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Transition Finance – A Bigger Hole to Fill in the World's Transformation

As we have tracked throughout 2021, sustainability finance related bonds continue to rise almost exponentially. As at 25 June 2021, green, social, sustainability and sustainability-linked bond sales from governments and corporates so far this year total USD531.0bn, 230% higher than the same point last year. But while governments, regulators, issuers and investors strive to improve their sustainability knowledge and activities, a perhaps more pressing need is the role and scope of the concept of Transition Finance. We see sustainability linked loans and bonds as a subset of sustainability finance and are the key investment instrument for transition finance as opposed to green loans and bonds that tie the use of proceeds to green uses or specific projects. They also differ from green loans and bonds in that sustainability linked loans and bonds can be at the entity level rather than be tied at the transaction level as green loans and bonds are. This provides some flexibility for borrowers or issuers and capital providers and can encourage borrowers or issuers to focus on sustainability across its entire business operations rather than solely through its investments.

Navigating the path to sustainability

According to the Organisation for Economic Co-operation and Development (“OECD”), Transition Finance is the financing of the journey towards the 2030 Agenda and the achievement of sustainable development. This [2030 Agenda](#) for Sustainable Development was defined by a 2015 United Nations resolution and includes 17 Sustainable Development Goals (“SDGs”) that act as a framework towards sustainability that is targeted to be achieved by 2030. Each SDG has specific targets and indicators to ensure they are actionable, and progress can be measured towards the achievement of the SDGs. The scope of the SDGs are broad and the depth of the problems are deep (especially considering the effects of the pandemic) hence the costs of achieving these goals are significant. The scale of the problems to be addressed and the relatively short time frame to achieve them has likely driven the substantial financing flows to date in sustainability finance. According to a previous estimate by the United Nations, USD5 trillion to USD7 trillion is needed annually between 2015 and 2030 to achieve a set of SDGs globally although this estimate has likely changed with the passage of time and impact of COVID-19 and will be highly variable given the scope in terms of tasks and countries.

Of interest though is the difference in problems to be addressed and the current uses of sustainable financing. Although the SDGs are interlinked and integrated (for instance climate change has contributed to a rise in undernourished people), the bulk of them (14 of 17) are focused on social goals. Conversely, we estimate roughly 15 % of all green, social, sustainability and sustainability-linked bonds issued over 2014-2020 are identified as social bonds as a use of proceeds. [S&P Global in its report on how sustainability-linked debt has become a new asset class](#) mentions that over 85% of Sustainability Linked Targets (“SLT”) or key performance indicators in sustainability-linked bonds are environmental in nature. This is likely due to the imminent threat of global warming and the need to control the production of greenhouse gas (“GHG”) emissions to achieve the goal of limiting global warming to well below 2, and preferably below 1.5 degrees Celsius, compared to pre-industrial levels as set out by the [Paris Agreement](#) on climate change. To achieve this, countries are expected to reduce GHG emissions by almost 50% by 2030 and achieve climate neutrality or net zero GHG emissions by 2050. It also reflects the belief that risks from climate change represent the biggest influence on the success of all SDGs and that in the world of ESG, there can be no success in “S” without solving “E”.

The other difference that exists in sustainable financing is whether all the green and sustainably linked bonds are funding new projects for a greener future or seeking to correct current projects and activities that are contributing to global warming. Indeed, the scale of the funding involved indicates the size of the problems that need to be corrected through both increased investment in low emission technologies and green projects but also through transitioning “brown” industries to become greener and more sustainable. According to the World Bank Group, around USD70bn to USD100bn per year is needed for developing economies to adapt to global warming of 2 degrees while the International Finance Corporation in 2016 identified USD23tr of climate related investment opportunities in 21 emerging economies by 2030. The United States Environmental Protection Agency breaks down the current largest emitters of GHG by [country](#) and [industry](#) with China, the United States and India being the three largest emitting countries (the EU-28 as a block is the third largest emitter comprising 28 countries and reflects the progression that EU members have made in their sustainability journeys) while Electricity and Heat Production, Agriculture, Forestry and other Land Use, Industry and Transportation are the four largest emitting economic sectors.

