to the forward looking scenario described in this report.

When looking forward, UNESCAP predicts that the FFA countries will be unable to meet the 17 UN Sustainable Development Goals (SDGs) by 2030. It pointed out that progress made so far in reducing poverty and food insecurity has been made with little attention paid to environmental and social protection. Bank lending and underwriting in FFA-plus countries have often financed harmful commercial practices that prevent attaining the SDGs as FFA case studies[1] illustrate. Billions of dollars in additional annual financing are required to implement the SDGs by 2030 but the contribution by the private sector is currently not adequate to fill the gap.

Insufficient progress is being made in meeting the climate change mitigation targets and intermediary steps, according to the Paris climate agreement. As per the estimations of greenhouse gas (GHG) emissions in FFA countries, GHG must be reduced drastically by 2030 to avoid rising temperatures. That annually requires significant additional financial investments. However, climate-friendly sectors in the region are suffering a large gap in funding from the private finance sector. Sectors that fuel climate change, on the other hand, are benefitting from high amounts of bank lending and underwriting in FFA countries.[2]

The COVID-19 crisis has triggered an unprecedented economic and societal turmoil, leading to increasing inequality, poverty, hunger, social unrest, and environmental problems in the region. As compared to estimations before COVID-19, mitigating the growing poverty gap will require 60% additional financing. This will increasingly burden governments' budgets in FFA countries which already had large debts to repay. The economic downturn is also foreseen to challenge banks' existing loan portfolios, with prolonged consequences.

This report provides a forward looking scenario that describes the trajectory based on this context and its economic, environmental, and social impacts that will unfold by 2030 if no immediate changes are made, and banks continue to adopt a business-as-usual mindset in Asia. It emphasises how climate change and environmental degradation will have severe human consequences in the region within the next ten years. For instance, FFA-plus countries are especially vulnerable to more frequent floods, rising sea levels, and ocean acidification because of their lengthy coastlines and large river basins. Consequently, this will deprive millions of people of their homes, communities and livelihoods, triggering migrations and economic losses, which will then perpetuate worsening labour and human rights violations that can ultimately destabilize financial and governmental structures within FFA-plus countries.

Banks providing loans to companies with abusive social and environmental practices promote not only the unsustainable progress in FFA countries, but also undermine the profitability and functioning of the banks themselves. Their risk assessment models are not fully informed about future impacts from climate and social problems. If these banks continue business as usual with little commitment to the sustainability of FFA societies, or with minimal adaptations to their strategies and risk assessments, their lending and underwriting will add risks and costs for the banks themselves, such as:

CREDIT RISKS

- The risk of defaulting loans and stranded assets due to the impacts of climate change, environmental degradation and abusive social practices that will undermine or annihilate the profitability of corporate borrowers and other bank customers. Examples include flooding of large cities and droughts that ruin agribusiness' harvests.
- New or modified environmental and social laws will also affect borrowers' capacity to repay loans (transition risk). For instance, fossil fuel industries and coal-powered plants will have to close to stop global warming before loans are being repaid.

MARKET RISKS

- Changes in the economy and society can lead to potentially more defaulting loans, for instance, due to changing production and energy prices, shifting consumption preferences and lower purchasing power.

OPERATIONAL RISKS

- Losses might arise out of extreme weather events that interrupt the operations of banks (e.g. storms damaging their buildings and computer systems).
- Protests against banks' failure to act on avoiding harmful socially and environmentally sustainable impacts (reputational risks).

Other potential significant changes in the regional financial sector landscape that could impact banks negatively if they continue with their current practices:

- Changes in financial regulations by supervisory authorities or through new banking laws, which introduce or reinforce codes, standards and guidelines in FFA-plus countries to ensure that banks account for climate, environmental, social and governance (ESG) risks and contribute to sustainable development.
- Negative ratings from credit rating agencies and ESG research reports for failure to integrate ESG risks, leading to:
  - higher borrowing costs for the banks themselves
  - tarnished attractiveness to shareholders.
- Increased scrutiny of the banks' impact on such risks from their progressive national and international shareholders, who might be under pressure from civil society protests when institutional shareholders vote against sustainability resolutions.

This report concludes that a strategy to avoid future risks as expected from this scenario building exercise with many climate, environmental, human rights, social and governance problems will, by itself, not be sufficient to avoid the negative long term impacts that bank loans might have on FFA communities.

The recommendations in this report provide ways forwards on how banks and their regulators can contribute to a positive future.

BANKS WILL NEED TO CONTRIBUTE ACTIVELY TOWARDS REVERSING SOCIAL INJUSTICE AND ENVIRONMENTAL DESTRUCTION, BY IMPLEMENTING THE FOLLOWING:

- Banks' management should make urgent strategic changes so that their loans and underwriting services can directly benefit climate mitigation, environmental resilience, and the promotion of respect for human rights and labour rights, in Asia.
- Risk management methodologies have to operationalise ESG risks as well as sustainability impact assessments, which fully take the long term future into account. These risk assessments will have to result in allocation of appropriate capital reserves.
- During the lending processes, banks will have to actively engage with potential borrowers to request and obtain all necessary information about potential negative impacts on sustainability, and condition their financing agreements to ensure those negative impacts are averted and/or addressed swiftly.
- High standards for due diligence processes will have to be fully integrated to prevent negative environmental, social and governance impacts on communities, people and planet.
- Remedial procedures and grievance mechanisms will have to be introduced, in case severe social and environmental damage has occurred anyway, and has to be paid for.
- The new strategy should provide direction on how and whether banks continue to engage with and finance companies, sectors and activities that have harmful ESG impacts, by demanding stronger ESG compliant policies and practices on which banks should publically report. Where banks decide to phase out lending to, or servicing, carbon intensive sectors and industries, they should do so in a time-bound manner that ensures a smooth transition for the affected communities.
- Banks will need to develop and advertise innovative financial products that have clear ESG impacts, while proactively advising their clients, companies, or projects on how to achieve those positive outcomes with the bank's support.
- Banks will have to be transparent about the impacts of their new strategies and processes, by providing full disclosure, including on financial exposures to different industries and use of ESG information, and publishing that information in formats that are useful to different stakeholders including CSOs.

MORE IMPORTANTLY, FINANCIAL REGULATORS AND SUPERVISORS IN ALL FFA COUNTRIES (AND WHERE POSSIBLE LEGISLATORS) HAVE TO PLAY A CRITICAL ROLE IN MAKING BANKS MOVE SWIFTLY IN A SUSTAINABLE DIRECTION BY:

- Creating an ESG level playing field in the form of mandatory regulatory or legally binding minimum requirements to avoid free riders among competing banks. These requirements need to strengthen the ESG risk and impact assessment methods of the banks, while also defining and promoting lending to activities that contribute to social and environmental sustainability, and phasing out lending that is not aligned with the Paris climate goals and the SDGs.
- Building their capacity and resources for improving their supervisory scrutiny of unsustainable practices, incomplete risks assessments and capital buffer allocation by banks.
- Providing different supportive tools to banks in order to facilitate the implementation of the mandatory measures.
- Developing comprehensive socially and environmentally forward-looking scenarios, which complement the currently developed scenarios that predict the consequences of climate change but tend to ignore social aspects. The scenarios will have to be adapted to what FFA countries need and how their banking sectors can adjust their operations.
- Promoting diversity in the banking sector to support more agile and innovative banking services.
- Identifying and creating fora for Asian regional coordination and cooperation among national financial authorities to support and strengthen the regulatory and supervisory measures on sustainable banking in the region.

The forward looking scenarios described in this report is meant to sound the alarm for all key Asian financial sector stakeholders to make urgent changes in their business models, lending practices, as well as regulatory requirements. The recommendations intend to propose how banks and regulators can move away from a scenario of social injustice and environmental tragedy, towards a future that protects millions of lives including the most marginalised communities in Asia.

INTRODUCTION

People in Asia are facing multiple challenges and a future that looks far bleaker than it did just a year ago. The COVID-19 pandemic has impacted Asian countries and their populations in different ways. The domestic and external economic shocks from measures to contain the pandemic have had unprecedented short and long term economic and social consequences. Moreover, the pandemic has further exacerbated existing ESG problems in many Asian countries.

Decisions made by governments and the financial sector to deal with, and recover from, the COVID-19 crisis, have focussed on the short-term survival and recovery based on circumstances before the pandemic. Some have even further relaxed regulations for the financial and corporate sector. There has been a severe disregard of measures to reach the UN SDGs by 2030 and the phased commitments of the Paris climate agreement. Such an approach will not only allow existing ESG problems to persist, but the cumulative effects will lead to these problems escalating long into the future if the financial sector continues in a business-as-usual mindset.

In 2015, the Governor of the Bank of England called for *"breaking the tragedy of the horizon"*[3] to avoid a financial crisis following climate chaos resulting from the financial sector's continuous funding of CO_2 emitting companies and activities. He explained that banks and other entities in the financial sector were only assessing short-term risks and profits, without looking towards the future impact their funding will have on climate change in the much longer term. Climate change, however, will impact many companies and the financial sector, making banks face unpaid loans by their clients and dwindling value of many financial products and services.

The financial sector and banks have no or little organisational instruments, methodologies and scenarios to integrate these problems and look forward in their loan assessments. This report, therefore, sketches what future ESG issues and risks are likely to occur by 2030 if the current status quo persists. It raises arguments against another *"tragedy of the horizon"* to avoid financial instability or a social and environmental crisis.

In Asia, banks are more important financial players for the economy and the regional financial system than institutional investors. They play a significant role in the economy, funding many projects, sectors, governments, and micro, small and large companies. Their funding and decision-making, therefore, greatly impact what is being funded and how that funding affects not just economic recovery and growth, but also climate change, environmental degradation, respect for human rights, social well-being and even political stability. These influences become critical during the COVID-19 pandemic. The last decades have seen many reforms in favour of a market based financial sector with regulatory requirements to safeguard their stability. However, Asian banks have generally had no binding obligations to prevent negative consequences for workers, communities, customers and citizens as well as environmental degradation and climate change. This report aims to be an urgent wake-up call to the banking sector as well as the regulators, supervisors and legislators of banks, to change course towards more long term sustainability.

Terms of reference and methodology: scope and limitations of this report

The report 'Asia's Dystopian Future?' covers the countries in the Asian region, which are part of the Fair Finance Asia (FFA) coalition, namely Cambodia, India, Indonesia, Japan, the Philippines, Thailand and Vietnam. The report partly covers the future situation in China too, given China's influence on these countries and the wider Asian region. The FFA countries, together with China, are referred to as FFA-plus countries.

The FFA network aims to raise concerns about the presence and progression of a multitude of social, human rights, climate and environmental problems in their countries. Many FFA case studies describe how large banks continue financing companies and projects responsible for sustained CO_2 emissions, environmental degradation, human rights breaches and social problems. The sectors on which the FFA case study focuses on, are reflected in this report- fossil fuels, power generation, infrastructure projects and agribusiness. While financial supervisors and central bankers are designing new forward-looking scenarios that highlight the impact of climate change on banks, they have so far largely ignored the consequences of environmental degradation, like loss of biodiversity, and their social impact. This report aims to draw specific attention to the social implications of climate change, environmental degradation and human rights breaches in the FFA countries. Social and human rights aspects are hardly integrated into new forward-looking scenarios by central bankers, bank supervisors and the financial sector, which this report wants to address.

To provide an insightful time perspective, which raises awareness about the urgency for change, the outlook in this report makes projections up to 2030.

To simplify the scenario and highlight the challenges banks will meet, it uses the assumption that large banks will not, or scarcely change their current lending strategies and practices.

The method used in this report is a qualitative approach, not a quantitative one.

First, three straightforward projections up to 2030 are being assessed, namely:
1. whether the SDGs are being achieved
2. whether the Paris climate commitments are being achieved
3. what will be the various likely consequences from the fall-out of the COVID-19 pandemic

The forward-looking scenario is then further developed in some detail by extrapolating existing climate, environmental, human rights and social problems and describing their potential consequences by 2030, with a focus on the social impacts and COVID-19 impacts as aggravating factors. These details of the forward-looking scenario serve to provide concrete insights into various risks that banks are currently ignoring, but will face in the coming decade.

Ultimately, this report aims to alert the (especially large) banks operating in FFA countries on ways to avoid the future ESG risks and impacts described in the forward-looking scenario. This report's recommendations for banks and banking regulators, supervisors and legislators in FFA countries provide proposals on how they can change strategies, risk assessments, financial services in order to contribute to a more sustainable future.

The information and analysis used in this report are based on selective desk research, research in database Refinitiv (Thomson Reuters Eikon), existing forward-looking climate scenarios published by central banks[4], data published by FFA on lending and underwriting by banks in and among FFA countries in the report "The Asian Web - Tracking Regional Financial Flows"[5], and comments from partners in the FFA network.

Overview of chapters in this report

CHAPTER 1 of this report highlights that the UN Sustainable Development Goals (SDGs) and Paris climate agreement commitments are expected to remain unmet until 2030. Moreover, the effects of COVID-19 have already been observed to reverse any progress that was made in this regard. These are the essential elements incorporated in the forward-looking scenario in the report.

CHAPTER 2 explains the current situation of harmful climate, environmental, social and human rights problems and how, by extrapolating their cumulative effects, they will deteriorate without the intervention of relevant financial sector actors in the region. This chapter completes the forward-looking scenario of this report that incorporates social injustice and an environmental catastrophe by 2030.

CHAPTER 3 provides insights into the risks and consequences for banks in FFA and, how this will impair their profitability and long term operations.

CHAPTER 4 recommends how banks and banking authorities can avert negative consequences for the banks themselves. The recommendations relate to new strategies, practices and initiatives to avoid adverse sustainability impacts and re-orient funding towards climate, environmentally and socially sustainable companies and activities.

CHAPTER 5 provides the overall concluding remarks of this report.

1

A 2030 SCENARIO OF NOT ACHIEVING THE SDGS AND CLIMATE MITIGATION GOALS

This chapter looks at some straightforward elements of a forward-looking scenario that projects what social, climate and environmental problems banks operating in FFA-plus countries will face by 2030.

The three elements that form the essential elements in this report for the forward-looking scenario by 2030 are:

1. **Expected delays and unmet SDGs commitments**
2. **Non-Alignment with the Paris climate commitments**
3. **Consequences of COVID-19**

These three elements provide major insights into the ESG challenges FFA-plus countries are facing, with consequences for the banks. For instance, to limit temperature rise to below 1.5° C, they must reduce CO_2 emissions by 7.6% between 2020 and 2030. The impact of the COVID-19 pandemic and the related lockdown and economic recovery measures play a significant role in a forecasting scenario.

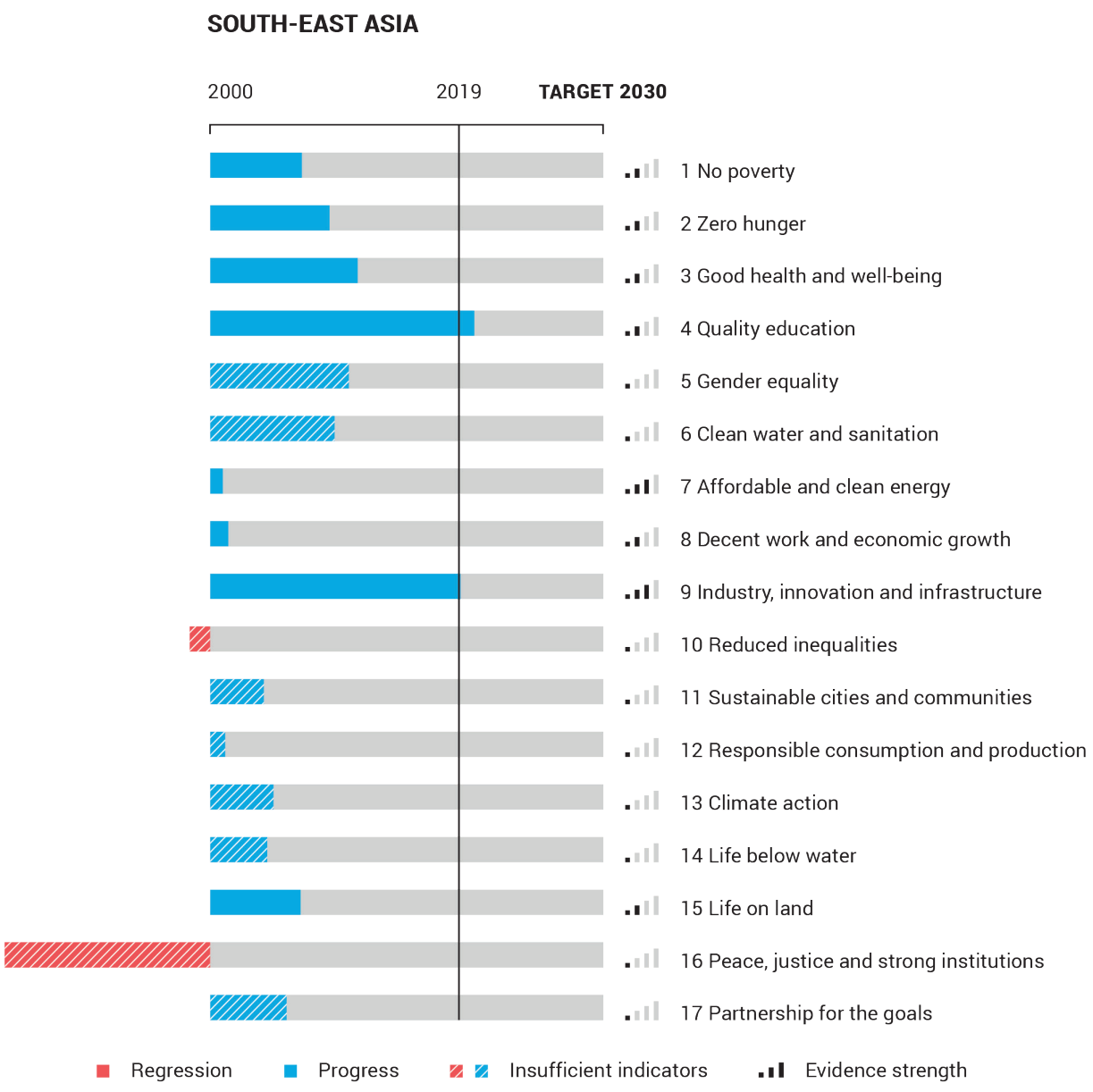
In such a scenario, there is a need for billions of dollars of additional financing. Given that estimations foresee that governments will not be able to provide all the required funding, this chapter provides an insight into the amount of funding the private financial sector is expected to raise.

1.1. Not reaching the SDG goals by 2030

To end significant social and environmental risks and challenges that still affect billions of people, members of the UN have agreed to achieve 17 UN Sustainable Development Goals (SDGs)[6] by 2030. The goals range from eliminating poverty, hunger, inequalities and gender discrimination, to making cities sustainable, restoring ecosystems and ensuring access to justice. The implementation is to be strengthened by partnerships and involvement of the private sector.