As the largest emitter, China is an interesting case study of current trends in sustainable and transition finance showcasing where it currently is and where it needs to be. China is the world’s largest coal producer and consumer with coal comprising almost two thirds of its energy consumption. Declines in coal consumption during 2016-2018 when the government banned new coal fired power plant construction was quickly reversed when the ban expired. New coal fired power plant construction rose and according to the [Global Energy Monitor](#), China built more coal fired power plants in 2020 than the rest of the world by a factor of over three to one. That said, China has announced a series of pledges to combat the impact of climate change. The [Council on Foreign Relations](#) has listed these as including:

- Carbon neutrality by 2060;
- Peak carbon dioxide emissions before 2030;
- Renewable energy sources to account for 25% of total energy consumption by 2030;
- Reducing carbon intensity (carbon emitted per unit of GDP) by more than 65% by 2030;
- Installing 1.2 billion kilowatts of combined solar and wind power generation capacity by 2030;
- Increasing forest coverage by around six billion cubic meters by 2030; and
- Banning sales of new gas-powered vehicles by 2035.

Accelerating the journey

We believe that as awareness of climate change continues to grow, the focus on transition financing could rise in kind and perhaps at a faster pace. We see three key reasons for rising prominence of transition financing:

1. Increasing evidence of climate change and occurrences of extreme weather events and natural disasters;
2. The still high existence of “brown” industries and brown growth which, according to [Senior Environmental Specialist at the World Bank Uwe Deichmann](#), “relies heavily on fossil fuels and does not consider the negative side effects that economic production and consumption have on the environment”. Some of these industries and companies will need time to transition from brown to green whilst at the same time still being significant contributors to GHG emissions; and
3. The need to reduce the possible related social impacts or effects from the wind-down in brown industries and the transition to green.

Historically though, adoption of Transition Financing has been relatively slow compared to the growth in green loans and bonds due to a nascent understanding of Transition Financing and lack of clarity on how meaningful Transition Financing is to achieving global sustainable development. This is notwithstanding that renewable energy is still a minority in the world’s energy sources. According to the [Center for Climate and Energy Solutions](#), renewables made up 26.2% of global electricity generation in 2018 and while renewable energy is the fastest-growing energy source in the United States and the only energy source which grew through the 2020 pandemic, renewable energy is only expected to rise to 45% of global electricity generation by 2040 with most growth from solar, wind and hydropower.

With this dual need to invest in new green low emission technologies and also drive transition of brown sectors towards a green future, what are the steps being taken to take advantage of the large investment opportunities, meet the ideals of the Paris Agreement and promote Transition Financing?

Using financial incentives to drive willingness before capacity

The cost to transform is high, especially for those industries where there is no economically or technically feasible option that exists at the moment. At the same time, the timeline for a net zero emission future continues to march on. Bridging the short-term costs for better long-term benefits are sustainability linked loans and bonds. These include funding cost adjustments should the borrower or issuer achieve certain Sustainability Linked Targets (“SLTs”). Categories of SLTs include energy efficiency, GHG emission levels, use of renewable energy, water consumption and sustainable sourcing. Recent examples of a sustainability linked loans and bonds include:

- Indian cement producer UltraTech Cement Ltd.’s USD400mn 2.8% 10-year sustainability linked bond priced at T+167.5bps. Its sustainability performance target (“SPT”) is linked to its direct or owned/controlled carbon intensity which is calculated as kilograms of carbon dioxide (“CO2”) emissions emitted per ton of cementitious material. This is to be equal to or lower than the lesser of 557 kg CO2/t.cem (reflecting a reduction of 22.2% from a 2017 baseline) or the Science Based Targets initiative (“SBTi”)-verified target, as of 1 May 2030 and in any event no later than 1 August 2030. The SBTi is a collaboration between CDP, the United Nations Global Compact, the World Resources Institute and World Wide Fund for Nature to enable companies to limit global warming through setting decarbonisation or GHG emission reduction targets. UltraTech Cement Ltd.’s SBTi-verified target is expected to be available no later than 31 March 2022. Should UltraTech Cement Ltd be unable to achieve its SPT by 1 May 2030 or 1 August 2030 (the Observation Date), then the sustainability linked coupon will step up by 75bps for the remainder of the bond. While the 75bps step up is around three times the market standard of 25bps according to Bloomberg, the higher rate would only apply for the last six months left until the bond matures.
- National Australia Bank Ltd’s (“NAB”) first-of-its-kind sustainability-linked loan for Port of Newcastle, Australia’s largest east coast seaport. The loan, part of a broader AUD666mn refinancing facility, includes AUD515mn in sustainability-linked loans that offer a lower margin on debt if the seaport hits targets across a range of social and environmental metrics. This is the first sustainability-linked financing by an Australian seaport and the first such loan in Australia to include a modern slavery assessment metric addressing the borrower’s suppliers.
- Japfa Comfeed Indonesia priced a USD350mn 5NC3 senior unsecured sustainability-linked bond at 5.375%, with a step-up coupon of 5.5%. The bonds are the first issued in the global agri-food industry and linked to an environmental target that requires the company to build nine water recycling facilities at its operations to reduce water pollution by three months prior to year four.

According to S&P and Bloomberg, green bond issuance was relatively concentrated with utilities comprising 56% of green bond issuance over 2020 followed by consumer discretionary and industrials at 12% each. In contrast, 61% of sustainability-linked bond issuance over 2019-2020 came from three sectors – utilities (24%), materials (19%) and industrials (18%). Consumer staples and consumer discretionary made up a further 22% at 13% and 9% respectively. Even within the product, sustainability linked loans and bonds themselves differ. According to [Gilbert and Tobin](#), the application, disclosure and verification required for sustainability linked bonds is higher or more specific than their loan counterparts.

The benefits of these products are multiple. They are forward looking and provide an economic incentive for brown companies to transition in the short term for their longer-term sustainability. It also helps capital providers to fulfil their own sustainability efforts through the provision of green or sustainability linked financing as part of their net zero carbon plans. As seen from HSBC Holdings PLC’s (“HSBC”) [climate plan announced in October 2020](#), sustainability ambitions can be multi-layered. HSBC’s ambition to support the transition to a net zero global economy by 2050 involves targeting net zero carbon emissions across its entire customer base by 2050 at the latest and provide between USD750bn to USD1trillion in financing to help clients make the transition. To achieve this, financed emissions will align with the Paris Agreement and use the Paris Agreement Capital Transition Assessment Tool (“PACTA”) to measure progress while disclosures will follow the Task Force on Climate-related Financial Disclosures. The bank also aims to be net zero in its operations and supply chain by 2030 while a third leg of HSBC’s plan involves the creation of HSBC Pollination Climate Asset Management as manager of ‘natural capital’ as an asset class.

We expect that sustainability linked loans and bonds structures will evolve over time and become tighter or stricter as acceptance increases and sustainability plans progress. At the moment, structures are somewhat lenient with sustainability linked targets only measured towards the end of the loan or bond near its maturity such as those targets for UltraTech Cement Ltd that are mentioned above. Currently, Europe leads in terms of adoption and acceptance of sustainability linked loans and bonds. [According to S&P Global](#), 85% of all sustainability linked loans

were issued by European borrowers in 2020, followed by Asia Pacific and North America at 7% and 5% respectively. Similarly, 84% of all sustainability linked bonds were issued by European borrowers in 2020, followed by North America at 9%. That said, issuance trends are diversifying - through early April 2021, European borrowers comprised 66% of all sustainability linked loans issued while European borrowers comprised 68% of all sustainability linked bonds issued, followed by Asia Pacific and North America at 10% and 15% respectively.