The Asian region is far behind in its progress towards achieving the 17 SDGs, according to the UN Economic and Social Commission for Asia and the Pacific (UNESCAP) in March 2020 (before the impact of COVID-19 was measured). It will *"miss all measurable SDG targets related to other forms of poverty, hunger, gender equality and reduced inequalities within and between countries by 2030."*[7] None of the Asian sub-regions, including South-East Asia, will meet any of 17 SDG goals by 2030 if they continue following the same trajectory as until the end of 2019 (see Figure 1).[8] The areas of poverty, food security, women's role in decision-making, and access to basic sanitation services had seen some progress, much of which was the result of economic growth. For example, ASEAN's real GDP had an average annual growth of 5.3% between 2000 and 2018.[9] However, UNESCAP warned that this growth has not been sustainable or equitable, nor has it been *"coupled with human well-being and a healthy environment".*[10]

Figure 1: Snapshot of progress to meet the SDG goals in South-East Asia* (2019)

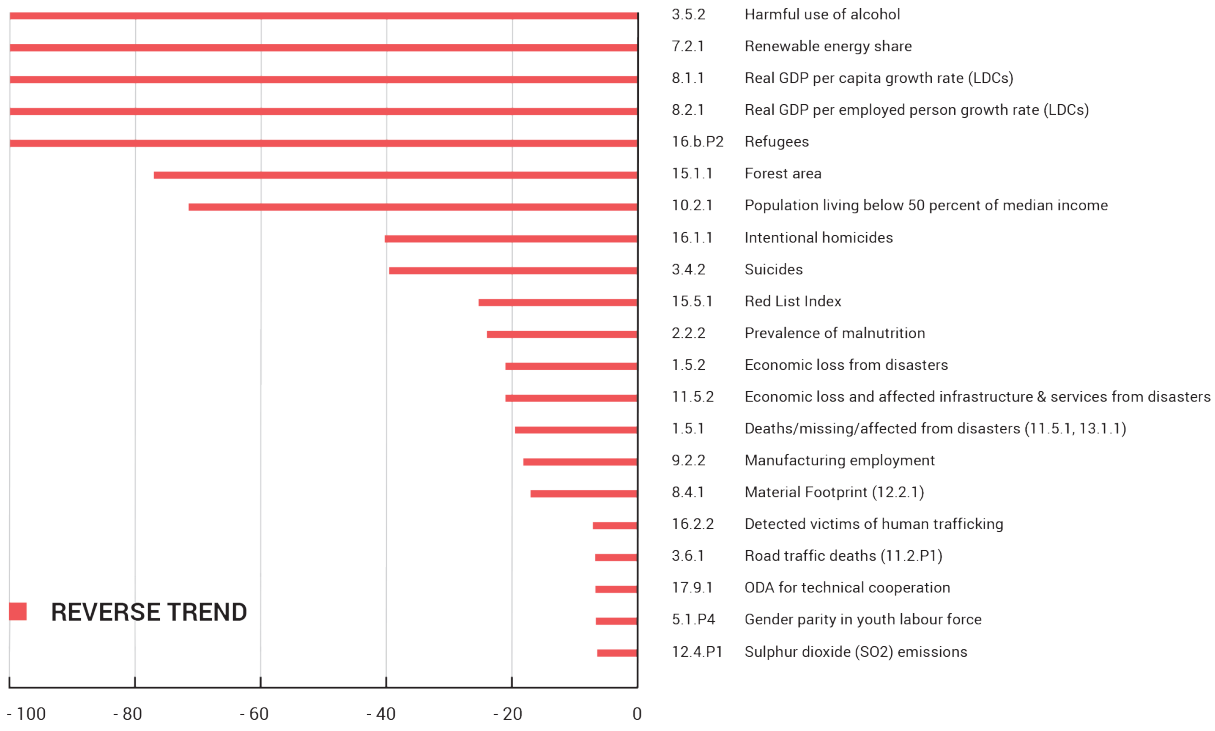


Source: UNESCAP, Asia and the Pacific SDG Progress Report 2020, March 2020, p. 57.

* includes Brunei Darussalam, **Cambodia, Indonesia**, Lao People's Democratic Republic, Malaysia, Myanmar, **Philippines**, Singapore, **Thailand**, Timor-Leste, **Viet Nam.**

According to UNESCAP, the South-East Asian region needs to accelerate efforts to achieve the targets of the SDGs.[11] Besides, some practices have resulted in regression, rather than progress, toward attaining the SDGs, and these need be reversed, e.g. the large amount of (employed) people living in poverty (see Figure 2).

Figure 2: Practices and trends in South-East Asia that need to be reversed to achieve the 17 SDG goals by 2030



Source: UNESCAP, Asia and the Pacific SDG Progress Report 2020, March 2020, p. 60.

As UNESCAP explains, to maintain the economic growth that has allowed progress on reducing extreme poverty in South-East Asia to 5% in 2017,[12] the region is dependent on international trade and resource extraction, with a heavy reliance on fossil fuel energy which contributes to climate change. Lack of social security for employees and lack of pensions for ageing populations among much of the region will increase inequality and reduce the implementation of human rights.[13]

Many activities and companies whose practices need reversals receive financing from banks. Conversely, banks can potentially fund many initiatives to accelerate the achievement of the SDGs.

Serious financing gaps

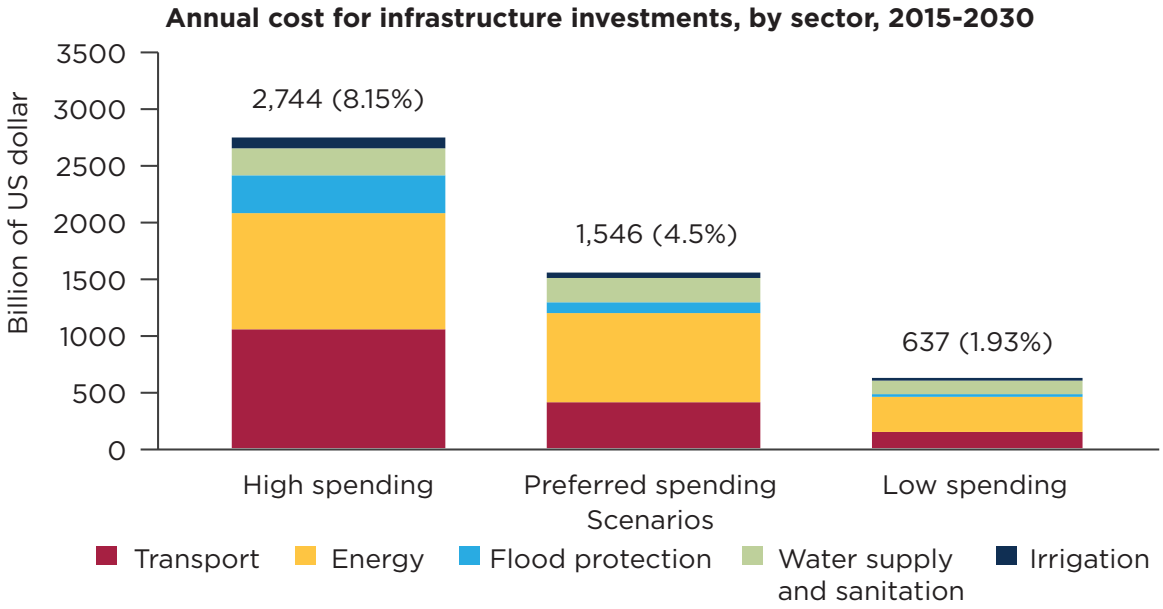
Numerous estimates indicate the need for considerably higher financing per country (depending on the economy), region and sector to accomplish the SDGs. For instance, low income developing countries like Cambodia and Vietnam[14] were already facing a funding gap of 49-59% of GDP before the COVID-19 pandemic. The so-called 'emerging market' countries with larger economies are estimated to need additional expenditures of $2.5 to 3 trillion per year to achieve the SDGs. Among them are China, India, Indonesia, Philippines and Thailand.[15]

According to global institutions such as the G20 and the IFC, new economic infrastructure, especially in energy and transport, require a large amount of additional funding.

Such infrastructure, from small to large scale, and local to regional levels, should benefit the entire population, especially the most disadvantaged people, and be in line with climate change mitigation needs.

Economic infrastructure is, and can be further, financed by the private financial sector. Strict conditions and regulations should guarantee positive outcomes for the whole of the population and additional finance for governments. Social infrastructure, such as health and education, also suffers from considerable government spending gaps.[16]

Figure 3: Infrastructure investment needs in low and middle-income countries, according to spending scenarios



Source: D. Doumbia and M. Lykke Lauridsen, Closing the SDG financing gap —Trends and data, IFC – Thought Leadership, Note 73, October 2019, p. 2.

Practices resulting in the denial of fundamental human rights and social justice, already embedded in many societies of FFA-plus countries, will continue if these countries do not reach the SDGs.

> In current unconditional pledges, the world is heading for a 3.2°C temperature rise.[17]

1.2. Not reaching the Paris agreement climate commitments by 2030

The year 2030 is the deadline to reach part of the reduction of CO_2 emissions to reduce climate change, as agreed in December 2015 at the Paris Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) and ratified by the FFA-plus[18] countries.

The climate commitments of the Paris climate agreement[19] aim to:

1. Prevent climate change by rising temperatures (Article 2.1a),
2. Adapt to climate impacts (Article 2.1b),
3. Make finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development (Article 2.1c).

One of the strategies to reduce climate change by 2030 is the so-called 20/20/20 targets:

- Reducing CO_2 emissions by 20%
- Increasing the market share of renewable energy to 20%
- Improving energy efficiency by 20%[20]

In contrast, the voluntary pledges *("Nationally Determined Contributions" (NDCs))* made in November 2019 by Paris agreement signatory countries will result in 56 Gt of CO_2 emissions by 2030, twice the environmental target. Emissions are thus estimated to be on the course of exceeding the limits by 2030.[21]

A few FFA-plus countries are among the biggest emitters of the global greenhouse gases.[22] China emits around 30%, India 7.2% and Japan 2.7% (i.e. 39.9% of total emissions in the world).

According to their NDCs, ASEAN countries will have to reduce the following share of greenhouse gas emissions (GHG) emissions by 2030 as compared to business-as-usual[23]:

- Cambodia- 26%
- Indonesia- 29%
- Philippines- 70%
- Thailand- 20%
- Vietnam- 8%

However, energy demand is expected to continue growing in ASEAN at 3.6% per year up to 2040.[24] ASEAN would need to start the energy transition to renewables as soon as possible to reduce emissions from fossil fuel energy production while satisfying a growing energy demand.[25]

China's reliance on coal-based energy is playing an important part in the region's contribution to combating climate change. At the UN General Assembly in September 2020, China pledged to peak its CO_2 emissions by 2030 and be CO_2 free only by 2060, thereby missing the Paris climate agreement deadline.

Without a reduction in CO_2 emissions, the FFA-plus countries will face increasingly damaging effects of climate change. Environmental tragedy will soon follow in the absence of significant changes and swift action.

Financing gap

The third goal of the 2015 Paris agreement was *"making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."* (Article 2.1c).[26] It aimed to encourage financial support for the transition to fossil-free energy and economies, while also adapting to the impacts of temperature change by 1.5°C. This covers both public and private finance, nationally and internationally, and both policies and regulations.

Estimations on the quantum of finance needed, through re-allocation or orientation of new loans and investments, vary globally, regionally and per country. Global estimates *"of the investment required to achieve the low-carbon transition range from US$ 1.6 trillion to US$ 3.8 trillion annually between 2016 and 2050, for supply-side energy system investments alone (IPCC 2018), while the Global Commission on Adaptation (GCA 2019) estimates adaptation will cost US$ 180 billion annually from 2020 to 2030".*[27]

For ASEAN alone, one official estimate for the additional funding needed for green investment from 2016 up to 2030 was at US$3 trillion, divided among different sectors: *"infrastructure (US$1,800 billion), renewable energy (US$400 billion), energy efficiency (US$400 billion) and food, agriculture and land use (US$400 billion)".*[28] This means an average annual demand for ASEAN of around US$200 billion through to 2030. The contribution of private finance was estimated to have to increase by a factor of over ten to meet the regional funding required to tackle climate change.[29] Such estimations do not take into account that building renewable energy infrastructure is energy-intensive, polluting and requires more rare minerals than is available in reserves, which reduces the possibility to rely on renewable energy.[30]

In ASEAN, *"Indonesia will require the largest volume of green finance".*[31] Indonesia *"needs an estimated USD 247 billion by 2030 to meet its NDC target of reducing greenhouse gas emissions by 29%. However, research from Climate Policy Initiative (CPI) tracked only about US$ 13.2 billion of private climate finance between 2015-2018, highlighting Indonesia's need to significantly scale up climate finance in the next ten years to achieve its NDCs".*[32] This private finance contribution *"only accounts for 2.3% of commercial FIs' total credit issuance (USD 378 billion), highlighting the big chasm between their total financing compared to their climate financing".*[33]

In addition to green investments, there is a need to reduce and eventually stop financing activities that contribute to pollution and climate change.[34] Given Asian's dependence on fossil fuels and unsustainable practices, a massive reversal of existing economic practices and activities is in order. Companies responsible for global warming and environmentally unsustainable practices may default on their bank loans as a result of swift action taken to stem climate problems. An indication of financial risks is the amounts of bank lending and underwriting within and among FFA countries in 2014-2019 related to climate change activities: US$ 225 bn went to selected fossil fuel companies and US$ 243 billion to power generation companies. Japanese banks have been especially significant financiers in this regard.[35] The big four state-owned Chinese banks have reportedly been important financiers of coal mining and coal power companies since 2016.[36] This situation reflects a global phenomenon in the banking sector, whereby 35 global private sector banks alone have lent US$2.7 trillion to fossil fuel projects and companies between 2016 and 2019, i.e. after the Paris agreement was signed.[37]

Figure 4: Destination region of climate finance, by public/private and mitigation/adaptation & dual benefit splits (USD billion, 2017/2018 annual average)

Source: https://climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2019/ (website iconographic).

With looming loan defaults resulting in banks having to write off high amounts of loans, less capital will be available to finance measures for mitigating and adapting to climate change.

1.3. COVID-19 impacts worsening the situation

> "COVID-19 has shown how a system-wide shock that hits the real economy can have significant effects on economic and financial outcomes."[38]

The spread of the COVID-19 virus and the measures to contain it have varied among the FFA-plus countries, from early lockdown in China to late but massive infections in India by September 2020. The resulting societal and economic shock has affected the lives and livelihoods of millions of people in FFA countries. Governments have been struggling to balance protecting lives through lockdown, protecting livelihoods through keeping the economy open and providing various support measures to absorb the shock that came not only from within but also other countries' actions and impacts of the pandemic.

1.3.1. Economic effects of COVID-19

Disruptions on both the supply and demand sides of economies at regional, national and international levels caused by the COVID-19 control measures have resulted in unprecedented economic declines. The estimated effects of COVID-19 on the economy, investment, businesses, poverty, essential services, energy demand and CO_2 emissions have fluctuated during the course of the pandemic. In the initial stages of the disease outbreak, extraordinary financial outflows caused significant damage to many emerging markets' economies. Oil price decline and instability are hurting the economies of countries that export fossil fuels.[39]

On 24 June 2020[40], the IMF estimated that the world economy would shrink by 4.5%, which would affect ASEAN-plus countries that depend on the world economy for their exports. Mid-September 2020, UNESCAP estimated that the economy of FFA-plus countries would fall dramatically in 2020 compared to pre-pandemic estimates (see Table 1). For instance, India's economy might experience an economic decline of 4% in 2020, a reduction of 10.7% compared to earlier forecasts[41], affecting its population of around 1.4 billion.[42] The forecast of the economy of China, traditionally an important factor for the growth in the Asian region, is a GDP growth of 1.4% in 2020, which is still a 4.6% decline in real GDP growth as compared to pre-Covid-19 estimates.[43]

Government debt has also increased in FFA-plus countries to different levels. On the one hand, Vietnam saw a debt increase of 6% of GDP raising gross government debt to 59% of GDP, and on the other hand, India's debt rose by 15% of GDP resulting in gross government debt of 83% of GDP. Japan stands out with a debt growth of 30.6% of GDP, raising gross debt to 268.3% of GDP. China increased its debt by 6% of GDP, raising gross debt to 66.9% of GDP (see table 1). In the short term, increasing debt might provide the means to overcome and recover from the pandemic. In the longer term, however, misallocation of debt-related funding to business-as-usual, unsustainable practices, combined with excessive debt repayment burdens, will result in fewer resources available to reach the SDGs and the Paris climate commitments.

It is as yet hard to predict the scale of the effects of COVID-19 in 2021. The economic recovery will depend on the spread of the virus, governments' responses, the behaviour of the general public, companies and the financial sector, and the availability and distribution of a vaccine. For instance, more information is surfacing that an estimated 35% of COVID-19 patients do not completely recover from the infection, impacting a country's health system, people's capacity to return to work as well as the lives of their care-giving relatives.[44]

Post-COVID-19, supply chains might be diversifying out of China into other Asian countries to reduce the dependence on production in China.[45] At the same time, several ASEAN countries

may need to restructure their economies away from vulnerable sectors like tourism, on which they are too highly dependent.[46]

Table 1: Impact of COVID-19 pandemic on the economy, employment, government debt and poverty (September 2020)

Change in percentage due to impact of COVID -19 in 2020, compared to Pre-COVID-19 estimates for 2020	Cambodia	China	India	Indonesia	Japan	Philippines	Thailand	Vietnam
GDP growth	-8.4	-4.6	-10.7	-6.1	-6.9	-13.2	-11.2	-4.3
Employment growth	-7.6	-2.2	-8.8	-4	-0.8	-5.7	-7.7	-2.6
Government debt (change as % of GDP)	9.4	6	14.9	7.2	30.6	11.5	16	6.1
Poverty headcount ratio at $1.90 a day	0.4	0	1.3	1	0	1.7	0.1	0.1
Poverty headcount ratio at $1.90 a day (2011 PPP) [% of population]	2.9	1.1	5.2	2.8	0	5.4	2.7	1.4
Post-COVID-19 baseline estimates for 2020								
Real GDP growth	-1.5	1.4	-4	-1	-6	-7	-8.1	2.3
Employment	-5.8	-2.5	-7.5	-2.7	-1.2	-3.7	-7.6	-1.9
General government gross debt (% of GDP)	39.5	66.9	83.4	37.1	268.3	50.8	59	59.4
Poverty headcount ratio at $1.90 a day (2011 PPP) [% of population]	8.6	0.3	11	4.4	0	6.9	0.1	1.7
Poverty headcount ratio at $5.50 a day (2011 PPP) [% of population]	56.1	18.3	68.1	55.1	1.2	51.1	9.8	20.9

Source: Own composition based on UNESCAP, Assessing the impact of COVID-19 in Asia and the Pacific and designing policy responses: An Excel-based model, 14 September 2020, online format per country, https://www.unescap.org/sites/default/files/UNESCAP_Excel%20model%20to%20assess%20the%20impact%20of%20COVID-19%20and%20design%20policy%20responses_12Sept%20%281%29.xlsx : data were updated until 12 September 2020.

1.3.2. Impacts of COVID-19 on poverty in FFA-plus countries[47]

Asian countries have introduced fiscal stimulus packages to avoid negative impacts on people's jobs, livelihoods and incomes. These include:[48]

- Supporting businesses, especially the small and medium-sized businesses (e.g. subsidising rentals, tax exemptions)
- Maintaining employment, wages and unemployment benefits
- Relaxing (the implementation of) rules and requirements by companies
- Subsidies for vulnerable households and sections of the population (e.g. elderly)
- Extra support for health services

However, these measures may not be sufficient to prevent poverty from rising again. Cambodia, for instance, is expected to be hard hit because the main pillars of its economy-garments, tourism, and construction, *"are basically decimated"*, notwithstanding the small amount of COVID-19 cases.[49]

The IMF already warned in June 2020 that low-income households would be hit especially hard, reversing the progress made on extreme poverty as needed to reach the SDGs. These households depend on the informal economy, have multiple generations living together, and have governments with fewer means to fight the virus.[50] Lockdowns have resulted in many Asian migrants having to return home, either internally (e.g. India), within the region (e.g. Cambodian workers from Thailand) or from other countries (e.g. from the Arab region). This has wiped out billions of dollars in remittances, significantly affecting poor people in FFA-plus countries.[51] Remittances and income from working abroad might take a long time to recover if at all, depending on the opening up of economies, recovery, and travel restrictions.

UNESCAP also calculated that, by September 2020, COVID-19 increased extreme poverty (at $1.90 a day) in FFA-plus countries between 1.7% and 0.1%. However, China and Japan were not estimated to see extreme poverty raise. Poverty at $5.50 a day increased in all FFA-plus countries except Japan.[52] The impact has been especially severe in Cambodia, India and the Philippines, where the percentage of the population living off $5.50 a day has risen to 56%, 68% and 51% respectively (see table 1 above).[53]

The reversal of poverty reduction because of COVID-19 in the lower-income, middle-income and emerging economy Asian countries exposes the fragility of the progress made. Many people were earning incomes just above the poverty line, and in many countries, there was a severe lack of social safety nets. Furthermore, COVID-19 mortality rates might increase due to pollution, malnutrition and poverty, despite the lower vulnerability of the relatively younger populations of many countries in the region.

The extra financial resources needed to fill the poverty gap and to get people out of poverty are estimated to increase by 60% due to COVID-19 when compared to the situation previously.[54]

The SDGs call for tackling poverty *"in all its forms everywhere"*. To do so would require extra financial resources to not only address the shortfall of income and consumption but also, for instance, poor nutrition, access to basic services and an unsafe living environment.[55]

1.3.3. COVID-19 impacts on climate change and the environment

The increasing amount of people getting more impoverished also has an impact on climate-changing practices and environmental degradation in the Asian region. Illegal deforestation and burning by large scale agribusinesses have been on the rise because travel restrictions and other governmental impediments have reduced local monitoring and inspections.[56] Where poor people are leaving the cities in which they have lost their jobs, they often return to rural areas for food, energy and shelter. When left without support in rural areas, they might grow more food and use wood for fuel, purely to survive, which might impact deforestation and exploitation of natural resources. Moreover, some governments are deregulating the environmental and climate requirements for businesses. In Indonesia, the government had already proposed an 'omnibus law' to impose less stringent labour protections and environmental impact requirements to attract more corporate investment.[57] Notwithstanding opposition and long public protests from labour groups, environmental and social organisations, academics and the public, the law was voted through at the Indonesian

parliament in an attempt to boost the economy in times of the pandemic.[58] In Cambodia, the government decided to build new coal power plants notwithstanding protests from investors.[59]

1.3.4. Banks at a time of COVID-19

COVID-19 will have an impact on the essential role of banks in funding Asian economies and societies as well as their ability to contribute towards reaching the SDGs and the Paris climate goals.

Asian banks will experience some benefits of the financial and monetary policy responses to the Covid-19 measures, such as:[60]

- Lowered interest rates
- Relaxed banking regulations (e.g. relieving capital requirements and reserve requirements, waiving penalties for non-performing loans, reducing requirements to do sustainability impact assessments)
- Fiscal stimulus that benefits bank customers and corporate clients (e.g. wage subsidies and tax exemptions)
- Various measures to provide liquidity
- Implementation of supportive unconventional monetary policies, such as quantitative easing (QE)
- Delayed implementation of macro-prudential policies
- Interventions to reduce stock market volatility (e.g. prohibiting short-selling)
- Interventions to maintain foreign exchange stability or depreciate national currencies
- Measures to avoiding capital flight

Nevertheless, negative financial consequences from the COVID-19 crisis in the ASEAN countries are still expected for the banking sector, including:[61]

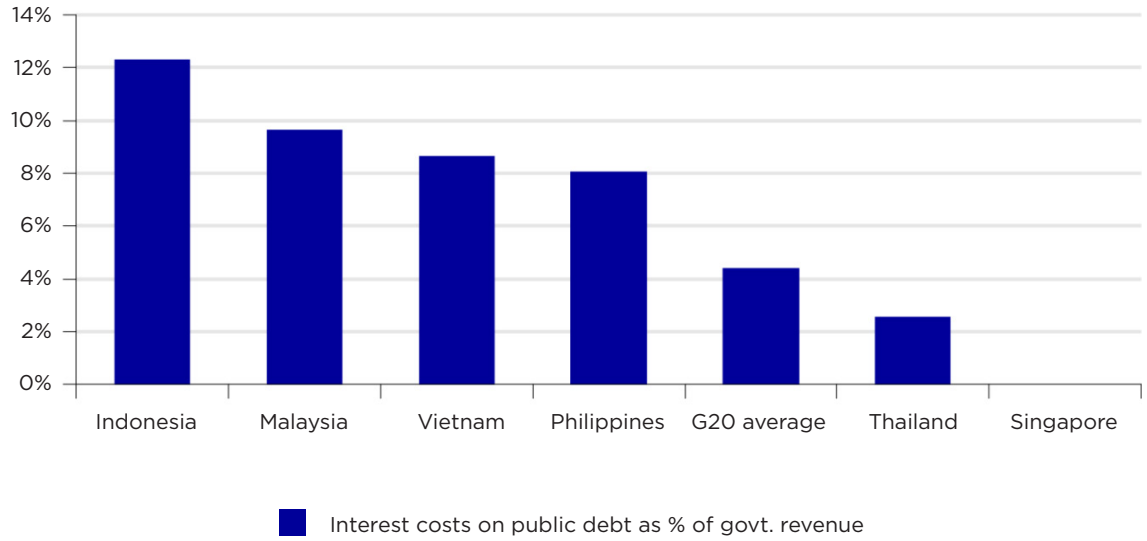
- Higher government and corporate debt and debt servicing costs
- Delays by businesses and SMEs to pay back loans
- Lower interest rates for loans
- Lowered bank fees and charges to reduce costs for businesses
- Liquidity problems
- Decreased lending activities
- Rising non-performing loan ratios that hurt banks' profitability and potential to finance and serve (small) companies and retail customers
- Supervisory advice not to pay dividends to the banks' shareholders
- Weakening and volatility of ASEAN currencies in the short term, resulting in higher or unpredictable prices for exports, imports and commodities.

Government budgets in FFA countries were already under stress before the COVID-19 period due to a growing extraordinary debt burden (see figure 5).

The surging governmental foreign debt repayment burden resulting from fiscal stimulus and currency depreciation will reduce the capacity of public budgets to support, or fund potential bailouts of, banks in order to survive the impacts of a massive economic decline.

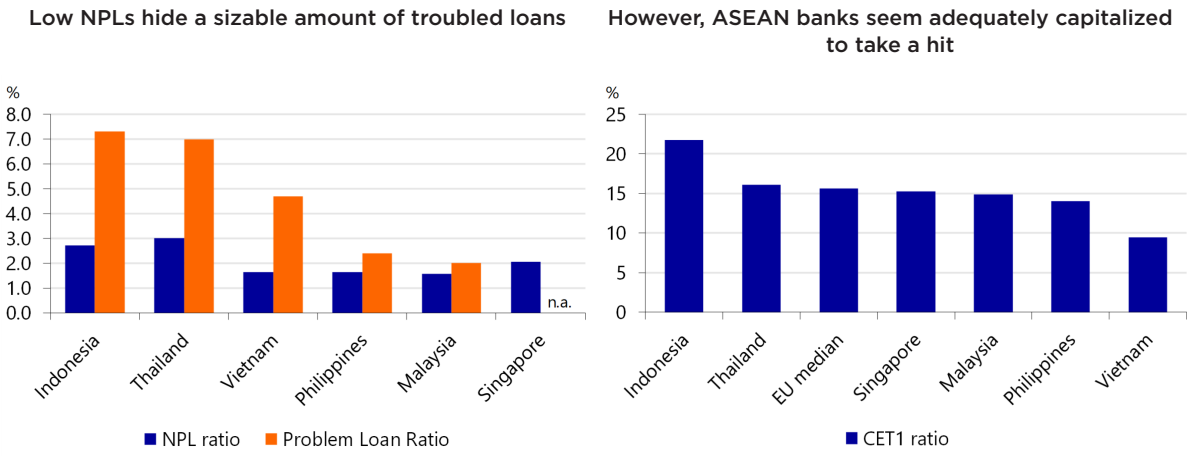
The full effect of the COVID-19 pandemic on the questions of whether, how and how long the Asian banking sector can play a role in the economic recovery will gradually become better measurable. In the first months of the pandemic, banks based in ASEAN saw their

Figure 5: High interest rate costs for government budgets in selected ASEAN countries



Source: R. Hayat, How COVID-19 will impact ASEAN: Deep recessions and a weak recovery, 19 May 2020, https://economics.rabobank.com/publications/2020/may/impact-covid-19-asean-recessions-and-weak-recovery/.

Figure 6: State of bank resilience in ASEAN countries at the time of COVID-19 (May 2020)



Source: R. Hayat, How COVID-19 will impact ASEAN: Deep recessions and a weak recovery, 19 May 2020, p. 6, https://economics.rabobank.com/publications/2020/may/impact-covid-19-asean-recessions-and-weak-recovery/.

NB: Non-performing loan ratio is the ratio of loans in default (90 days overdue) to total loans.

profits drop. While loan defaults were still limited, these banks did set aside financial buffers to absorb potential losses in the future.[62] The banking sector could be seriously affected if the COVID-19 pandemic and its economic impact continue much longer, for instance, when having lent to the hard-hit tourism and commercial real estate sectors.

Before COVID-19, ASEAN banks did not have a high percentage of non-performing loans (NPLs) but had a high amount of 'problem loans'. The banks in 6 ASEAN countries (including Indonesia, Philippines, Thailand and Vietnam) had relatively high capital buffers ('Tier 1' capital), which might allow them to withstand financial stress from extra NPLs in the short term (see figure 6).[63] These buffers are also needed when capital flows from abroad, on which Asian banks rely, decrease sharply and become more expensive.[64] Banks might have to transfer those extra costs to their customers.

COVID-19 will also impact Chinese banks operating in the FFA countries, both in China and in the rest of Asia. They have multiple branches and subsidiaries across Asia which are involved in *"investment and project loans, trade financing, and consulting services"* as well as in syndicated loans and *"cross border security issuances in various sectors including infrastructure, energy, and natural resource extraction."*[65] These are sectors not just under pressure from the economic downturn but also exposed to environmental and social problems.

The decreasing opportunities for profitable lending and services, and provisioning measures for potential troublesome loans, due to the economic downturn will test the resilience of the banking sector in FFA countries. Banks are reportedly prioritising and scrambling for the most profitable business opportunities, including servicing traditional large corporations with abusive environmental and social practices. COVID-19, therefore, makes banks in FFA countries further inclined to continue financing activities that contribute to undermining the achievement of the SDGs and the Paris climate commitments (see 1.1 and 1.2 above).

However, according to UNESCAP calculations, a transition in corporate practices towards more social and environmental sustainability and good governance (ESG), *"could create an additional 14 million jobs in Asia and the Pacific. Such jobs will be secure compared to the ones created in a business-as-usual counterfactual world"*.[66] The banking sector could play an essential role in such a transition, but this will not be possible if they also continue operating as before and during the pandemic crisis.

1.4. Conclusions for the basic elements of a forward-looking scenario by 2030

The overview of the straightforward elements for a forward-looking scenario up to 2030 predicts that banks in FFA-plus countries will face significant economic, social, climate and environmental problems by 2030 if the current trends continue without intervention.

SDGs not being met by the target date of 2030 will hamper the resolution of many social and environmental issues. Social issues of poverty, lack of social safety nets and ecological degradation that affects livelihoods are predicted to continue in the next decade.

The FFA-plus countries will not meet the intermediate targets of limiting temperature rise to below 1.5°C by 2030. Conversely, these countries are forecasted to continue contributing towards climate change in the decade to come, owing to increasing energy demands.

The COVID-19 pandemic and its significant economic fall-out are already aggravating poverty and social problems while providing opportunities for more climate harming practices. Banks

are already being affected by the loss of profits and provisioning for potential non-performing loans. The impact on banks will be more protracted, the longer the pandemic lasts.

Estimations made even before the COVID-19 pandemic called for billions of additional financing to avert a growing social, climate and environmental crisis. To finance the economic recovery from the pandemic, governmental budgets have been burdened with additional debt that will require repayment in the future.

The much-needed additional funding for achieving the SDGs, climate goals and swift recovery from the COVID-19 measures requires contributions from the private financial sector, especially banks, which are vital financiers in the FFA countries. Whether banks are well equipped to fulfil that role in an increasingly challenging and complex context will be further explored in this report.

2

UNFOLDING A FORWARD-LOOKING SCENARIO WITH A CLIMATE AND ENVIRONMENTAL CATASTROPHE AND INCREASED SOCIAL INJUSTICE

This chapter develops the detailed aspects that banks will face in a forward-looking scenario in which Asian countries are not in a trajectory to reach either the SDGs or the Paris climate commitments. It takes into account that some large banks in the region are financing companies and activities that contribute to that trajectory.

Particular attention is paid to the social aspects of such a scenario. It aims to complement existing forward-looking scenarios that have been developed to predict the consequences of continuing climate change but fail to fully incorporate the social impact as well as existing human rights problems.

2.1. Current and future impacts of climate change

Most of the economic development, production and consumption in FFA-plus economies is based on fossil fuel energy (coal, oil and gas) and extraction of natural resources. Many economic sectors that are dependent on fossil fuels are financed by loans, underwriting, shares, bonds, derivatives and other financial products. They have generated profits or financial returns for banks, financial intermediaries and investors such as shareholders and bondholders.

The CO_2 emissions resulting from such fossil fuel-based economy have already contributed to climate change. The Intergovernmental Panel on Climate Change (IPCC) has observed that they have already caused changes in the climate system. As a result, both land and ocean temperatures have increased, and there are more frequent heatwaves in most land regions. Global warming has already led to an increase in the frequency and intensity of heavy rainfall and rising sea-levels, while the impact on monsoons is currently more difficult to assess.[67] These current climate change phenomena will continue to evolve as described below.

Continuing contributions to climate change

Each of the FFA-plus countries will continue to contribute to climate change, according to their varying economic and energy models.

Indonesia, for instance, continues to be a major producer of fossil fuels (especially oil and coal)[68] for both export and domestic consumption. The country also continues to extract minerals and other natural resources. While its policy of processing as much as possible within the country itself helps extract more value and reduce the transport of raw materials[69], this further increases the need for fossil fuel-based energy.

In the case of Cambodia, coal is a vital source of the country's electricity. Several new coal-fired and dual-fuel thermal power plants are expected to be completed between 2020 and 2023[70], thus locking the country into a long term reliance on fossil fuels with subsequent impact on global warming.

China's rapid increase in CO_2 emissions after the COVID-19 lockdown was over, was the result of the swift recommissioning of coal power plants for the production of cement and other heavy industries[71]. This coal-heavy recovery by China shows its economic growth dependence on fossil fuels. China plans to increase CO_2 emissions until 2030[72]. In September 2020, China's President Xi Jinping pledged to be carbon-free only by 2060, missing the target of the Paris Agreement. This has global climate implications given that China is the highest emitter (29.4%[73]) of CO_2 in the world.[74]

The continued dependence on coal power plants in FFA-plus countries, some of which are still under construction, means that these countries will not meet the interim target for decreasing CO_2 emissions by 2030 without interventions that reverse the continuing trends.

Forward-looking scenarios by central banks

Central banks around the world, i.e. bank regulators and supervisors, have already designed scenarios modelling the consequences of climate change and whether the measures taken to reduce CO_2 emissions and climate change are sufficient. They have done so because, within their mandate, they must assess whether banks and the financial system at national and international levels risk becoming unstable when the impacts of the consequences of climate change increase. The loans, bonds, shares and other financial products financing the fossil fuel industry and related sectors could see their financial value decrease or evaporate rapidly in case the production and use of fossil fuels are forced to halt suddenly. That would have a negative destabilising effect on the banks' capital reserves, profitability, capacity to serve their clients and the economy, and perhaps their survival (see also chapter 3. on banks). Such financial turmoil and defaults would put financial stability at stake, especially if it occurred in concurrence with many large banks undergoing the same problems. That is a problem that central banks, financial regulators and supervisors must avoid as part of their mandate to preserve financial stability.

The Network on Greening the Financial System (NGFS), with central banks and supervisors as members including those from Cambodia, China, Indonesia, Japan, the Philippines and Thailand[75], has developed the following future climate change scenarios based on changes in sources of energy (see also figure 7):[76]

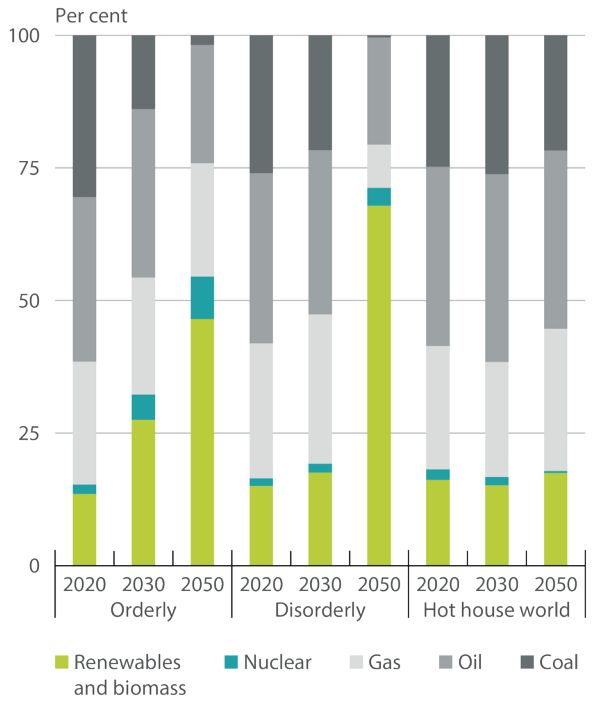
1 **AN "ORDERLY" SCENARIO**
with sufficient measures taken by 2030 up to 2050 to reduce CO_2 emissions to zero (and keep the temperature at 1.5° C)

2 **A "DISORDERLY" SCENARIO**
where actions to limit temperature rise to 1.5°C by 2050 are either insufficient, late or taken in a disruptive sudden or unanticipated way

3 **A "HOT HOUSE WORLD" SCENARIO**
where no additional transition measures are taken by 2030 up to 2050 to reduce CO_2 emissions from coal, oil, and gas, resulting in temperatures rising well above and 1.5°C-2°C, causing considerable physical damage.

Note that the NGFS scenarios are not to be considered as forecasts, but as an exploration of the risks that will affect banks and the financial sector.[77]

Figure 7: Primary energy use according to three scenarios

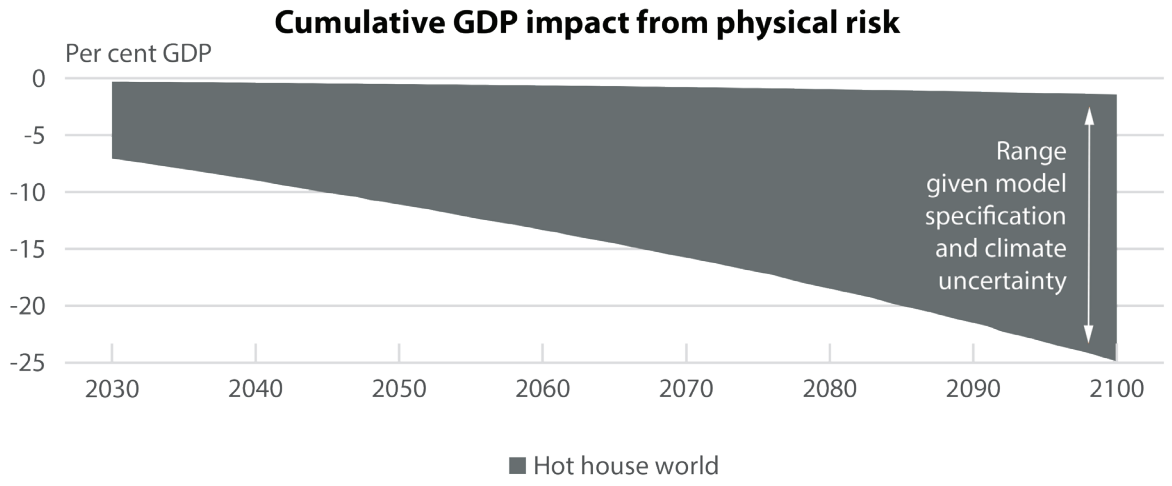


Source: Network for Greening the Financial System (NGFS), Guide to climate scenario analysis for central banks and supervisors, June 2020, p. 17, https://www.ngfs.net/sites/default/files/medias/documents/ngfs_climate_scenarios_final.pdf.

As stated in chapter 1, Asia has deviated from the trajectory of meeting the commitments of the Paris climate agreement. This report, therefore, emphasises the *"hot house world"* scenario described by the central bankers' NGFS, which assumes that substantial risks of physical damage over the medium and long term will occur by missing the Paris climate goals. This damage from climate change impacts threatens to cause a 7% reduction in global GDP by 2030, according to NGFS estimates (see figure 8). Furthermore, this scenario excludes risks related to *"high sea-level rise, extreme events and societal changes like migration and conflict".*[78]

Modelling the economic impact from intensifying climate change by 2030 can be subject to

Figure 8: Impact of climate change in a "hot house world" scenario with impact physical impacts



Source: NGFS, NGFS Climate Scenarios for central banks and supervisors, June 2020, p. 8, https://www.ngfs.net/sites/default/files/medias/documents/ngfs_climate_scenarios_final.pdf (viewed 30 June 2020).

many assumptions and therefore, various outcomes that will affect the financial sector. A scenario that takes into account all the countries' Paris pledges (the NDCs) would still result in a trajectory of temperature rise above 2°C by 2050 and only slightly reduce the projected physical risks.[79] *"The largest reductions in economic growth at a temperature rise of 2°C are projected for low- and middle-income countries and regions"*, including Southeast Asia and India, one of the reasons being the decline of the tourism sector.[80]

Existing central bank scenarios have so far either entirely or partially ignored the impact of the COVID-19 crisis. Worsening economic conditions have been projected from the economic, financial and social fallouts of the pandemic, which are estimated to have a significant influence many years into the future. The reduction in CO_2 emissions during COVID-19 lockdown may be transient and limited to periods of relative economic inactivity, as the renewed increase in CO_2 emissions in China demonstrates.[81] A forward-looking scenario up to 2030 will also depend whether measures taken by governments to deal with the pandemic have been aiming at reducing CO_2 emissions or *'building back better'*.

2.2. Social impacts from continuing climate change

Like most other climate change scenarios and models, the "hot house world" one described above does not factor in all impacts and interactive dynamics of social consequences.[82] It therefore underestimates the climate change-related damage caused to countries with low resilience and adaptability. The forward-looking scenario in this report aims to bridge this gap by also taking into consideration the adverse social impacts of climate change.

Although the social consequences are not always quantifiable, the development of standardised "Shared Socioeconomic Pathways" (SSPs) can assist in modelling different climate change mitigation scenarios. SSPs, however, provide quantitative projections of only three variables – GDP, population, and urbanisation rate[83] - excluding many other social aspects.