Establishing the rules of play

If SDG's and Paris Agreement targets are the goal posts and sustainability linked loans and bonds are the equipment, then players also need to know the rules and amongst other things, a large driver of Europe's adoption of sustainability linked loans and bonds is the European Union's ("EU") [Taxonomy Regulation](#) for sustainable activities. Per the EU, the Taxonomy Regulation establishes a classification system or 'framework' that is necessary to drive capital towards the funding of activities to achieve the EU's 2030 climate and energy targets. The taxonomy covers both the definition of a financial product (which is contained in other EU regulations) as well as definitions of "environmentally sustainable" economic activities. These activities must provide a net benefit (ie its contributions should outweigh its harm) to either of six environmental objectives including (1) climate change mitigation; (2) climate change adaptation; (3) sustainable use and protection of water and marine resources; (4) transition to a circular economy; (5) pollution prevention and control; and (6) protection and restoration of biodiversity and ecosystems. Implementation of this regulation is in stages with climate change mitigation and adaptation objectives to be implemented from 1 January 2022 and the following four to be implemented from 1 January 2023.

Other aspects of Taxonomy Regulation that complete its effectiveness and intentions is a requirement that the economic activities should not result in negative social impacts and the inclusion of disclosure obligations. While social issues are being considered for inclusion in addition to broader environmental considerations, the current six "environmentally sustainable" economic activities are heavily focused on environmental considerations. This is possibly another reason why sustainability linked loans and bonds are focused on the achievement of environmental objectives, in addition to the relative ease in setting environmental goals that re easier to quantify and assess than goals related to social or governance. Investors will need to adjust their investment processes and disclosures to conform with this taxonomy.

Establishing the taxonomy is a start. There remains much work to be done on establishing standardized terms and methodologies that are globally recognized and accepted. There also remains further development of the EU Taxonomy in order to enable inclusive transition financing. The EU's Platform on Sustainable Finance, which was established to advise the European Commission on the development of the sustainable finance market with a particular focus on the ongoing development and update of the EU taxonomy, recommended in its [March report](#) that: (1) the EU Taxonomy maximise inclusiveness through appropriate communication and reporting requirements that support and enable more transition finance activities for as many parties as possible; (2) there should be opportunities to extend the current EU taxonomy to make the framework more future ready; and (3) there should be an ability to use other non-Taxonomy policies and tools to support transition finance.

Understanding how to play the game

Whilst rules, definitions and frameworks assist players in the sustainability space, understanding and interpreting them is also needed to ensure that the market continues to develop. To this end, sustainability linked loans and bonds themselves are also subject to various principles designed to promote and govern their use including (1) the [Sustainability Linked Loan Principles](#) issued in March 2019 by the Loan Markets Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association, and (2) [Sustainability-linked Bond Principles](#) that were issued by the International Capital Market Association ("ICMA") in June 2020. Both are designed to provide investors and issuers with a framework to assess if a bond can be classified as transition finance using key criteria including:

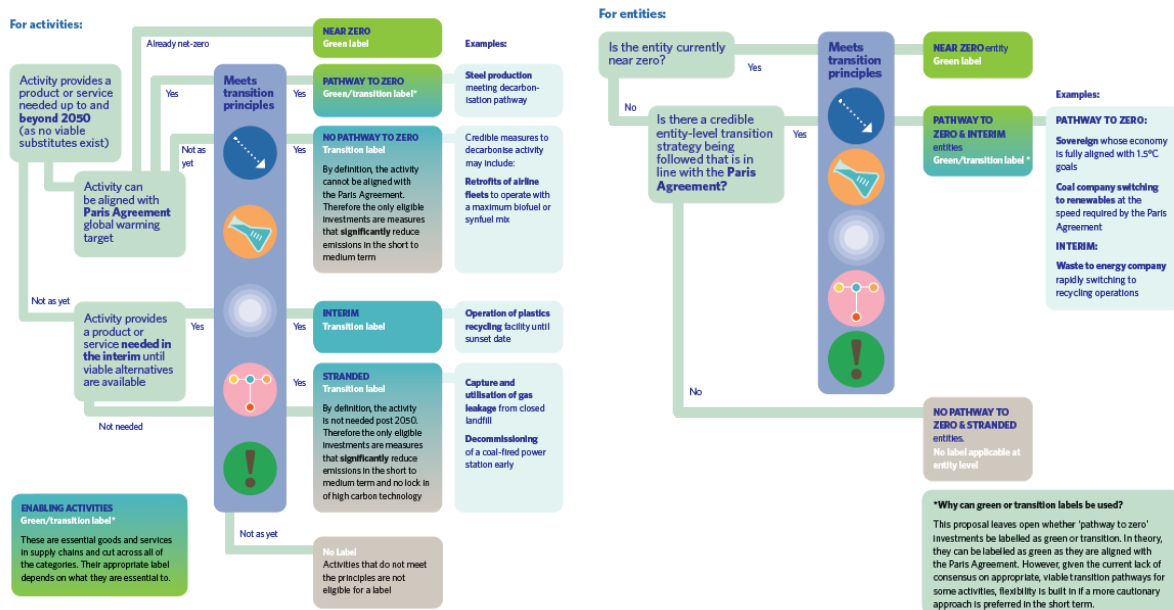
- Setting of ambitious performance targets that are tied to the borrower or issuer's sustainability plan to measure progress and overall sustainability of the borrower or issuer;
- Appropriate reporting and verification guidelines; and
- In the case of sustainability linked bonds, the inclusion of credible KPIs and meaningful terms that incentivize the achievement of performance targets.

The Sustainability Linked Loan Principles were recently revised with the key changes including (1) stricter restrictions regarding the selection of KPIs and the scope of SPTs; (2) the requirement for independent and external verification

of a borrower's performance level against each KPI and SPT is now mandatory; and (3) the principles have been adjusted to align with Sustainability Linked Bond Principles. Sustainability Linked Bond Principles themselves were supplemented in December 2020 by the release of ICMA's [Climate Transition Finance Handbook](#) as additional guidance for bond issuers to ensure their bonds conform to the climate related principles of sustainable financing.

While sustainability linked loans and bonds are the tools or equipment for transition, their sources, uses and application in financing energy transition is not so straight forward. The Organisation for Economic Co-operation and Development's ("OECD") Development Assistance Committee ("DAC") has therefore established a [toolkit](#) to give guidance on how to finance transition in the most optimal manner. In particular, the DAC in their role to (1) promote development co-operation to implement the 2030 Agenda for Sustainable Development and (2) achieve a future where no country will depend on aid, studied who is the more effective provider of finance as an economy transitions from being low income to high income. They concluded that (1) domestic financial resources (e.g.: tax revenues) must be a dominant and growing contributor to sustainable financing as opposed to external flows as a country moves towards a high-income status; and (2) while dependence on public external support such as Official Development Assistance ("ODA") is necessary for low income countries and early stages of transition, financing sources should gradually move from public financing sources (ODA, Other Official Flows) to private financing sources (foreign direct investments and remittances). Such substitution is necessary for both effective economic development as well as optimal sustainable development to eliminate any financing gaps that could lead to sustainable development setbacks. Financing sources are not uniform and have different objectives so must conform with the needs of the economy. For instance, external public financing sources are likely to be more focused on social issues while private sources will be more focused on infrastructure development.