In its 2018 report, the IPCC developed a better methodology (see below) to identify the consequences of global warming-induced temperature rises of 1.5° C or higher for people and countries in an attempt to *"strengthening the response to the threat of climate change, sustainable development, and efforts to eradicate poverty."*[84]

Consequences of the continuing rise in sea levels

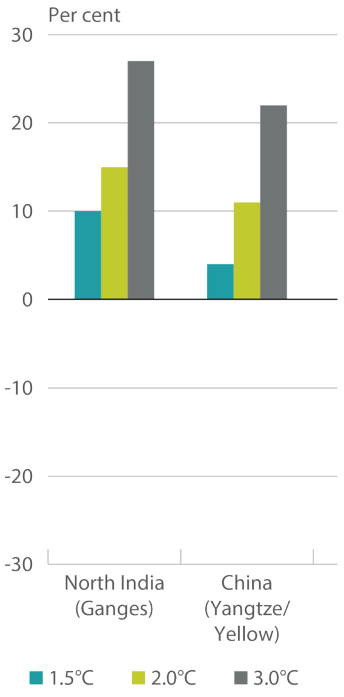
Asian countries are especially vulnerable to rising sea levels resulting from melting ice caps and glaciers due to climate change. The IPCC estimates that, relative to the period between 1986 and 2005, sea levels can rise by almost 0.26-0.77m in the event of a 1.5°C global temperatures rise.[85] Sea levels will continue to rise, even after CO_2 emissions have reached net-zero.[86] A July 2020 study warns that glaciers will continue melting even if greenhouse gases are reduced today, making coastal flooding and permanent inundation more frequent.[87]

The FFA-plus countries are vulnerable to a sea-level rise given their many (small) islands and the long coastlines[88] along which sit the capitals, major cities, smaller cities and villages of those countries. These are expected to be sinking, flooded and disappearing due to climate change events. It is estimated that *"more or less 10 million people living in Bangkok will be*

affected by the implication while the sea level rises"[89] since 30-40% of the city is at risk of sinking underwater. Estimates indicate that 26.9% of Jakarta will be covered by seawater by 2025, increasing to 35.6% in the longer term. The Government of Indonesia, in anticipation of a similar threat, planned to move the capital to Kalimantan.[90] The move has now been postponed due to the COVID-19 outbreak.[91] 25% of Vietnam, with its long coastline, is estimated to sink underwater if climate change continues. Building along the coastline, however, continues unabated.[92] Rising sea levels are already affecting the coastal city of Manila, and projections show that large parts of the Philippine capital are at risk of submersion in the absence of action against climate change.[93]

These social consequences of sea-level rise will be the displacement of people, disruption of businesses and employment, physical damage to housing from flooding, and other related consequences. Millions of people, ranging from large cities up to fishing communities, will lose their homes, belongings, communities and livelihoods. Large migration waves will influence many Asian regions, posing social, economic, environmental and political challenges.

Figure 9: Changes in annual maximum discharge, relative to 1986-2005 (Risk of flooding with a rise in temperatures)



Source: NGFS Climate Scenarios for central banks and supervisors, June 2020, p. 22, https://www.ngfs.net/sites/default/files/medias/documents/ngfs_climate_scenarios_final.pdf.

NB: The "discharge" is the water flow in a river or watershed

Other water-related impacts from climate change

Continued global warming threatens to increase heavy rainfall and river flooding, exacerbating the effects of Asia's regular typhoons, monsoons or cyclones. The regions around the Ganges in Northern India and the Yangtze and Yellow river in China are at a significantly higher risk of such flooding (see figure 9). High river flows are also expected in South and Southeast Asia[94] *"Tropical cyclones are complex to model, but emerging evidence suggests an increase in their intensities (110% higher wind speeds and 14% higher rain rate) across basins due to global warming. There is less agreement on the change in frequency".*[95]

Oceans and seas have already undergone unprecedented acidification and changes to their carbonate chemistry due to their absorption of carbon dioxide and warming up. A scenario where temperatures rise 1.5°C or more will therefore endanger a wide range of marine ecosystems, species and organisms. Small-scale fisheries in

tropical regions, which depend heavily on the habitat provided by coastal ecosystems such as coral reefs and mangroves, will be increasingly affected. People dependant on the fishery and aquaculture sectors will lose their food security and income.[96]

Melting ice and rising sea levels related to climate change, therefore, threaten to cause loss of livelihoods, crops, agricultural land (due to salination), fish stocks, property, infrastructure and real estate. Forced displacements and migration, disrupted economic activities and unemployment, increased poverty and perhaps conflicts for scarce water resources are some of the potential issues facing people, families and communities.

Impacts of droughts and heat on people

Heatwaves and droughts due to global warming have already affected agriculture and food production[97] and will intensify further in regions more severely affected by climate change, according to projections. The consequence will be net reductions in yields of soy, rice, maise and cereal crops. Food quality will also be affected by a decrease in the *"CO_2-dependent nutritional quality of rice and wheat"*, amongst other crops in South-East Asia.[98] This puts a large number of farmers, households and livelihoods in the FFA-plus countries at risk, affecting access to food and undermining nutrition and health.

A wide variety of flora and fauna are sensitive to fluctuating temperatures in their native habitats and hotter, drier weather puts them at the risk of extinction. Forest fires resulting from global warming threaten to intensify loss of biodiversity.[99] Invasive species and pests will, on the other hand, proliferate. Such phenomena affect people and livelihoods dependent on biodiversity in nature, from food gathering to tourism. Forest fires affect people's respiratory health, placing them at higher risk of coronavirus infections.

The heat will also affect open-air workers, such as farmers and construction workers.[100] Their working conditions will become harsher, affecting their health and reducing their productivity. Some open-air work might become impossible, depriving farmers and open-air workers of income and access to food. Similar challenges face outdoor jobs in the tourism industry, which might impact women and men differently.

Heat-related illnesses and deaths will increase with rising temperatures. In many tropical and sub-tropical coastal cities, the health effects of heatwaves are amplified through the combined increase in humidity and heat above body resilience.[101]

Overall social impacts of climate change

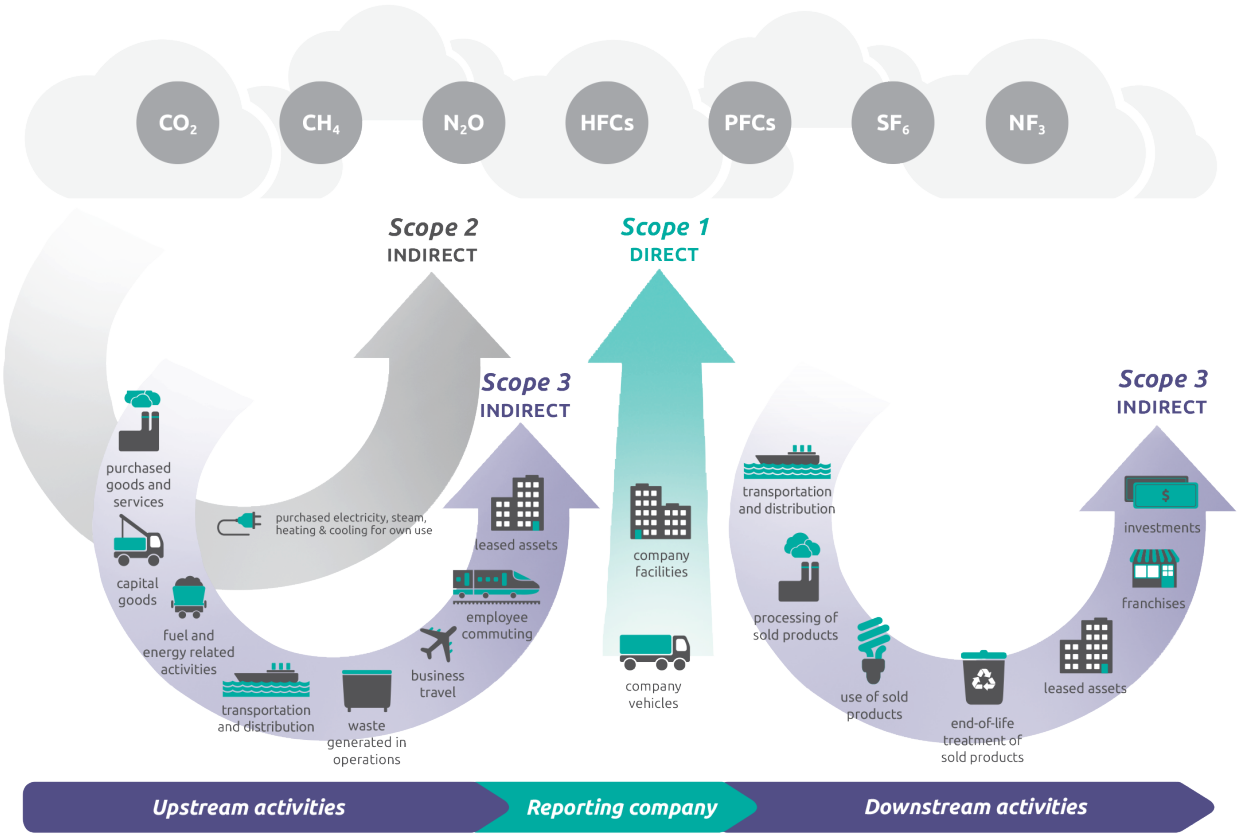
The above-described impacts of continued global warming, with rising temperatures and worsening weather conditions, on the environment, people, communities and societies will have substantial economic and social consequences by 2030. Cumulative effects will be felt on poverty, inequality, hunger and social upheaval, and potential political unrest and conflict. Especially in Asia, economically disadvantaged people and communities are particularly at risk.[102] Women with traditional roles to care for their families can be especially affected by increased food insecurity and malnutrition, health problems of family members, damaged houses, loss of agricultural production and livelihoods, and migration.

Responses to climate change

It is difficult to accurately predict how people, businesses and governments will respond to the increasing impacts of climate change.

One adaptive response might be changes in consumer and dietary preferences in FFA countries and their export market countries. That will disrupt current global value chains, in which FFA-plus countries are involved in and economically dependent on. This will spill over on the income of workers in sectors like agriculture, industry and services and transport systems, affecting their access to food, healthcare and education. Existing problems of land conflict and land grabbing might continue in the search for new profitability production and business models.

Figure 10: Impact of the full lifecycle of value chains on greenhouse gas emissions



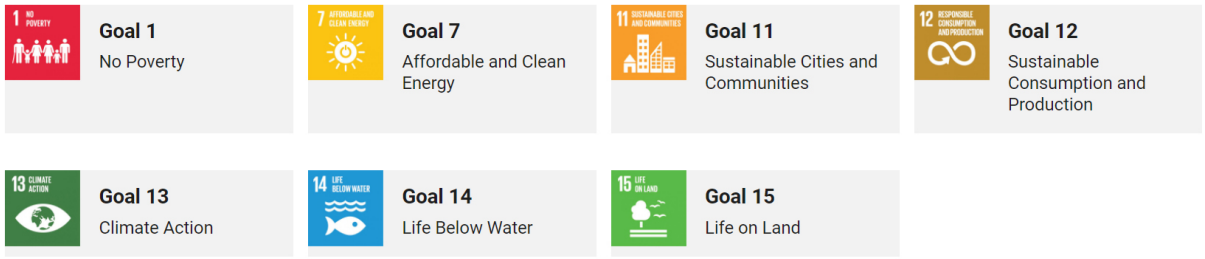
Source: World Resources Institute & World Business Council for Sustainable Development, Technical Guidance for Calculating Scope 3 Emissions - Supplement to the Corporate Value Chain (Scope 3) - Accounting & Reporting Standard, 2013, p. 6.

Harnessing more renewable energy to adapt to climate change will require more solar power stations, windmill parks, dams for hydropower, bioenergy geothermal energy power plants, and batteries. Building these large energy production systems has proven to be associated with poor working conditions, poverty wages and other social problems. Extracting minerals or constructing infrastructure (like dams) for renewable energy cause pollution, and displace indigenous communities or deprive them of livelihoods through killings, threats, intimidation,

land grabs without sufficient compensation.[103] The mineral requirements might result in an excessive and exhaustive mining boom which can then cause stress in new supply chains, while waste from solar panels is difficult to recycle.[104]

In conclusion, the social impact of continued climate change will, in the next decade, undermine the fulfilment of human rights, improvement of social justice and progress in achieving the SDGs (see figure 11).

Figure 11: Sustainable development goals related to climate change



Source: UN Environment Programme, Cut global emissions by 7.6 per cent every year for next decade to meet 1.5°C Paris target - UN report, Press Release, 29 November 2019, https://www.wri.org/blog/2015/12/insider-understanding-paris-agreement-s-long-term-goal-limit-global-warming

2.3. Continued environmental degradation

FFA-plus countries have experienced many aspects of deteriorating environmental and ecological conditions, which will worsen without interventions being made to reverse the trend. They will be aggravated by continuing climate change, as has already been the case. The phenomena of environmental degradation described in the following section will have substantial economic and social consequences if they persist through the next decade. These problems are, in turn, related to modes of economic production and consumption that have been financed by banks and investors.

Widespread waste pollution

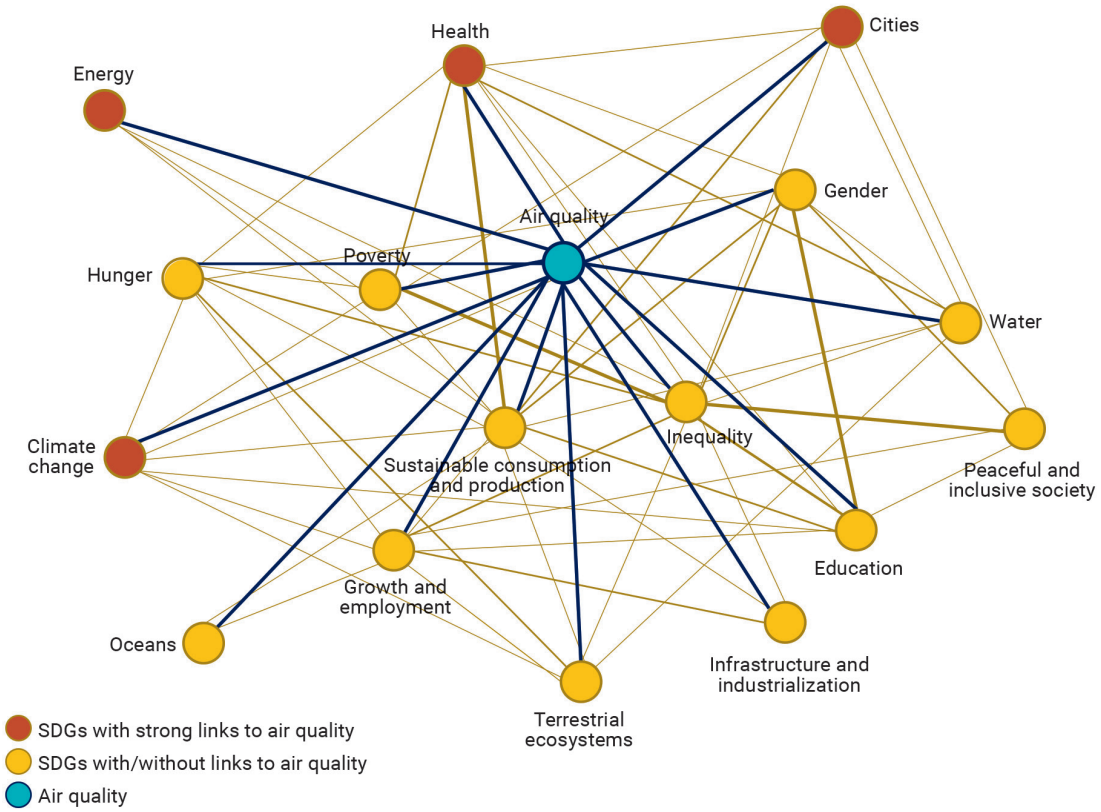
The pollution from waste on land, water, rivers and seas has already been significant. As an example, substantial plastic waste, including single-use plastics, have littered and filled rivers, beaches, bays, seas and oceans, and affected potable water quality and availability.[105] If this trend continues, countries and people will face significant impacts on the environment and high clean-up costs in their efforts to limit the consequences. Whether ASEAN's initiative to deal with plastic waste will have a sustainable effect remains to be seen.[106]

Air Pollution

Already a widespread current problem, air pollution will increase over time. Billions of people living in South and East Asia have been exposed to levels of air pollution that pose significant risks to their health.[107] The haze problems from palm oil plantation fires are a well-known annually

recurring problem in Indonesia and its neighbouring countries. Cross border haze also reportedly occurs due to the burning of maize in Myanmar and sugar cane in Cambodia. Burning by farmers in the surroundings of New Delhi has resulted in millions being annually subject to a thick haze in the city. The progressive rise in the levels of fine particulate matter will further damage human health, food production, water security, and even affect monsoon rains in Asia.[108] Reaching the SDGs, in turn, will become more challenging in the light of these effects (see figure 12).

Figure 12: Relationship between air quality and the SDGs



Source: UNEP and Climate Air & Clean Air Coalition, Air pollution in Asia and the Pacific: Science-based solutions, p. 31, https://www.ccacoalition.org/en/file/5802/download?token=dBM5KOkC .

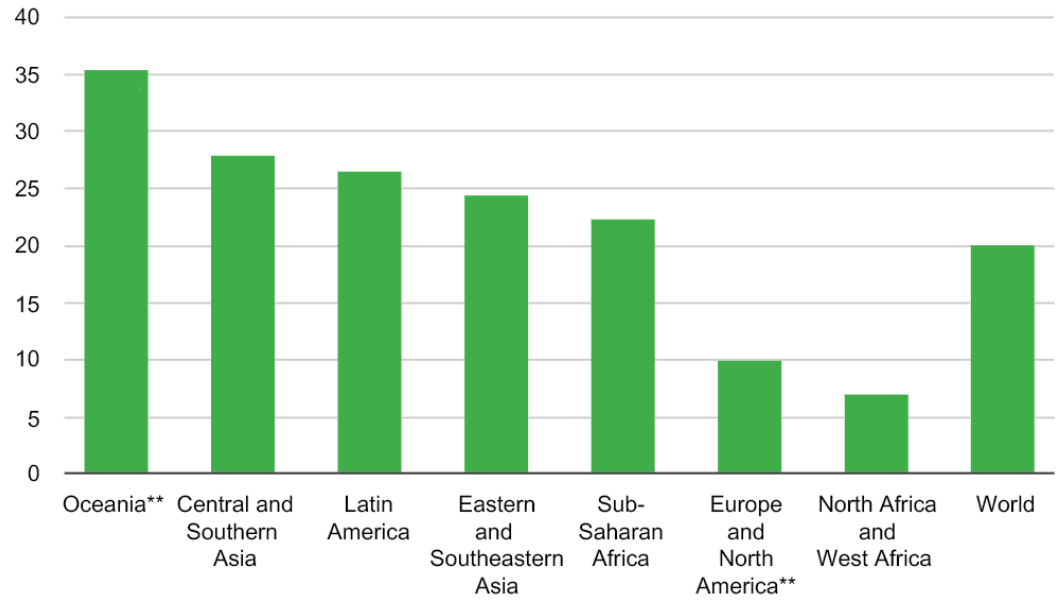
Bio-diversity loss, rapid deforestation and land degradation

The ASEAN region is one of the world's most biologically diverse areas (it includes the FFA countries Cambodia, Indonesia, the Philippines, Vietnam). ASEAN's biodiversity covers large parts of the world's mangrove forests, coral reefs and plants and animals in forests and water. However, most flora and fauna have seen their numbers severely reduced over the past decades, with thousands of species predicted to undergo extinction in the future.[109]

Since forests host most of the planet's biodiversity, a significant negative impact on biodiversity will come from continued deforestation, forest degradation and effects from climate change (e.g. invasive species, forest fires).[110] This has already occurred at alarming rates, e.g. in remote areas as well as densely populated areas of Southeast Asia, India and China.

Large scale commercial agricultural expansion and logging for palm oil, rubber and logs have been the primary drivers of deforestation and loss of biodiversity in South-East Asia. While

Figure 13: Proportion of land in a degraded state by region (2000-2015)



Source: FAO and UNEP, The state of the world's forests – Forests, biodiversity and people, [May] 2020, p. 96, https://wedocs.unep.org/bitstream/handle/20.500.11822/32472/WF20EN.pdf?sequence=1&isAllowed=y

these provide high profitability,[111] biodiversity is not only essential for the resilience of the human food system, but millions of people also depend on it for their livelihood.[112] Destruction of habitats, more intensive agricultural practices and other intensified interactions by people with nature has been associated with increased risks of new zoonotic diseases.[113]

Commercial deforestation is likely to continue unabated since governments often fail to protect forests in view of short-term economic gain. The COVID-19 pandemic has made the deforestation problem more acute as people turn to forests to clear land for food production and survival.[114]

Agricultural practices and land tenure systems have similarly been causing severe land degradation in the FFA-plus countries (see figure 13) for a long time. This trend is likely to continue with population growth, migration, land grabbing and conversion to real estate. Land degradation will have severe consequences like soil and hill erosion, loss of soil fertility, soil contamination, water shortages and increased costs of land restoration. Agricultural production, farming incomes, and the communities' access to food and sufficient nutrition will, in turn, be reduced.