Knowing what to use and who best to provide it though may not be enough to achieve effective sustainable development. Understanding where to use financing sources is also important. To this end, the [Climate Bonds Initiative](#) ("CBI") together with Credit Suisse Group AG published a [white paper on Financing credible transitions](#) that focuses on ensuring that transition financing activities are impactful on the 17 SDGs by (1) being credible and ambitious in significantly reducing GHG emissions; (2) are aligned with Paris Agreement targets and accompanied by an entity-level carbon reduction strategy; and (3) and have clear transition pathways. The whitepaper establishes a framework at both the entity and activity/transaction level that breaks down whether the entity or activity meets, is likely to meet in the future or will have difficulty meeting five identified transition principles and whether the activity is needed up to and beyond 2050. Entities or activities are then labelled on a continuum whether they are green, in transition or stranded. A green entity or activity is needed beyond 2050 and is basically near zero emissions already with little need for further transition (e.g.: wind power). A transition entity is also needed beyond 2050 but is a material emitter and either has a decarbonation plan (e.g.: shipping) or does not (e.g.: long-haul aviation). Finally, a stranded entity or activity is a material emitter, and either cannot meet the five transition principles, is not needed beyond 2050 or has a low emissions substitute (e.g.: coal fired power generation). These transition labels are expected to enable investors to more efficiently allocate capital to the right activities and/or entities that will effect meaningful change and achievement of SDGs. The framework also aims to eliminate greenwashing by helping capital providers avoid mislabeled transition investments that ultimately would not yield progress for SDG achievement due to their inability to transition or the existence of a green substitute.



Source: Climate Bonds Initiative – Financing Credible Transitions: Summary note, September 2020

Looking to the future - Consistency, Coordination, Commitment

To support its push to provide USD750bn-USD1trillion in transition financing, [HSBC published its own white paper in June 2020](#) on why transition finance is vital to combat climate change. Whilst highlighting technical, economic and institutional challenges to a timely transition, the bank also highlighted how the UK has successfully transitioned its electricity generation capacity from 75% coal to almost predominantly natural gas and renewables (wind, solar power) in just 10 years over 2010 to June 2020 (coal is still used as a peaking source).

Although the steps mentioned above have been taken to encourage the use and acceptance of transition finance linked instruments, there remain gaps in the market that need to be addressed. One is the difficulty in comparing the relative structures of different sustainability linked loans and bonds from different issuers. Each borrower or issuer’s sustainability plan will be different from the next and specific to that borrower or issuer’s characteristics. In addition, it will be difficult to compare just how meaningful sustainability linked targets are for the different borrower or issuer’s and what that may mean for the capital provider and their own sustainability linked or financial targets.

Reporting and disclosure also remains non-standardized which impacts assessment and verification. Use of third parties to assess if SLTs are met can be done but the cost of implementing SLTs and hiring independent reviewers can be a disincentive for transition finance and the use of sustainability linked loans and bonds as opposed to the relative ease in understanding and assessing the sustainability impact from implementing green projects that are funded with green bonds. Netherlands-based asset manager NN Investment Partners surveyed institutional investors and found that 45% believed that green bonds make the most positive impact, followed by sustainability-linked bonds (37%), social bonds (11%) and lastly, transition bonds (7%). Transition bonds are the laggard given they are effectively sustainability-linked bonds without KPIs or SPTs and therefore harder to assess as to their sustainability impact. Proponents of transition bonds however see them as another tool to enable transition and providing even more flexibility for borrowers or issuers, albeit at the expense of clarity.

Finally, HSBC in its white paper highlighted some financial factors that can accelerate the growth of transition finance. These include the efficient pricing of climate-related risk and determining a relationship between environmental and credit performance, a comprehensive carbon pricing framework, financial incentives for both borrowers/issuers and investors and regulatory support such as allowing early write-offs of stranded assets. As mentioned above in “Implications on Stranded Assets”, policy intent may increase with the world seemingly behind in Paris Agreement targets, hence the changes and impacts on stranded assets will increase with stronger policy intent.

What will be key however through (1) the development of sustainability linked loans and bonds and their related principles; (2) a taxonomy; as well as (3) a toolkit and operational framework is to establish a consistency in approach that provides relevance and clarity on transition pathways and impacts. This should drive more coordination amongst issuers/borrowers, industries, and countries to achieve SDGs and establish a commitment towards a sustainable future.

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