2.4. Increased human rights violations, inequality, and social injustice

Most forward-looking scenarios that predict the consequences of climate change tend to ignore social issues like breaches of human and labour rights, social injustice, and non-achievement of SDGs. The capacity to tackle and adapt to climate change, however, will be hampered by the prolongation of these social issues into the next decade.[115] Forward-looking scenarios, therefore, need to integrate the future development of social sustainability issues, as it will affect economic growth, people's income and well-being, societal cohesion, and political stability in the coming decade. This context will influence how banks can operate in the Asian region.

2.4.1. The state of human rights and social problems

Social problems and breaches of human and labour rights are significant problems in FFA-plus countries. Poor governance, irresponsible government policies, weak laws or the lack of enforcement of protective social laws lead to a state of social precariousness, amongst other problems. A poor state of the economy or abusive practices of private corporations (financed by the private financial sector) frequently result in social problems and violations of human and labour rights.

The political and economic situation, aggravated by the consequences of COVID-19, is likely to prevail in the next decade. The reported lack of progress towards the SDGs by 2030 further reflects this situation.

Various human rights abuses by governments

Governments in FFA-plus countries are involved in significant human rights abuses. Amnesty International described the situation in 2019 as follows:[116]

- Repression of civil and political rights, such as:
  - freedom of expression (including through the media)
  - freedom of association for citizens, opposition politicians, human rights defenders and activists, through related repressive laws and abusive use of judicial powers (police surveillance, illegal detention, false convictions, torture, disappearances, killings and deaths in prison)

  Such repression and shrinking civic space have taken place in countries like Cambodia, China, India, Indonesia, Thailand, the Philippines and Vietnam.
- Human rights violations against ethnic minorities through violence, illegal and arbitrary detentions as has happened in countries like China, India, Indonesia, and Thailand.
- Oppression of freedom of religion occurred in countries like China and India.
- Oppression of the rights of lesbian, gay, bisexual, transgender and intersex people (LGBTI), as has occurred in countries like China and India.
- Human rights were also breached by the corruption that, for instance, results in illegal land concessions, forced evictions and land grabbing for agro-industrial development, in countries like Cambodia, Indonesia and the Philippines.
- Discrimination against refugees and asylum seekers in Thailand, and against foreign workers in Japan.
- Lack of protection against discrimination and violence against women, in countries like India and Thailand.
- Violence against, and killings of suspected drug users in the Philippines.
- Labour laws that restrict workers' and union rights, arbitrary criminal charges against trade union leaders, and repression of the right of freedom of association and the right to organise.
- Disruption and eviction of communities, and loss of jobs and livelihoods due to the building of new large-scale dams promoted by governments as is the case in the Mekong region.

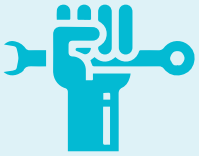
Rising populism and nationalism resulting in breaches of human rights and disregard of climate mitigation commitments is a current feature in FFA-plus countries like the Philippines and India.

Labour right violations

Serious labour rights' violations are occurring throughout the economies of FFA-plus countries:

CHILD LABOUR[117]

Labour by children 5-17 years of age is the highest in India (5.8 million), mostly in agriculture. Child labour negatively affects the education and futures of children who are combining school and work, or not going to school at all.[118]



VULNERABLE EMPLOYMENT VS LABOUR RIGHTS AND DECENT WORK

While economic growth in Asia had lowered unemployment by the beginning of 2020, vulnerable employment was still estimated to be almost 50%. Many people still had to *"take jobs with poor working conditions that do not generate stable incomes nor safeguard them and their families against poverty in the longer term".* The impressive economic growth in ASEAN countries has resulted in only minimal improvement of policies for unemployment benefits, minimum wages and collective bargaining, with disproportionate impact on female workers, notwithstanding some efforts.

WORKING HOURS

The average worker, especially those in low-paid jobs, has working hours that are the highest in the world: 46.4 hours per week in Southern Asia and 46.3 hours per week in Eastern Asia (2017). In Eastern Asia, almost one in five workers has been working over 60 hours per week.[119]

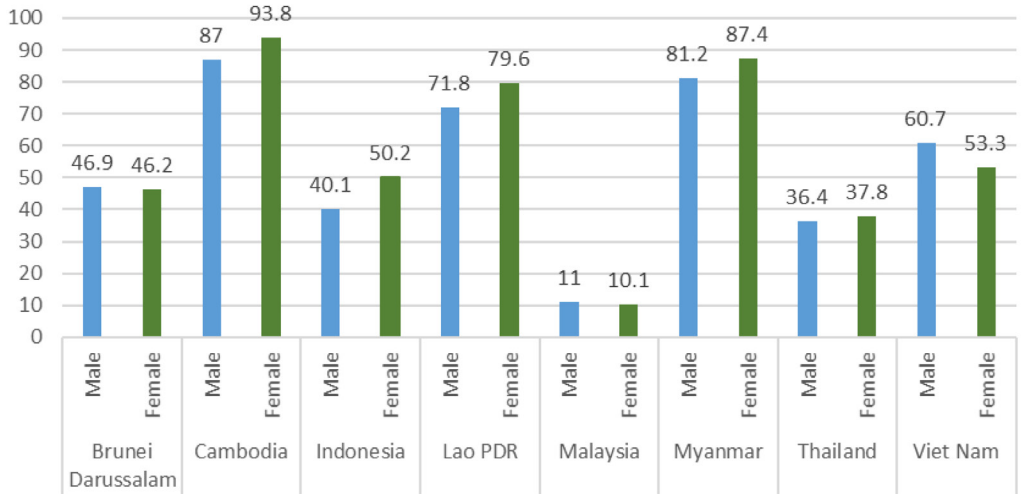
INFORMAL WORK

Some, but not all, ASEAN countries still have sizeable informal employment in their economies, contributing to poor working conditions. Although figures are not always available or comparable, ASEAN reported that on average, informal employment ranged from 37% in Thailand, 44% in Indonesia, 57% in Vietnam to 90% in Cambodia.[120] In these countries, informal employment is higher for women (except Vietnam) and in the countryside than in urban areas (see figure 14).

In India, according to a 2017-2018 estimate, self-employment constituted 52% and casual workers 25% of overall employment, leaving only 23% regular salaried and wage employees.[121]

In China in 2018, the ILO estimated that more than 50% of the workforce in cities was in the informal sector, *"ranging from freelancers and private contractors to migrants working without formal employment contracts and proprietors of small-scale private enterprises".*[122] Most of them are, willingly or unwillingly, not covered by social insurance, including health care and a pension plan.

Figure 14: Informal employment rate, by sex, in ASEAN according to country reports (published 2019)



Source: ASEAN, Regional study on informal employment statistics to support decent work promotion in ASEAN, December 2019, p 57, https://asean.org/storage/2012/05/13-Regional-Study-on-Informal-Employment-Statistics-to-Support-Decent-Wo....pdf (viewed 10 July 2020).

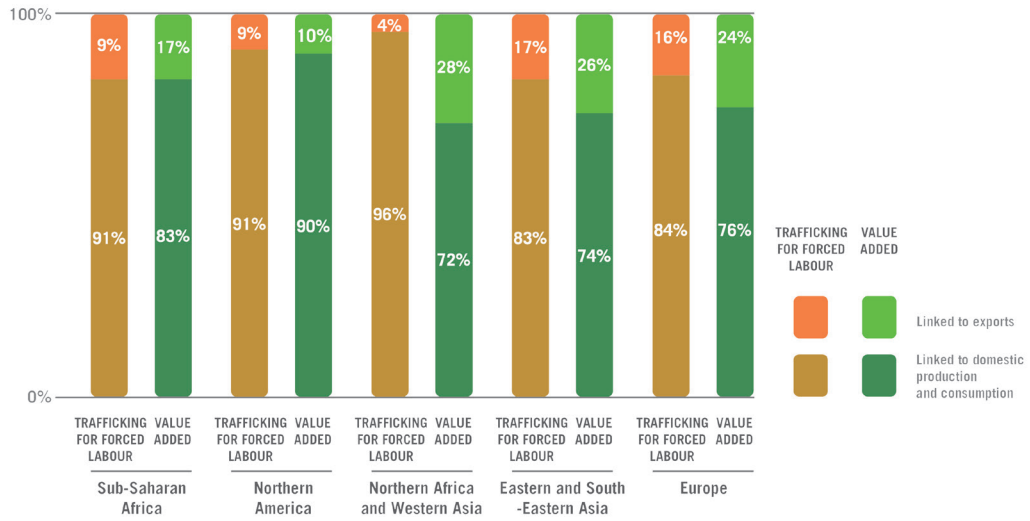
GENDER INEQUALITY

Women make up a disproportionally large share of vulnerable workers in Asia. The opportunities for women to earn a good income from work while performing their dual roles as earners and family caregivers are therefore more limited.[124] Women still face discrimination at the workplace, ranging from lower wages and lack of opportunities to sexual harassment and violence, and lack of participation in important decision-making institutions. Women migrants and domestic workers in and from the ASEAN region experience violence and harassment, while they have low incomes, social protection and access to services and justice.[125]

FORCED LABOUR AND MODERN SLAVERY

Illegal informal employment is often the result of forced labour and trafficking for forced labour. Trafficking within supply chains in East and Southeast Asia happens predominantly for production for domestic consumption (see figure 15). When for exports, an estimated 48% of trafficking for forced labour happens for the direct supply chain, while the rest is for the indirect supply chain.[123] The problem is that such modern slavery and abuse of migrants is easy to hide in the region. The consequences include meagre wages, lasting poverty and diverse social issues from terrible labour conditions.

Figure 15: Estimates of trafficking for forced labour and value added for exported goods and services, and domestic demand, by region (2015), % of the total estimated trafficking



Source: Ending child labour, forced labour and human trafficking in global supply chains: International Labour Organization, Organisation for Economic Co-operation and Development, International Organization for Migration and United Nations Children's Fund, 2019, p. 14, https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---ipec/documents/publication/wcms_716930.pdf .

PROBLEMS BY SMALL SCALE FARMERS

Land-grabbing affects smallholder farmers, depriving them of their livelihoods while subjecting them to harassment and human rights abuses (e.g. in Indonesia and the Philippines). Informal and intricate supply chains in the agribusinesses sector have led to meagre incomes for farmers and problems of indebtedness. Smallholders with no access to finance are excluded from the ever-dominating global supply chains. Displacement and rapid land conversion from agricultural to residential lands are problematic processes happening in the Philippines.[126] Vested interests, both domestic and foreign, are hampering the progress of legal frameworks to prevent land grabbing and human rights abuses in agribusiness supply chains.

LABOUR AND HUMAN RIGHTS ABUSES AT MULTINATIONAL ENTERPRISES

Reports indicate human and labour rights violations occurring throughout the long supply chains and operations of multinational and domestic enterprises which are linked to many large, small and informal companies. Companies in a few particular sectors are more likely to engage in gross abusive practices. These include garment, agriculture, forestry, mining and extraction, and value chains of many consumer goods linked to the retail sector.

Abuses at the workplace along the supply chain include unpaid working hours and overtime, flexible contracts and arbitrary dismissals, poor health and safety protection, little to no social insurance, discrimination and sexual harassment, and a ban on independent trade unions.

Repression of union rights' of freedom of association and the right to organise, non-living wages, short term or flexible contract employment, non-application and non-enforcement of labour laws, sexual harassment and police interventions reportedly happened at the workplace in countries like Cambodia, India, and the Philippines.

Communities subject to human rights breaches from companies also experienced land grabbing for new plantations (e.g. for palm oil, agribusinesses), in addition to water, land, air or noise pollution, deforestation and other deprivation or destruction of livelihoods or religious places, and violence, including killings by corporate security guards.[127]

The Corporate Human Rights Benchmark notes that the majority of companies for which it investigated serious allegations of human rights abuses in 2019 were headquartered in OECD countries. However, the alleged abuses themselves occurred in developing countries, especially India (19), Indonesia (16) and China (15).[128]

Companies responsible for such abusive practices often ignore human rights policies or preventive measures as required by the UN Guiding Principles on Business and Human Rights. They also fail to implement (sufficient) due diligence throughout their (global) value chains as required by the OECD Due Diligence for Responsible Business Conduct guidance[129] or take remedial actions.[130]

2.4.2. Continuing and new social and human rights problems in the future

Upcoming social challenges in FFA countries will interact with the social consequences of climate change and environmental degradation as well as the impact of COVID-19. Together with the reported lack of progress in the implementation of SDGs (see chapter 1.1), the forward-looking scenario in this report incorporates the diverse human rights and social issues described above because they will impact the evolution of the economies and societies of the FFA countries in the next decade.

The impact of COVID-19 reinforces the perpetuation of social injustice (see also Chapter 1)

The economic and societal shock from the pandemic has reinforced the weaknesses in the social structures in FFA countries. Examples include weak social security systems and lack of access to essential public services. The large informal economy, low wages and poor

NEW CHALLENGES

In the next decade, FFA-plus countries will increasingly face challenges from an ageing population as already being seen in Japan with high health and care costs, and worker shortages. In countries with little to no old age social security, the challenge will be to prevent poverty and exclusion from basic services by the elderly.

The economy will need structural changes to remain competitive and become sustainable by creating decent green employment and high-income jobs. New technology (robotisation, artificial intelligence, Fintech) and moves to the higher skilled and services sectors will be at the expense of jobs in agriculture and fishery sectors --which are still the relatively highest job sectors. Industrial policies and education/ training strategies developed by the governments and/or corporations can promote a smooth transition.

These structural changes will need to be aligned with achieving the Paris climate commitments and SDGs to avoid an economic backlash in the medium term.

health services have deprived many people of their fundamental human rights and left them vulnerable to immediate and long term negative impacts of COVID-19.[131] People are starving and will continue to starve due to lost incomes and lack of access to food.

The FFA-plus countries' dependence on global supply chains makes employment and incomes vulnerable to the global economic recession, with likely economic restructuring already visible during the pandemic:[132] Trade shrunk about 20% by mid-2020 in Japan, India, and the Philippines. The garment, footwear, electronics and agricultural production in FFA countries for global supply chains were reportedly affected by cancellations and reduced demand overseas.

Such trends of changing supply chains might continue in the coming years and dramatically increase the already precarious positions of many workers suffering from excessive overtime, unpaid wages, and harassment. Unemployment resulting from the economic impact of COVID-19 is causing the movement of garment workers out of cities and farmers towards the cities.

The decline in the tourism industry and remittances from work abroad will deprive many people in ASEAN countries and India from income. The economic recession, expected to continue into the next year, will reduce new job opportunities for the young, raising poverty and inequality.

Governments dealing with the COVID-19 impact and recovery might take the opportunity of pushing through pro-business policies that relax (sustainability-related) laws and regulations

while stifling civic space. The Indonesian government argued successfully that the Corona pandemic was the time to reform the Indonesian economy through its proposed omnibus law that includes a dilution of labour protection and environmental assessment by companies[133] at the expense of labour rights implementation and environmental responsibility. Lockdown measures and travel restriction have already prevented sufficient inspections and enforcement of social laws.

Few governments are taking actions to 'build back better' by which their financial support and fiscal stimulus would promote the achievement of the SDGs and the Paris climate commitments. On the contrary, risky investments have been attracted, such as coal power plants with Chinese investments.[134]

The COVID-19 crisis and its longer-term impacts are worsening the already existing situation of unfairness. In many Asian countries, this also means rising populist politics and nationalism which then results to greater injustice and inequality that breed social unrest, discrimination and political upheaval while undermining the political will to tackle the unfolding climate and environmental tragedy.

2.5. Conclusion: The continuation of social injustice and unfairness until 2030

By paying particular attention to the social aspects, the forward-looking scenario by 2030 in this report complements existing climate change scenarios. The following features will have to be taken into account by banks operating in FFA countries (see also next chapter):

- The physical risks from continued climate change will decrease economic growth, aggravated by the economic effects by COVID-19.
- Rising sea levels and acidification of oceans will flood many cities, and destroy fishing communities and livelihoods along the coastlines and rivers.
- Increasing heavy rainfall will cause crop failures and reduced access to food, and destroy properties and livelihoods, again forcing people to migrate.
- Intensifying droughts and heat will affect access to food and health, as well as an increase in deforestation, land grabbing and biodiversity loss.
- Widespread pollution of land, water, rivers and seas will continue to degrade the environment and affect people's health and resistance to illnesses like COVID-19.
- Continued labour rights violations will sustain severe levels of child and forced labour, lack of decent work and income, large informal employment with low wages and no social security, thus maintaining and raising high poverty levels and unjust working conditions.
- Continued discrimination and abusive working conditions for women will reduce women's resilience and contribution to society and the economy.
- Continued land grabbing and exploitative commercial behaviour against millions of small scale farmers will lead to increased social injustice and poverty in rural areas with consequent migration to cities.
- Labour rights and human rights abuses that continue to be practised by multinational corporations and throughout the supply chain will have harmful impacts on incomes, health and living conditions of the workers as well as the communities living in the vicinity of extracting or processing operations. Such exploitative practices will increase the profits to the owners and shareholders of the corporate conglomerates, thus raising inequality.

- The economic downturn due to COVID-19 is likely to increase the precarious situation of many workers and poor people for the coming years, including a decline in remittances and new jobs for young people, without certainty what the outcome will be by 2030.
- The cumulative effects of the above impacts will increase poverty and inequality by 2030, severely affecting disadvantaged populations and women, particularly those with traditional family care-giving responsibilities.

Overall, without strategic change by all actors involved, the forward-looking scenario up to 2030 is one of an environmental tragedy, temperature rise above 1.5°C and aggravated social injustice. This tragic and unfair scenario implies severe impacts on the banking sector, as is explained in the next chapter.

3

THE RISKS AND IMPACTS FACING BANKS IN A SCENARIO OF ENVIRONMENTAL CATASTROPHE AND SOCIAL INJUSTICE

This chapter describes how banks that are lending within and among FFA countries will face various new risks and impacts in the next decade in case the forward-looking scenario described in the previous chapters materializes. Banks are especially vulnerable if they continue operating in a business-as-usual way. Bank strategies and risk assessment methodologies have as yet not acknowledged many of these existing future social and environmental problems.

The consideration of additional and longer-term risk factors might be difficult for banks In the times of COVID-19, but not doing so may ultimately backfire in the longer term.

THIS CHAPTER PROVIDES AN OVERVIEW OF:

1. Why banks have difficulties recognizing existing and upcoming social and environmental risks
2. How a forward-looking scenario translates into credit, market and operational risks for banks
3. Which new risks come from regulators and other stakeholders
4. Why banks need to look beyond risks and financially contribute towards achieving the SDGs and climate mitigating targets

3.1. Bank's business as usual

The absence of sufficient progress on climate mitigation, SDGs, human rights and environmental protection needs to be directly linked to the lack of change in detrimental corporate, consumer and governmental behaviour, and to the continued financing of such behaviour. Such financing results from lending practices by banks in FFA countries, which have been traditionally characterized by:

1) **Neglect of social and environmental impacts**: Banks' business models and lending practices do not include due diligence instruments and responsibilities that assess the negative impacts on society, people and planet from borrowing companies, (infrastructure) projects and other activities. Large banks' computerized operational instruments are focused on financial risks and profits while keeping shareholders satisfied with ever-higher returns. They are not fully equipped to identify and assess social and environmental long term impacts. In case there are close, or corrupt, links between the bank and the corporations it finances very few questions are raised during the loan assessment process. Nor do banks have an effective strategy implemented by the whole management and operational systems, on how to contribute, and be aligned with, the Paris climate goals, the SDGs and respect of human rights. In some FFA-plus countries, banks have started to develop green and sustainable policies, but many have been struggling to implement them. Due to the pressure to survive the economic crisis from COVID-19, they may have poor strategies, or little willingness, to look at other, longer-term sustainable business models.

2) **Uninformed risk methodologies**: Banks' risk assessment models for loans, and own stress tests, are designed to calculate financial risks to the bank and avoid non-performing loans, i.e. potentially financial or "material" losses for the banks. The forward-looking timespan is traditionally a few years or as long as the loan may last. Those traditional risk models and stress tests completely or partially ignore the harmful climate and environmental or exploitative social practices by the borrowers because these practices might contribute to the profitability of the borrowing company, and thus the repayment of the loan to the bank. Only obvious social and environmental material risks are therefore considered.

   Traditional risk assessment models are based on data from the past (history-based data) to assess future risks. However, the impacts of socially and environmentally abusive practices are likely to materialize in ways unprecedented or unnoticed in the past and therefore, not adequately captured in the assessment models.

   In other words, banks insufficiently use new forward-looking scenarios that assess the risks from unprecedented rapid climate change and environmental degradation and disregard of social or human rights abuses and new situations (e.g. ageing). Risk models may not even include pandemics that happen once in 100 years like COVID-19 ("tail risk") since banks are only now updating their pandemic risk scenarios.[135]

3) **Lobbying for short-term interests**: Increasingly, supervisors, central banks, some shareholders and citizens want banks to take into account climate, environmental, social and governance (ESG) risks and impacts. However, some banks in FFA countries lobby against the introduction of mandatory supervisory/regulatory guidelines, definitions and laws to integrate ESG risks and ESG impacts into their operations. The main arguments used are that they cannot change swiftly and want to avoid profitability loss. In the times of the pandemic, they are asking for delays or relief from sustainable finance measures. For instance, the Japan Business Federation (Keidanren) even lobbied hard in the EU against a strict framework for defining environmentally sustainable finance, which financial players, including Japanese banks, operating in the EU would have to use.[136]

3.2. How banks are facing growing social and environmental risks

This sub-chapter explains the link between, on the one hand, the impacts of climate, environmental and social problems and ESG malpractices by corporate borrowers and, on the other hand, negative consequences for the banks' operations, stability and profitability in the short and long term. In case banks continue their current business and risk models in the coming decade in which growing social injustice and the environmental tragedy is building up, banks will face the following risks.

3.2.1. Credit Risk

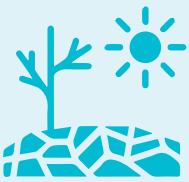
Most current risk assessment methods do not sufficiently incorporate the adverse climate, environmental, social, human rights and governance impacts by, and on, their borrowers. Banks will, therefore, face particular credit risks, i.e. unexpectedly being affected by badly or non-performing loans.

Environmental and climate risks

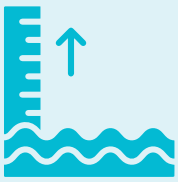
The different ways the intensifying climate and environmental problems manifest themselves and have social consequences in FFA-plus countries have been described in detail in chapter 2 (see 2.1. to 2.3. and overview in 2.5). How these phenomena affect banks' credit risks through non-performing loans, stranded assets, riskier corporate clients, projects and customers, and more unpredictable business opportunities are illustrated as follows:

BANKS WILL FACE PHYSICAL RISKS FROM CLIMATE-RELATED SPECIFIC WEATHER EVENTS AND CHANGES, SUCH AS:

Extra-ordinary floods and monsoons or typhoons



Extreme heatwaves and droughts



Sea-level rise

FFA-plus countries' islands, long coastlines or rivers with capitals, other cities and villages along the shores, will be severely affected or even disappear.

The resultant damage and loss of commercial and household property will affect the ability of commercial real estate loans and mortgages to be repaid, and diminish the value of the collateral. Banks will therefore need to put aside higher capital buffers to provide for such risks. Moreover, repair costs will further reduce the capacity of borrowers to borrow more.

Bank risk assessment for loans and other financial services will become more unpredictable and complex to operate in the coming years. For instance, infrastructure such as roads and bridges are likely to be affected by floods, storms and mudslides, but predicting the amount and location of the damage will be difficult. In FFA countries, this could impact the domestic and regional lending and underwriting services to large infrastructure companies- valued at US$ 86 billion in the period 2014-2019. Indonesian banks such as Bank Rakyat Indonesia (US$ 13.9 bn) and Bank Mandiri (US$9.5 bn) have been especially large providers of loans and underwriting services to large infrastructure companies in 2014-2019.[137]

Agricultural production, transport and energy production will be increasingly affected by extreme weather events and variabilities, such as excessive or unpredictable rainfall, droughts,

salination, heat waves, and water shortages, as well as environmental degradation and biodiversity loss. ASEAN countries host large agribusinesses as well as many small farmers whose harvests will become more unpredictable, smaller or destroyed, resulting in reduced or no incomes to repay or apply for more loans, underwriting and other financial services. Loans will become riskier, for which the banks might have to put aside larger capital buffers to avoid losses due to bad or non-performing loans. Within and among FFA countries, agricultural loans and underwriting services to large agribusinesses were valued at US$127bn in the period 2014-2019. Banks most at risk are the largest creditors and underwriters to large agribusinesses in 2014-2019, namely Japanese banks and financial conglomerates such as Mizuho Financial Group (US$34.2 bn), Mitsubishi UFJ Financial Group (US$ 24.1 bn) and Sumitomo Mitsui Financial Group (US$ 13.7 bn).[138]

Some regions are dependent on particular economic sectors like tourism and retail, which have an intricate supply chain with often informal workers. Greater impacts of climate effects on these sectors will therefore mean more significant social consequences (see also chapter 2.2), such as unemployment and increasing poverty, especially if climate-friendly jobs are not created swiftly. Climate disruptions will impact people's food security and livelihoods, and trigger human migration throughout the region with spill-over across countries. These climate risks will leave banks exposed to more bankruptcies, fewer customers, and customers requiring less profitable financial services. Banks will need to spend more on services and bank models to adapt to changing customer behaviour and requirements.

Social risks

Banks will face unexpected losses in profitability due to the social risks from their corporate clients, ranging from non-performing loans to lost business opportunities. Examples of such social credit risks within the context of the described forward-looking scenario include:

- Companies will face increasing public scrutiny when breaching human rights, directly or indirectly via their supply chain, through non-living wages, lack of social security, gender and racial discrimination and violence. Civil society organisations that investigate and expose such socially abusive behaviour are putting pressure on companies, leading to reputation risks and risks of reduced income.
- Human right benchmarks, credit rating agencies and ESG rating companies are alerted about investigations when they scrutinize companies' labour rights and social impact behaviour. They might consider the problems to be about material risks, i.e. risky for lending banks.
- National regulators have of late been adopting measures or national plans to ensure companies apply to UN Guiding Principles on Business and Human Rights. For instance, in the Philippines, the SEC requires companies to report on their ESG impacts.[139] Companies headquartered in the EU and with supply chains in Asia are similarly subject to the EU's Non-financial Reporting Directive.[140] Such reporting can lead to pressure on companies to change or abandon certain production and income streams.

Examples of risks to banks from human rights abuses are:

- Thai banks have been confronted by CSOs (like Fair Finance Thailand) and communities about their financing of dams in neighbouring countries, especially after the Xayaburi dam collapsed, communities were wiped out, and losses were made by the companies involved. It made Thai banks better understand the risks and start rethinking the way they finance dam construction.[141]

- The EU removed Cambodia's special trade status for exporting without tariffs (the EU's Everything but Arms policy (EBA)) due to political and social human rights breaches by the Cambodian government. As a result, the Cambodian industry, especially the garment sector, has lost part of its export market and banks face challenges from the resulting economic downturn.
- Farmers in the Philippines that have loan contracts with unfavourable terms will remain poor and non-profitable clients.[142] Such loans have long term negative societal impacts on food production and poverty.

Governance risks

Banks may face unexpected losses and losing financial service opportunities to profitable corporate clients that became less profitable due to governance issues if the forward-looking scenario described in this report materializes. These governance risks may unfold as follows:

- Several company governance issues have been receiving increased attention of late. Fighting company corruption, for instance, has often become part of political campaigns and crackdowns, resulting in fines and other negative financial consequences for the companies involved.
- Most large companies are complicit in tax avoidance and evasion using tax havens, profit shifting and aggressive tax planning. Tax dodging as a profitable strategy may be untenable in the future due to the growth of inequality, government budget deficits (to invest in social services, infrastructure, Paris agreement and SDG goals) and public outcry.
- COVID-19 has exposed how the dominance of company business models to create high shareholder value and management bonuses has been at the expense of wages and income throughout the value chain. Companies might become under pressure to ensure more profits accrue to workers

Transition risks

Political pressure and government action to, for instance, reach the SDGs by 2030 and the intermediate commitments of the Paris Climate Agreement, are more likely once the negative consequences from climate change, environmental deterioration, human rights breaches and social problems become more pressing and harmful.

Central banks and financial supervisors designing forward-looking scenarios due to concerns about the impact of climate change warn about "transition risks", wherein the change of rules and laws by governments and regulators will lead to many corporate loans and mortgages turning into non-performing loans and stranded assets. This will lead to reduced profitability and stability of banks and financial institutions.

There may be disorderly consequences for the financial sector if governmental actions for a transition to a carbon-free and sustainable economy are taken too late after the effects of climate change are already being felt due to inaction. Accelerated climate change and poverty may force these transitions to occur rapidly and unexpectedly, putting financial stability at risk.

One prominent example of transition risks is linked to fossil fuels: Climate mitigation efforts can result in sudden government actions and laws to stop their use, shareholders pressure will move business models away from them, and consumers will move to renewable energy.

Coal and oil companies will consequently suffer bankruptcies, or at least losses of profit, making them unable to repay their loans. It is estimated that banks in the Philippines are exposed to transition risks and stranded assets risks of $21 billion for coal alone.[143] Loans and underwriting services to major fossil fuel companies within and among FFA countries might be at risk in both short and long terms. They have been valued at US$ 225 bn in the period 2014-2019. The largest financiers were Japanese with Mizuho Financial Group (US$ 51.6 bn), Mitsubishi UFJ Financial Group (US$ 43.3 bn) and Sumitomo Mitsui Financial Group (US$ 40.7 bn).[144] Mitsubishi UFJ Financial and Mizuho Financial Group are at risk of having large amounts of stranded assets in case fossil fuels will need to be rapidly banned to stop climate change. They have been among the largest global financiers of fossil fuels between 2016 and 2019.[145] For instance, Mizuho Financial Group has financed, in 2016-2019, US$34.3 bn in key oil, gas, and coal companies that still expand fossil fuels.[146] Mitsubishi UFJ Financial Group reported in 2019, based on the framework of the TCFD, that its scenario analysis identified that 6.6% of its assets are carbon-related.[147] These assets could be identified as potential stranded assets.

ESG risks

The above mentioned environmental, social and governance risks and related transition risks mean that banks will have to better assess the risks from loan and financial services' concentration and exposures to sectors and companies with ESG risks. Banks will need to strategise whether to continue or disengage from such sectors. The ESG related sector risks might also be more extensive for particular countries. In Indonesia, for example, palm oil and coal currently play significant roles for the country's exports and GDP. ASEAN countries which are part of outsourcing arrangements in supply chains might be affected when ESG and COVID-19 risks become more prominent.

3.2.2. Market risks

Market risks for banks comprise the risk of non-performing loans arising due to changes in the market, such changes in the economy or market sentiment or prices for commodities. In the context of a scenario with increasing climate and social problems, the following examples might illustrate potential market risks that banks will have to deal with.

- Energy generated from renewable sources is becoming increasingly cheaper and more attractive than that from fossil fuels, with rapid advances in technology. With greater urgency of transition to non-fossil fuel energy and industries, traditional power generation firms face massive write-offs or bankruptcy, seriously affecting the banks that lent to them. Select power generation companies received US$ 243 bn in loans (52%) and underwriting services (48%) within and among FFA countries in the period 2014-2019. The largest loan providers were Mizuho Financial Group (US$ 26.5 bn) and SMBC Group (US$ 25 bn).[148]
- A particular market risk from climate change and climate mitigation measures is the fluctuation of prices for energy commodities. Lowered coal and oil prices arising out of their reduced demand is disrupting planned profitability by fossil fuel companies. This phenomenon was already seen when energy demand dropped due to reduced economic activities during the COVID-19 lockdown: US oil prices plunging below zero for first time in history in April 2020.[149] Oil and gas companies saw their profits drop unexpectedly, and their debt burden rise, forcing for instance Shell to write off US$ 22 bn of assets in June

2020.[150] Energy prices rebounded to a certain extent but show significant price volatility. Such price and profit uncertainties will make it difficult for banks to assess the risks of lending or provide underwriting services to fossil fuel industries.

- Another market risk may arise out of people's increasing awareness and concerns about climate change and the social impacts of their diets and consumption patterns. These concerns will translate into changing preferences for food, products and transport means or even reduced overall consumption. Companies with unsustainable practices might face public pressure and reputational risks. Many established businesses and shops that form the banks' clientele will meet falling incomes and bankruptcy if they fail to adapt their products and services and eliminate ESG risks.
- New environmentally and socially friendly businesses may emerge, but assessing their creditworthiness in a rapidly changing market will require novel and innovative risk assessment models. Banks will need to set aside budgets for the same and train staff to apply them.

3.2.3. Operational risks

Banks might face operational risks from in a scenario of increasing climate change and sustainability problems. Some examples are as follows:

- Extraordinary storms and floods will damage bank buildings (many bank headquarters are in capitals at the coast), or cut electricity, halting their computerized systems. These risks will complement the technological challenges (e.g. cyber crime, privacy issues) that Asian banks already face from a rapidly developing fintech sector.
- Asian banks operating in FFA-plus countries currently borrow from other private and international financial institutions like the International Finance Corporation (IFC) and the Asian Development Bank (ADB). Given the growing pressure to finance sustainable activities, these finance partners of Asian banks might initiate new or strengthen existing sustainability and safeguarding requirements. Banks operating in FFA-plus countries will need to adapt to those demands to maintain access to (international) finance.
- Greater awareness of the role banks play in climate change, environmental degradation, human rights breaches and social problems may influence customers' choice of banks. Banks and investors that significantly finance companies linked to human rights abuses and intense fossil fuel usage will be especially denounced by civil society. Such reputational damage may make customers change banks to those that make efforts to minimize ESG risks or invest in activities that help in climate change mitigation and social progress, a phenomenon already visible to a small extent in Europe. Since competition is fierce, a bank might need to integrate sustainability when competing banks have been compelled to do so and are getting better ESG scores, e.g. through the Fair Finance Guide.[151]
- Banks providing 'green' or 'social' or 'impact' financial products like green bonds, climate mitigating saving accounts, and impact investment funds will come under increasing scrutiny. If the actual extent of the sustainability impact of these products is insufficient, banks will be accused by the public and the press of 'greenwashing', i.e. making false claims to mislead customers, resulting in fewer customers for these financial products.
- During and after the COVID-19 lockdown, banks will have to make operational decisions to whom they extend loan agreements or provide new loans or refuse to provide financial services any longer from a profitability perspective. This will affect access of impoverished people to financial services. It may have an impact on their reputation and the willingness of their customers to stay with the bank.

* Civil society is increasingly calling for more stringent regulation. Banks' lobbying against strict sustainable finance laws may become exposed and denounced from civil society organisations that view such lobbying to be against the public interest.

3.3. Risks from changes by regulatory and supervisory authorities and laws

A rapidly increasing number of central banks and financial supervisors have expressed their concern about the impact of climate change on the stability of private financial institutions, due to stranded assets from credit and other risks (see above), and on the stability of the financial system as a whole. They are bundling their analysis and concerns in the central bank and financial authorities' Network on Greening the Financial System (NGFS). Among the 69 members are Bank Indonesia, Bank of Japan and Japan FSA, Bank of Thailand, the Central Bank of the Philippines (BSP), the National Bank of Cambodia and the Peoples' Bank of China, among other Asian members including Malaysia, South Korea, Hong Kong and Singapore, and with the Asian Development Bank among the observers.[152] The NGFS has been warning, as mentioned above, about transition risks such as changing laws and rules, especially when done in unexpected and rapid ways as climate change and societal responses accelerate. For instance, to prevent further climate change, new regulations might require buildings to be climate-friendly by tightening energy efficiency standards. To prevent financial instability in the future, the NGFS encourages supervisors and regulators to use forward-looking scenarios[153] to require banks to introduce risk assessment methods that are not only based on historical data and to identify where supervisory interventions are needed.

In FFA-plus countries, financial regulators have started to introduce codes, principles or guidelines for banks, investors or the entire financial sector to take ESG risks or sustainable development into account. Indonesian financial services authority OJK has been a frontrunner in this regard, adopting a Road Map on Sustainable Finance in 2014 and introducing a Regulation on Sustainable Finance (POJK) in 2017.[154] The Regulation stipulates that financial institutions have to develop a Sustainable Finance Action Plan (RAKB) and a Sustainability Report, according to minimum criteria for both outputs. It includes the timeline and instructions for publishing them. The RAKB has to include the development of sustainable finance products and services, sustainable risk management, internal capacity development and adjustments throughout the financial institution.

Another example is the recent voluntary Sustainable Finance Framework for all banks in the Philippines issued by the Central Bank of the Philippines (Bangko Sentral ng Pilipinas, BSP) in April 2020.[155] The BSP expects banks to adopt sustainability principles and to perform them at all levels of the banks' operations. Environmental and social (E&S) risks are to be included in banks' annual reports, corporate governance, and risk management frameworks within three years, and these should be publicly disclosed. The Environmental and Social Risk Management System (ESRMS) framework should identify, assess and mitigate E&S risk exposure, including physical risks and transition risks, and involve stress testing.

Both the BSP and OJK are part of the Sustainable Banking Network (SBN). The SBN consists of mostly of financial authorities and bank associations from developing countries, including many Asian countries, who are encouraged and supported by the IFC that provides technical assistance. SBN has played a promoting role to introduce voluntary

sustainable finance regulations as well as integrating sustainability policies by banks. Progress has however proven to be slow as reported in October 2019.[156] Experience in FFA countries has exposed the difficulty, lack of expertise and resistance by banks to adapt swiftly to sustainable finance needs.

So far, many regulators did not have enough power or political will (and support) to make banks change their lending behaviour due to resistance from the financial industry and the impact of COVID-19. However, in the described forward-looking scenario, they are likely to become under increasing public scrutiny and public pressure to ensure the banking sector moves swiftly in a more sustainable direction. In the future, ESG risk management, and the use of forward-looking scenarios, are therefore likely to become mandatory and stricter, as is already the case in the EU and China.

Regulators and law-makers are already exploring or taking initiatives to ensure banks make positive contributions to climate mitigation, the environment, human rights and social factors. Given the lack of additional financing for achieving the SDGs and the Paris climate commitments, banks will be pressured to develop, identify and offer new kind of loans and financial services. They will have to enact changes in their current business and risk models, especially if new and strict interventions from regulators and mandatory requirements are adopted by sustainable finance laws. Strict standards will then apply to financing "green activities", offering sustainable financial products and prohibiting the financing of companies that extract fossil fuels and breach human rights (see chapter 4). In China and the EU, a common set of definitions ("taxonomy") is being developed to standardize what can be called and financed as climate mitigating and environmentally sustainable.[157]

3.4. Risks from credit rating agencies and ESG ratings

In principle, credit rating agencies (CRAs) should identify and assess all material ESG risks that which might undermine the profitability and payment capacity by a company or a bank. CRAs have, however, been slow to integrate material ESG risks fully, but are under increasing (regulatory) scrutiny.[158] In a scenario of increasing prominence and visibility of climate risks, environmental damage and social injustice, credit rating agencies will have to include much more ESG risks in their assessment of the creditworthiness of companies, banks and other financial institutions.[159]

Credit ratings have important implications for banks' own costs of financing: the worse the credit rating of a company, the more carefully a bank has to make a risk assessment, and increase the interest rate and its financial reserves when providing a loan. Deteriorating credit ratings of banks themselves reflect in higher costs for their own borrowing, less interest from shareholders and drop in share value. Banks exposed to potentially stranded assets and without adaptations to ESG risk policies and assessments might see their credit ratings decrease when CRAs increasingly use ESG risks in their ratings.

Given the increased interest by creditors and especially investors in the ESG performance by companies, ESG research and rating firms have developed as a separate industry of late. However, the ESG data choice and gathering, research and analysis, and rating by these ESG firms have been subject to criticisms and concerns by NGOs, the financial industry, academics

and EU financial authorities.[160] Academic research analysed the many discrepancies of the different ESG methodologies by these ESG firms, resulting from different definitions of ESG and sustainability. Indeed, there is no globally accepted list of definitions[161], or taxonomy, which could hinder regional cross-border regulatory cooperation. Moreover, regulation or supervision of the ESG industry is missing. ESG data or ratings of a borrowing company, therefore, do therefore not accurately indicate all ESG risks a lending bank could face. Banks will have to bear the costs of developing their own robust ESG risk and sustainability impact assessment (see also chapter 4).

3.5. Risks from bank shareholders

Many banks active in FFA-plus countries have shareholders who value the banks' shares according to their assessments of the profitability and strategy of the banks. In a scenario where ESG risks will increasingly affect the profitability of the banks (see 3.2. above), this will also impact the behaviour of its shareholders.

One trend that is becoming visible among part of the institutional shareholders, such as investment funds or private pension funds: They pay attention to climate and ESG risks from a long term profitability perspective. This will be reinforced by the COVID-19 impact, as investors will be more interested in longer-term resilient investments. Investors have created coalitions to cooperate on those new themes (See table 2).

Table 2: Examples of investor coalitions on ESG themes

INSTITUTION	FOCUS ON
Investor Alliance for Human Rights[162]	Human right issues
Asia Investor Group on Climate Change (AIGCC) which is a member of the Global Investor Coalition on Climate Change[163]	Paris climate agreement
Global Investors for Sustainable Development (GISD) Alliance[164]	UN SDGs

Another trend is that some shareholders want to ensure that the banks have positive ESG impacts or sustainability initiatives. For instance, shareholders of some banks that operate in FFA countries are (see below) from the European Union, which requires by law that investors disclose whether they made an ESG assessment of their investments.[165] A small number of the banks' shareholders are from Singapore, where authorities are also introducing sustainable finance policies.[166] They may put more pressure on banks to avoid negative ESG risks and promote the financing of sustainability initiatives, or at least to disclose such information. One of the top Japanese financiers in FFA countries, Mizuho Financial Group, has already felt the pressure from part of its institutional shareholders (see box 1).

BOX 1: Example of shareholders resolutions at 2020 annual meeting of Mizuho Financial Group

"In March 2020, Kiko Network submitted Japan's first climate shareholder resolution, calling on the Mizuho Financial Group (Mizuho) to disclose a plan outlining its business strategy to align its investments with the climate goals of the Paris Agreement. Although the resolution did not pass at the shareholders' meeting, held on June 25, shareholders representing 34.5% of the votes supported the resolution."

"[T]he resolution was supported by a vast majority of overseas investors, as well as four Japanese asset managers, namely, Nomura Asset Management, Norinchukin Zenkyoren Asset Management, Nissay Asset Management, and Asset Management One. Meanwhile, opposing votes in Japan came from several asset managers, including Sumitomo Mitsui Trust Asset Management, Nikko Asset Management, Daiwa Securities, and others, revealing that the Japanese shareholders were divided."

"Based on the findings, Kiko Network confirmed that there was considerable support among Japanese institutional investors for our climate resolution and that the inclination is also growing stronger for ESG investments consistent with the Paris Agreement."

"BlackRock, which has declared its commitment to sustainable investments, voted against the resolution. The resolution called on Mizuho closes a plan outlining its business strategy to align its investments with the climate goals of the Paris Agreement, in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)."

"Mizuho had updated its policy 'Taking firm action toward a low-carbon society' in April, followed by the publication of its 'TCFD Report 2020' in May." Namely, Mizuho stated it would cut its lending to new coal-fired power plants and end all loans for coal by 2050.[167]

"Mizuho is making progress in its efforts to reduce its credit balance for coal-fired power plants and to disclose more information. However, Mizuho's corporate finance portfolios continue to be non-transparent, and the bank does not conduct its financial business in a way that would be consistent with the Paris Agreement."

Source: Kiko Network, Voting results of shareholder resolution for Mizuho Financial Group (1st tally) - Majority of investors, including Japanese asset managers' Nomura and Norinchukin, supported Kiko Network's resolution, Press Release, 24 September 2020, https://www.kikonet.org/eng/press-release-en/2020-09-24/Mizuho_resolution_report_20200924 (viewed 26 September 2020).

The ESG-minded shareholders might not (yet) have majority ownership at major banks operating in FFA countries, as the following identification of shareholders reveals:[168]

- **Mizuho Financial Group** (Japan) has the majority of its shares traded on the stock exchange. On 20 May 2020 the composition of 36.5% of its shareholders was identified as follows:[169]
  - 21.33% of the shareholders were from Japan (including 5.08% by Sumitomo Mitsui Trust Holding Inc, and 3.7% by Sumitomo Mitsui Trust Asset Management Co, Lt,),

and 0.12% of the shareholders came from the rest of the Asia-Pacific (including Singapore 0.04%);
- 9.02% of the shareholders were from the US (The Vanguard Group holding 2.92%) and 0.56% from Canada;
- 5.46% of the shareholders were based in European countries, including 1.91% from the UK while those from each EU member state were holding less than 1%;
- BlackRock subsidiaries based in different countries were holding at least a total of 6.26% of the shares.

* **Sumitomo Mitsui Financial Group** (Japan) had the majority of its shares traded on the stock exchange. The composition of 45.3% of its shareholders was identified on 20 May 2020 as follows:[170]
  - 22.7% of the shareholders were based in the Asia/Pacific region, of which 22.02% from Japan (including 3.13% by Mitsubishi UFJ Trust and Banking Corporation)
  - 13.92% of shareholders were from the US (including large US asset managers such as The Vanguard Group (2.77%)), and 1.02% from Canada
  - 7.69% were European shareholders (of which 3.99% were from the UK while those from each EU member state were holding less than 1%).

* **Mitsubishi UFJ Financial Group** (MUFG, Japan) has the majority of its shares traded, and the composition of 34% of its shareholders was identified on 27 May 2020 as follows:[171]
  - A majority of shareholders from Japan (18.24%) with 0.27% from Singapore and 0.13% from Hong Kong
  - 9.68% of the shareholders were from the US (including funds from large asset managers), and 0.54% of the shareholders were from Canada
  - 5.19% of shareholders were from countries in Europe (with the UK shareholders owning 2.11% while those from EU member states owning less than 1 %).

* **Bangkok Bank** (Thailand) has the majority (90%) of its shares traded, and the composition of 20% of its shareholders was identified on 28 May 2020 as follows:[172]
  - 16.33% of the shareholders came from Asia/Pacific, of which 16.03% was from Thailand (including 4% from the Social Security Office and 0.82% from the Government Savings Bank)
  - 2.6% of the shareholders were European, of which 1.72 % was from the UK, and those from a few EU countries were holding less than 1%
  - 1.31% of shareholders were from North America.

* **Bank Mandiri**[173] (Indonesia) and **Bank Rakyat Indonesia**[174] are both majority-owned by the government of Indonesia, respectively by 63.5% and 57.32%. 35% of shareholders of Bank Mandiri were partly from Asia, the US and Europe with shareholders per EU country holding less than 1%. Bank Rakyat Indonesia has also shareholders from Asia (including 0.34% by the Government of the People's Republic of China) North America, and Europe.

* **Punjab National Bank** (India)[175] is majority (59.56%) owned by the Government of India, with the rest of shareholders from India, Asia, North America and Europe (little detailed information available).

The third trend in future shareholding might be changing decision-making at banks that are majority state-owned, for instance, from Indonesia and India. In case the government wants to

impose more stringent climate or sustainability measures, these state-owned banks would be able to make rapid changes.

However, the impact of COVID-19 has put banks under pressure from mainstream shareholders to maximise profits based on short term strategies. Hence, banks are lending in the traditional way, including to fossil fuel companies or companies that receive COVID-19 governmental support without sustainability requirements. This might, however, undermine bank profitability in the long term. For instance, the Japanese bank Mitsubishi UFJ Financial Group had disclosed, according to the TCFD guidelines, that 6% its assets are fossil fuel-based.[176] Based on that percentage, a very rough calculation estimates that $ 294 million of the bank's $4.9 bn net profits in 2019[177] came from its business of financing fossil fuels. Such profitability might decline in the future when fossil fuels are either phased out or swiftly banned to avoid climate change.

In the event of a worsening COVID-19 pandemic, and rising problematic and non-performing loans, governments or central banks might have to support or bail out the banks. At that time, they could impose sustainability requirements to the lending and other operations of the bank – although it remains to be seen whether such political will to 'build back better' will exists.

3.6. Too little contribution to sustainability

Avoiding ESG risks is a valuable do-no-harm strategy that banks can use in their lending, underwriting or other financial services. However, especially with the COVID-19 pandemic, such risk avoidance might not be enough to:

- contribute to the Paris climate commitments,
- repair environmental damage (e.g. undo plastic pollution),
- support environmental resilience (e.g. promote biodiversity),
- actively promote the full respect of all socio-economic human rights,
- achieve particular SDGs (e.g. SDG 12: responsible consumption), and
- eliminate governance problems such as corruption and tax avoidance and evasion.

The Governor of the central bank of the Philippines (BSP) has been among central bankers and others warning that *"Environmental and social risks arising from the [COVID-19] health crisis offers a glimpse of how severe and long-lasting other potentially systemic risks such as climate change may drag the banks' performance and long-term growth"*. He, therefore, urged banks to now prioritize a sustainable recovery by lending to sustainable sectors and activities, such as micro-, small- and medium-sized enterprises (MSMEs) and health or food security sectors.[178]

For banks, many of the conditions to make such a positive impact are not yet in place.

One obstacle for swiftly orienting loans towards activities or companies with direct positive sustainable impacts, is the absence of a clear definition of activities that are aligned to the Paris agreement, environmentally and socially responsible and fully respecting human rights. In the EU and China, definitions are being designed of activities in different sectors (e.g. agriculture) that will contribute to limiting temperature rise to under 1.5 °C by 2050. The development of such so-called "green taxonomy" has been complicated as it requires scientifically based criteria.[179] There is also no clear global definition of what it means in practice to take all aspects of ESG impacts into account.

Another obstacle to avoid a scenario of environmental catastrophe and social injustice is that banks and other financial institutions are not subject to a globally mandatory prohibition of financing activities and companies that contribute to the rise of CO_2/GHG emissions, environmental disruption, breach of human rights and social harm. In other words, there is no strict level playing field for banks to focus their financing and services to long term sustainability (see chapter 4).

CONCLUSION
Banks exposed to new risks and pressures by 2030

In a forward-looking scenario of growing social injustice and damage by climate change and environmental degradation, aggravated by COVID-19 impacts, the current risk models of banks operating in FFA countries will fail to detect upcoming credit risks, market risks and operational risk. This will affect their profitability in the medium and longer-term by 2030. By not changing their strategies and practices, banks can expect interventions from regulators and shareholders, pressure from civil society, while also facing downgrades by credit ratings and ESG ratings. By insufficiently funding activities and projects that contribute to achieving the SDGs and Paris climate commitments, reversing human rights breaches or solving social problems, banks do a disservice to society, and this will cause them distress in the long term.

4

RECOMMENDATIONS FOR BANKING ON A SUSTAINABLE FUTURE

Banks that are facing growing risks and pressures from a future described in this report's forward-looking scenario can find ways to avoid such negative impacts. This chapter makes some recommendations on how banks and financial regulators can undertake different steps in such a strategy.

Banks as important players in FFA countries' economy and societies, can contribute to addressing the future social and environmental challenges in the region by moving away from traditional banking business models and operational instruments. Given the need for additional funding and the stress on government budgets from COVID-19, this report calls on banks operating in FFA countries to actively develop plans and financial products that contribute to achieving the SDGs and Paris climate goals, joining many existing initiatives around the world.

Bank regulators, supervisors and legislators can support and encourage, or even force, banks to change their risk and business models and shift lending away from unsustainable companies, activities and projects. This chapter suggests methods for supportive and improved supervisory practices, incorporating and going beyond international experiences to accelerate a much-needed transition.

4.1. How banks can adopt sustainable practices

Given the primary function of lending, banks operating in FFA countries will need to improve their risk assessment methodology to address potential financial losses from climate risks and other ESG risks. That alone will not be sufficient to assess the long term impacts banks have on social and environmental sustainability. In addition, in order to contribute to the achievement of the Paris climate, SDG commitments and full respect of human rights, specific bank strategies, business models, lending and other financial services will need to be developed. Special attention will be required to develop operational means to deal with the significant human rights abuses and social problems – including those resulting from climate change and environmental degradation.

4.1.1. Bank business models and strategies – governance issues

Banks that want to improve their ESG risk management and contribute to a positive sustainability impact, Paris climate goals and SDGs, can best start their decision-making process at the management board (or executive board). Guidelines or regulations issued by supervisory authorities, sustainable finance laws, or the myriad of banking sustainability initiatives could form the basis from where to start. Forward-looking scenarios - including ones with severe deterioration of climatic, environmental, SDGs-related and human rights' situations - might provide insights in long term strategic directions.

For input, the management board members should hold dialogues with staff at all levels, unions, clients, other stakeholders, civil society, the supervisory board, shareholders and supervisors. Ensuring gender balance and diversity during such dialogues would enrich the feedback received. The bank management might need to convince its shareholders who focus on high profitability and see sustainability requirements as costly affairs that undermine short term profits. COVID-19 impacts on the banks might make it more challenging to advance arguments of changes that may seem expensive. Banks should nevertheless be more willing to avoid additional climate and social risks, given the already increased risks from COVID-19.

The bank's management board will first need to understand and assess the financial risks for the bank from climate change, environmental deterioration, human rights breaches and social problems, and decide how to address them as part of its overall business strategy and risk appetite. Asian banks are already being assessed against such areas as climate change, gender, transparency and accountability, using the Fair Finance Guide International methodology which analyses banks' policies on different ESG criteria in FFA countries.[180]

Secondly, beyond risk assessment, the board will have to identify and decide on ways to ensure that its lending and financial services do not contribute to climate change, environmental deterioration, human rights abuse and social problems. Banks, therefore, have to expand risk assessments and prevent a negative sustainability impact on society and the planet. This may involve phasing out and excluding significantly harmful sectors from financing. Prime examples of such sectors are fossil fuel-based energy production, exploitative agribusinesses and unsustainable infrastructure. This approach should also include a policy to remediate harm in case the bank contributed to negative impacts (see 4.3.).

Thirdly, and importantly, the board will have to take strategic decisions on how its lending and financial services can directly contribute to reducing climate change and achieving the SDG objectives[181], environmental resilience and improved respect for human rights. Developing new sustainable strategies and financial products can also be approached as expanding the bank's innovative business opportunities. In order to promote financial inclusiveness in FFA countries with increasing poverty and many small companies, banks will have to decide how to better service small companies, smallholder farmers and poor customers, including by ensuring more trained staff to advise them and support small sustainability initiatives.

Fourthly, these board decisions on ESG risks and sustainability impacts and objectives will need to be operationalised by assigning clear responsibilities and roles by, and within, the management board and the different levels of executive management and staff. The organisational requirements will need to be identified, developed and provided with sufficient financial resources, adequate skill training and expertise, with effective oversight for measuring progress, monitoring effective compliance, communication and reporting. Overall, this will need a change in corporate culture away from the overall priority of only financial profitability and growth, towards sustainable, responsible decisions and long term strategies.

Once the bank has decided to fully embrace a sustainability strategy, the bank should also become a front-runner in vocally advocating for better integration of sustainability impact obligations into regulations and legislation.

4.1.2. Risk management

In practice, the board decisions will first lead to adaptation of the risk assessment and risk weighting for capital reserve allocation (based on the capital requirements in bank law). ESG risks and (long term) sustainability impacts of borrowers will need to be included in the credit risk, market risk and operational risk assessments (see also chapter 3). Various public and commercial instruments are available to calculate credit risks related to physical and transitional impacts of climate change.[182] The riskier the loan, the more regulatory capital reserves will be required. It will be imperative to provide the resources to build the internal capacity, e.g. training of all staff, technological tools and methodologies for qualitative assessments.

To adequately assess the ESG risks and sustainable impacts in the future, banks should operate forward-looking scenarios and stress testing, for shorter and longer time horizons. The forward-looking scenarios developed by central banks that are members of the NGFS[183] provide guidance on the risks when lending for fossil fuels is not phased out by certain dates (see figure 7 above). Since the NGFS scenarios focus mainly on climate change, forward-looking scenarios in FFA-plus countries will be more comprehensive if developed by better integrating the environmental, social, human rights and governance impacts of the borrowers as well. The effects of COVID-19 will also need to be considered.

By using the forward-looking scenario in this report, banks should identify which of their loans and assets are related to fossil fuels and companies with human rights' breaches and social or environmental problems. They can use some of the many the voluntary guidelines and tools developed to identify climate-related financial risks and complement this with their own expertise in identifying human rights and social risks as described in the previous chapters. This should allow banks to calculate potential non-performing loans and stranded assets up to 2030 and beyond. Different methodologies have already been developed to calculate potential stranded assets resulting from climate change.[184]

BASIC HUMAN RIGHTS CRITERIA[185]

In order to screen whether borrowers respect and implement human rights obligations, the following are the basic human rights instruments to be used as assessment criteria:

1) Universal Declaration of Human Rights (UDHR) which includes the International Covenant on Civil and Political Rights (ICCPR) and the International Covenant on Economic, Social and Cultural Rights (ICESCR),
2) The ILO Declaration on Fundamental Principles and Rights at Work in 1998, by which the ILO identified eight of its conventions as "fundamental" conventions. These eight cover four topics that are considered as the fundamental principles and rights at work:
   - The freedom of association and the effective recognition of the right to collective bargaining;
   - The elimination of all forms of forced and compulsory labour;
   - The effective abolition of child labour; and
   - The elimination of discrimination in respect of employment and occupation.
3) The principle of Free, Prior, and Informed Consent (FPIC) for indigenous peoples.

Instruments for implementation include:
The United Nations Guiding Principles on Business and Human Rights (UNGPs) (2011) operationalize the Protect, Respect and Remedy Framework by the UN Human Rights Council (HRC).

The OECD Due Diligence for Responsible Lending and Underwriting[186] provides considerations on how banks should apply the OECD Guidelines for Multinational Enterprises.

Since all information about the corporations that banks need to assess will not be available, the lending process will need to operationalize, and train staff on getting the right ESG and sustainability information. Banks may want to turn to ESG ratings or benchmarks, such as the non-profit corporate human rights benchmark.[187] Existing commercial ESG data, research, and rating firms do not always

have all the necessary information available (see 3.4 above). To have useful qualitative data, banks will need to develop their own robust sustainability assessment methodologies. Banks will have to actively engage with the companies they lend and provide financial services to, in order to demand and obtain all necessary sustainability information and the correct data – something banks can do much better than investors buying company shares and bonds.

Some initiatives that support banks to make better decisions based on sustainability risks of corporations have already been developed. Countries like The Philippines[188] and India[189] require (listed) companies to report in detail about their environmental and social impact and contributions. Initiatives based on the United Nations Guiding Principles on Business & Human Rights (UNGPs) provide practical procedures to improve the ESG risk assessments of corporate clients. Data that companies provide when implementing the Voluntary Recommendations of the TCFD[190] may provide some input. More ESG risks and sustainability reporting initiatives might be forthcoming, such as the launch of a Task Force on Nature-related Financial Disclosures (TNFD).[191]

To get more information about a company's actual sustainability performance on the ground, information from other sources will be necessary too, including from civil society organisations, unions, and affected communities (through published reports, case studies, media reports and dialogues) and public data (like environmental impact reports and labour right fines).

Sectoral risk policies and assessment methods

Per economic sector in which banks are financing companies and activities, banks should develop particular risk assessment policies and manuals, develop forward-looking scenarios, identify problematic loans, and calculate potential stranded assets. They should start with the sectors and areas or countries (*"geo-location"*) which are the most problematic and vulnerable to climate change, environmental destruction, human rights breaches and other negative social impacts. They could attach conditions to their financing agreements in these sector to ensure those negative impacts are averted and/or addressed swiftly.

ECONOMIC SECTORS WHICH ARE OFTEN IDENTIFIED AS BEING CLIMATE-SENSITIVE[192] AND ARE ALSO RELATED TO BREACHES OF HUMAN RIGHTS AND NEGATIVE SOCIAL IMPACTS INCLUDE:

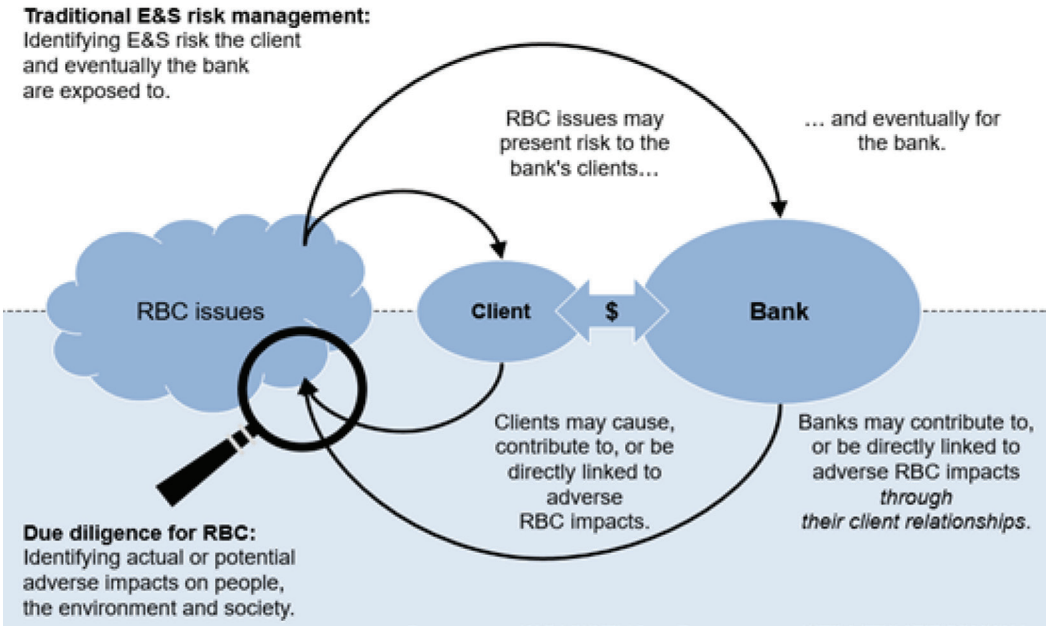
1. Agriculture, forestry and fisheries
2. Coal, oil and gas
3. Power and energy, and related infrastructure
4. Metals, minerals and mining
5. Manufacturing of consumer goods, including garment and footwear
6. Real estate
7. Transport like shipping and aviation
8. Tourism

For large corporate clients, banks will have to assess all operations in each subsidiary in the sectors and geographical areas at risk. The many sectoral voluntary guidelines might be a starting point for the screening criteria to be used, but sector and geographic-specific policies will also need to be developed. Such sector policies will also provide decision-making guidance to the bank on when to phase out and stop lending to particular companies and sectors or decide to advise such clients how to transform their operations to increasingly have climate, environmental, human rights and social benefits. Advice on transformative solutions will have to be supported by the training of bank staff to do so.

4.1.3. Beyond risk: assessment of impacts

In order to avoid and prevent negative *impacts* on society and the environment through its lending activities, a bank should apply a due diligence scrutiny of the borrowing companies. That would include investigating the company's long term impact on the environment (e.g. land degradation by agribusinesses), on human rights (e.g. impact on indigenous people by using Free Prior Informed Consent (FPIC standards)), on other social issues (e.g. gender diversity in decision-making) and on governance issues (e.g. effective tax rate). Such due diligence policies can be specific per sector, starting with the most risky and salient ESG issues (e.g. deforestation by palm oil companies). A multi-stakeholder initiative by the OECD resulted in some practical guidelines to apply due diligence on actual and potential adverse impacts through bank lending and underwriting (see box 2).

Box 2: Due diligence process for preventing adverse impacts on society, the environment and people (Responsible Business Conduct (RBC) impacts)



Source: OECD, Due Diligence for Responsible Corporate Lending and Securities Underwriting - Key considerations for banks implementing the OECD Guidelines for Multinational Enterprises, 29 October 2019, p. 15, http://mneguidelines.oecd.org/Due-Diligence-for-Responsible-Corporate-Lending-and-Securities-Underwriting.pdf.

Forward-looking scenario analysis might help to identify problems and actions to be taken in advance as precautionary and preventive measures.

For cases when banks' lending and underwriting have caused and contributed to harmful social, environmental and governance impacts, the banks should put in place grievance, mediation and remedial procedures. Ultimately, banks might have to compensate the people and communities if their lending and underwriting has contributed to harmful impacts. They might do so together with the company that received the loan or underwriting services. Banks themselves can apply the UNGP Grievance Mechanism and provide remedy even if the company refuses to do so.

Overall, the risk and impact assessment tools will need to clarify how to decide not to lend or service a company or client in case the necessary information is not made available, too high ESG risks and impacts appear, and the borrower does not align with the sustainability objectives defined by the management board of the bank. It could result in changes in the concentration of loan portfolios, or abandonment of lending and underwriting to particular firms or sectors. Such loss of bank business could be compensated by identifying and developing new sustainable financial services. Banks should be aware that such an approach to risk and impact assessment might be useful to avoid reputational risk from customers, civil society organisations, the public and shareholders.

4.1.4. Shifting finance to sustainable activities

Beyond avoiding and preventing ESG risks and sustainability impacts, banks should take the opportunity to identify ESG and sustainably responsible activities and companies to lend to and develop new products and services. They can so contribute to the additional annual billions that are needed to reach the SDG and climate commitments. At the same time, banks are growing opportunities for new profitable financial services and products.

The opportunities to be taken can be in line with the bank's sustainability strategies, scientifically aligned to limit temperature rise to not more than 1.5°C, achieve particular SDGs and fully respect human rights. Such opportunities do not always manifest themselves easily- banks often claim a lack of sustainable companies and activities to lend to. Banks will have to undertake active search and identification of green and sustainable corporations, projects, products, activities and citizens' needs.

Examples of green, sustainable and innovative activities to lend to or to underwrite are:

- Green loans and sustainability loans, linked to green or sustainable long term saving accounts offered by the bank (e.g. a fixed interest rate for ten years). Obvious activities to lend to are:
  - renewable energy projects that avoid adverse social and environmental impacts, and meet the needs of local communities,
  - sustainable and ecological agricultural production (including in rural and remote areas and to farmers converting to ecological farming),
  - loans to micro and small businesses to promote financial inclusion and prevent poverty due to COVID-19,
  - water and waste management companies and projects,

  - conversion products that help to transition away from harmful sectors such as unsustainable palm oil, coal and fossil fuel production.

- Green and sustainable mortgages, resulting from advice and active engagement with households on making housing climate-friendly, resilient and responsibly built (e.g. linking the interest rate with the amount of energy bill reduction).
- Issuing and underwriting of green bonds, social and sustainability bonds. When issuing green bonds, banks can use the proceeds specifically for green/sustainable loans and mortgages. It would be important for banks to disclosure:
  - clear definitions of what the expected positive impact is ,
  - description of what is being financed and how the positive impact will be achieved,
  - how the use of proceeds is organized,
  - how the independent review process is taking place.

- Sustainable transport and infrastructure projects, including at a small and local scale.
- Activities that improve sustainability and resilience of cities, including building new areas and cities based on circular economies.
- Companies that produce consumer goods in a sustainable way and are part of a circular economy.
- New opportunities to contribute to a green and fair recovery in a post-COVID-19 situation.

Many sustainable initiatives in the agricultural, industrial and services sectors are often small. Also, not all sustainable activities are less risky or as profitable as loans to large companies and mainstream activities. Banks will need to set aside sufficient financial and human resources for its innovative sustainable approaches in the short term, the benefits of which will gradually be visible over the long term.

An important issue is to improve access to finance, especially in rural areas and for disadvantaged and poor people, and women with no capital. Dealing in a fair way with farmers' debt –and avoiding it – would solve dramatic problems, for instance in India (farmer suicides) and the Philippines (farmer contracts as collateral). In addition, COVID-19 has seriously increased the risks and challenges for banks. Banks now face the dilemma of estimating for which borrower to prolong non-payment or give new loans. Since low wage workers are significantly affected, and many customers have become unemployed, they are the less profitable clients and easiest to exclude, reducing financial inclusion.

4.1.5. Disclosure and transparency

Disclosure is to be an essential part of the sustainability strategy of a bank. Banks will need to explain internally and externally many aspects of their sustainability objectives, including:

- related ESG risk and sustainability impact assessment methodologies
- due diligence policies and their impact on lending and underwriting decisions
- remedial instruments and actions
- loan exposures per industry or sector and countries
- governance and managerial tools and responsibilities
- innovations or new financial products to contribute actively to the sustainability objectives and defined targets.

Such transparency can take the form of:

- annual reports
- publically available policy papers and guidelines
- presentations at bank associations
- leaflets for customers
- information documents for borrowers and citizens.

Corporate borrowers might not always be pleased with additional scrutiny. They might have to be convinced that positive sustainability impacts will benefit the company in the short and the longer terms.

Shareholders might be interested in the disclosure of how climate-related financial risks are integrated into governance and risk management processes, and what are new opportunities, which can be disclosed through the framework of the TCFD.

Transparency and detailed disclosure internally and externally may contribute to feedback from different stakeholders including CSOs, which supports the improvement of the sustainability strategy. Indeed, there should be awareness that applying sustainable finance at a bank will be an evolving journey where different kind of expertise can reinforce themselves.

Also, supervisors may want to see sufficient public disclosure and be interested in banks' evolving understanding of the financial ESG risks and sustainable impacts, and how comprehensive forward-looking scenarios are being advanced.

4.2. Recommendations to regulators, supervisors and legislators in FFA countries

Bank supervisory and regulatory authorities (central banks and others) have already explored and developed in different ways how to integrate the climate risks in prudential supervisory practices. The NGFS has issued a guide for supervisors[193] and methodologies to develop supervisory practice on climate and environmental risks.[194] The Basel Committee on Banking Supervision published an overview of existing initiatives by bank supervisors about climate-related financial risks.[195] The Financial Stability Board concluded a similar stocktaking for financial authorities' initiatives in the whole of the financial sector and concluded that *"no approach to quantification provides a holistic assessment of climate-related risks to the global financial system".*[196] The Sustainable Banking Network (SBN)[197] promotes knowledge sharing and capacity building that provides practical support to national sustainable banking initiatives by members, based on the IFC's environmental and social standards.

In Asia, the regulators are an important force to move banks jointly forwards. Pressure from shareholders, investors, retail customers or citizens will not be sufficient to move banks swiftly forwards. Regulations thus have an important role to play.

4.2.1. A comprehensive forward-looking approach

While it would be useful for all FFA countries to join the Network on Greening the Financial Sector (only India and Vietnam are currently not members (see table 3), it is important that the policies, guidelines, principles and road maps issued by FFA banking authorities not focus their

sustainable finance strategy only on climate and environmental risk. Their approach should be to develop new forward-looking scenarios that integrate all ESG risks, social and environmental sustainability impacts, and promote sustainable finance innovations. Such an approach is more suitable for Asia's urgent challenges, which have been aggravated by the fall-out of COVID-19. China, however, has developed climate-friendly and green financial reforms to deal with its environmental challenges and joined platforms that focus on finance and climate change. However, it might show reluctance to include human rights and social aspects into its domestic or regional sustainable finance agenda.

4.2.2. Upscaling supervisory practices

The prudential supervision of the banks –the *"Supervisory Review and Evaluation Process (SREP)"*[198] – should innovate with the various aspects of sustainability and review a bank's:

- Strategies and objectives
- Internal governance and organisational requirements
- Forward-looking ESG risk management and sustainability impact methodologies
- Sustainability innovations
- Compliance mechanisms
- Disclosure requirements
- Board responsibilities
- Top managers with a sustainability 'fit-for-purpose' check.

Supervisors in FFA countries will need to find ways to deal with the massive amount of potential future stranded assets of banks from non-performing loans to coal, oil and gas companies and power generation companies, unsustainable infrastructure and agribusinesses. Loans and underwriting services, in 2014-2019, within and between FFA-countries in these four sectors were valued at least US$ 681 bn and might become increasingly risky assets.[199]

To prevent new potential stranded assets in case of dramatic phasing out of coal and fossil fuels by 2030, bank supervisors and regulators should come forward to identify and clearly define what sectors and activities should not receive financing anymore from a climate, environmental, human rights and social perspective. Thereafter, regulatory authorities or legislation should consider whether to impose higher capital requirements[200] to discourage loans and underwriting in such assets, or whether to phase in a prohibition to lend to and underwrite such assets.

To ensure effective compliance by the banks, bank supervisors, regulators, and legislators will need sufficient financial resources to strengthen their sustainable finance supervisory and enforcement capacity, with sanctions wherever required.

To get enough input and feedback about the effectiveness of the banks' sustainability operations, supervisory and regulatory authorities could initiate dialogues with bank unions and staff (who have practical experience), consumer organisations, civil society organisations with expertise in banking and company field research, and, wherever possible, with affected communities and customers. These dialogues could provide interesting counter-arguments from a public interest perspective, against those from the bank lobby that is also active with regulators and supervisors.

4.2.3. A mandatory approach to avoid a scenario of social injustice and environmental tragedy

Given that domestic and foreign banks operating in FFA-plus countries are competing against each other, waiting to implement voluntary sustainability strategies might be their strategy of gaining profitability and competitive advantages in the short term. Also, companies not willing to be screened for ESG risks and impacts when requiring a loan might turn to bank competitors that do not have ESG and sustainability conditions. Therefore, an ESG level playing field could be created at the national and regional levels, whereby regulators or legislators impose the same mandatory or legally binding minimum requirements regarding:

1. ESG risk and impact assessments, and related standardized risk weighting for allocating capital reserves
2. Providing clear definitions of what are activities and companies that have positive sustainability impacts, as well as harmful ESG impacts
3. Promotion of financing of lending with positive socially and environmentally sustainable impacts, and
4. Defining activities and sectors whose financing needs to be phased out.

Mandatory measures would provide an ESG level playing field among the banks and clarity about which effective banking operations to undertake, especially in the COVID-19 period. Several supervisors and central banks have taken various approaches in FFA-plus countries for guiding banks and supervision to address climate, environmental and social issues, e.g. in Indonesia (OJK) and the Philippines (BSP).

To stimulate implementation in practice, especially when made mandatory, regulatory authorities should help banks to operationalize and integrate the sustainable finance framework in their strategies and operations. They can provide training on risk and impact assessments, as was the case in the Philippines after the BSP's introduction of guidelines, and provide methodologies for forward-looking scenarios.

Another initiative could be to bring together representatives from various banks to share experiences and approaches. Such fora are called *'regulatory sandboxes'*. Hosting by the supervisory or regulatory authorities prevent claims of anti-competitive and cartel-forming meetings. This approach has been undertaken by the central bank of the Netherlands (DNB), bringing together different financial players. The resulting publication[201] of existing practices provides an interesting overview of how various Dutch banks integrate climate risks. It also identifies gaps and challenges which regulators can address.

The impact of Covid-19 has resulted in new challenges. Governments, e.g. in India and Indonesia, are relaxing existing requirements for companies to assess their climate impact or apply labour laws. This makes it more difficult for supervisors and regulators to require an ESG risk and impact assessment by the banks.

Avoid shifting non-sustainable finance to shadow banking and non-banking sector

By imposing stringent ESG/sustainability criteria on the regulated banking sector, supervisors and regulators need to pay due attention to prevent the shadow banking and informal lending sector from escaping the sustainability requirements and eventually becoming bigger and riskier creditors than banks. Companies may turn to the non-banking sector and informal lenders to escape the mandatory sustainability scrutiny arising from banking regulations.

Moreover, since the shareholders play an important role at banks through their voting at annual meetings and influence on company management, regulators and legislators should consider accompanying sustainable banking initiatives with sustainable investment initiatives, including obligations to implement ESG risk and impact assessments (details for such initiatives are beyond this report but many initiatives have already been taken around the world).

4.2.4. Promote diversity of the banking sector to move forward in an agile way

Finally, the whole structure of the banking sector might not be sufficiently agile to meet the huge sustainability challenges in FFA-plus countries and the rest of Asia, struck by the COVID-19 fall-out. More diversification of the banking sector could provide better access to small loans for small and new sustainable and/or rural/farming initiatives, and for supporting the growing poor population.

Diversity of the banking sector could be promoted by governments, legislators (e.g. parliaments) and regulators. For instance, more proportionality of regulations and financial laws would support the creation of (or the expansion of existing) smaller, inclusive and sustainably oriented banks. A diverse banking sector could include local and regional private or not-for-profit public banks, cooperative banks, ethical or green/sustainable banks, Islamic banks and credit unions. Conflicting mandates would be avoided if their profitability would not be under shareholder pressure to increase shareholder value nor under undue pressure from international competition by large banks. Rather, their sustainability objectives and long term goals should get priority in all their operations. Public banks should have explicit mandates to serve the whole of the population and be publically accountable for their operations to avoid corruption.

4.2.5. Promoting a regional approach

The different efforts by national supervisory and regulatory authorities could benefit and increase the efficiency by discussing and coordinating on sustainable banking at a regional level. Such regional cooperation would avoid regulatory arbitrage by banks between countries and strengthen regulatory measures with exchange of information and experiences.

One way to promote a more regional approach, is to discuss it at the only forum where central bankers of all the FFA-plus countries meet in the same platform, namely the Asian Regional Consultative Group of the Financial Stability Board (see table 3).[202] As of June 2020, this group

is co-chaired by the Indian Deputy Governor of the RBI, B. P. Kanungo, and the Philippine Governor of the BSP, Benjamin E. Diokno. They could create a sustainable finance platform for cooperation and coordination and expand it to all Asian countries.

Table 3: Memberships of bank supervisory and regulatory authorities of FFA-Plus countries in international alliances of regulators working on sustainable banking and finance

Country & authority	Sustainable Banking Network (SBN)	Network on Greening the Financial Sector (NGFS)	Financial Stability Board (FSB)	Basel Committee on Banking Supervision (BCBS)	Coalition of Finance Ministers for Climate Action	International Platform on sustainable finance (serviced by the EC)	Issuance of official national policies, guidelines, principles or roadmaps on sustainable finance
Cambodia	[Association of Banks in Cambodia]	x					x
China	x [and: China Banking association]	x	x	x		x	x
India	[Indian Banks Association]		x	x		x	[National Voluntary Guidelines for Responsible Financing by the Indian Banks Association]
Indonesia	x	x	x	x	x	x	x
Japan		x	x	x			
Philippines	x	x			x		x
Thailand	[Thai Bankers Association]	x					[Sustainable Banking Guidelines Responsible Lending by the Thai Bankers' Association]
Vietnam	x						x

Source: Websites of the mentioned organisations and associations (last viewed 15 September 2020).

4.3. Conclusion: Steps towards long term sustainable banking

In order to avoid a forward-looking scenario in the next decade of climate and environmental destruction, inequality and social injustice, banks operating in FFA countries can take different steps. Although a basic lending process by a bank is to assess the risks of non-repayment or financial losses, undertaking an ESG risk approach would only be one step. Specific bank strategies, business models, lending and other financial services will be needed, to contribute to the Paris climate and SDG commitments, and ensure full respect for human rights. Extra

steps include implement and act according to long term social and environmental impact assessments, and actively develop sustainable lending opportunities and financial products.

Regulators, supervisors and where appropriate, legislators, in FFA countries can play an important role to move the banking sector into the direction of more sustainability. They can do so by improving their supervisory scrutiny of the sustainability strategies and practices of banks. By helping design various tools that banks can use, or providing training and information sharing, they can support banks to make swifter transitions towards sustainable practices. The most effective step would be to impose mandatory obligations and standards on 1) ESG risks and impact assessments and related capital requirements, 2) lending with sustainability objectives and 3) phasing out of financing unsustainable activities, based on clear definitions. This would avoid unfair competition among banks at the national level. Regional cooperation among banking authorities might, in the long term, provide a significant contribution to make the banks being part of commitments to achieve the SDGs, respect for human rights and the Paris climate goals.

5

CONCLUDING REMARKS

The dramatic economic and social impacts from COVID-19 are testing the financial stability and short-term profitability of banks operating in FFA countries. However, for longer-term resilience, these banks will need to take into account more forthcoming risks. A forward-looking scenario developed in this report exposes how COVID-19 is aggravating already existing problems like human and labour rights abuses, exhaustion of natural resources and too little progress towards achieving the SDGs by 2030. Also, FFA countries have not been taking the necessary steps to avoid climate change, whose impact is already manifesting itself. Millions of people and businesses are in danger of being affected by increased inequality, social injustice, floods, droughts, rising sea levels and extreme weather events in the coming decade. The resulting loss of livelihoods and communities, increasing poverty and migration, and potential conflict, will affect the operations and profitability of banks in the decade to come.

By ignoring the social and environmental impacts of their corporate borrowers during risk assessment processes, banks in FFA countries have contributed to climate change and social injustice. According to the forward-looking scenario in which these trends continue up to 2030, banks will themselves be increasingly confronted by the consequences. For instance, banks will face defaulting loans in coal power plants, the fossil fuel sector, agribusinesses, real estate, infrastructure and many other sectors.

Banks operating in FFA countries can avoid and prevent longer-term climate, environmental and social risks and negative impacts by adjusting their traditional methodologies with forward-looking data to assess credit, market, and operational risk. When failing to do so, they may come under pressure from concerned regulators and supervisors, credit rating agencies, and even shareholders and civil society.

The forward-looking scenario of social injustice and environmental tragedy by 2030, as developed in this report, necessitates banks to take a step further. They need to contribute to positive social, climate and environmental impacts in the societies in which they operate, in line with the SDGs and the Paris agreement. To avoid a "tragedy of the horizons", banks need to take strategic and operational steps to discontinue lending to socially and environmentally harmful sectors, companies and activities. In the meantime, they can create innovative opportunities by developing sectoral lending policies and financial products that directly benefit climate mitigation and social justice.

Regulators, supervisors and legislators of FFA-plus countries have an important role to play in ensuring that their banking sectors make swift changes to more sustainable banking. The most efficient way, and to avoid free-riders, is to issue mandatory requirements for (1) ESG risk and impact assessment methodologies and related allocation of capital reserves, as well as for (2) promoting sustainable lending and (3) phasing out the financing of detrimental activities and companies. Supervisors have the means to accelerate the transition at banks by upscaling their own sustainability supervisory practices and interventions, develop forward-looking guidance, and provide capacity building for bank management and staff. Ultimately, regional cooperation on sustainable banking might be considered to find long term solutions with special attention to social justice and local needs.

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