Role of Financial Services on ESG: ESG Ecosystem and What Are We Seeing in the Market

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What are the latest developments?

International development

As part of COP26, there had been significant developments in a number of areas. The patterns that we are seeing is – (a) increasing trend to reference TCFD as a framework (b) starting to consolidation of framework and standards and (c) changes are coming at a much accelerated pace.

COP26

- **URGENCY**
- Aim global warming to 1.5C. Current pledges, if met, will only limit global warming to about 2.4C
- Explicit plan to **reduce use of coal**. However, countries only agreed a weaker commitment to "phase down" rather than "phase out" (e.g. China and India)
- **Developing countries** - financial supports; phase out fossil fuel subsidies
- **US and China** – pledged to cooperate more in areas including methane emissions and switch to clean energy
- 100 countries promised to step **deforestation** by 2030
- Financial organisations agreed to **back "clean" technology**.

International Sustainability Standards Board

IFRS

- "**Climate related disclosures prototype**" was issued by the Technical Readiness Working Group of IFRS Foundation for the consideration of ISSB In November 2021
- Based on **PwC 2021 Global Investor Survey**, only about 1/3 of investors, on average, think the quality of the reporting they're seeing is good enough. Simply put, **investors cannot easily differentiate between companies on ESG-related performance**.
- Investors **question whether much of today's ESG reporting gives them the relevant, reliable, timely, complete, and comparable information** they need for effective decision-making.

Common Ground Taxonomy

- The International Platform on Sustainable Finance (IPSF) issued the "**Common Ground Taxonomy – Climate Change Mitigation**" – instruction report and also reference tools in early November 2021
- Comparison of EU and China taxonomies to identify areas of **commonalities and differences**.
- Focus on **climate change mitigation**. Some other environment objectives yet to be covered.
- HK regulators are aiming to adopt this framework.
- Will facilitate international green bond market growth

TCFD

- "**Guidance on Metrics, Targets, and Transition Plans**" was released in October 2021.
- "**2021 Status Report** (Oct 2021)" provides updates on adoption of TCFD framework and illustrates best practices.
- HK regulators expecting TCFD disclosures by 2050.
- China planning mandatory climate risk disclosures. Expect to be largely TCFD aligned.

- **Taskforce on Nature-Related Financial Disclosures (TNFD)** released a workplan in June 2021.
- The goal of the TNFD is to provide a framework for organisations to report and act on evolving nature- related risks, in order to support a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes.
- The **TNFD will not create a new disclosure standard**. Our aim is to establish and promote the adoption of an integrated risk management and disclosure framework that aggregates the best tools and materials.

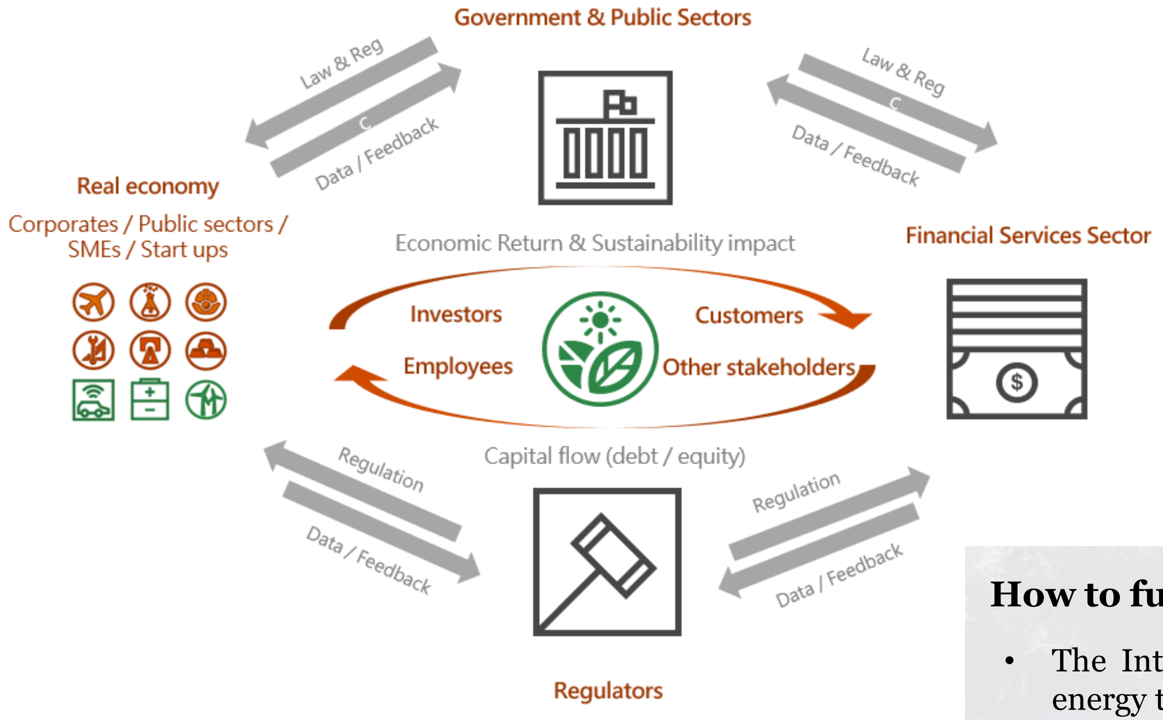
ESG

- Much increased focus and awareness from investors and customer side
- Real economy waking up. Momentum picking up.
- APAC – striking a balance with the net zero goal and other social and economic development objectives is challenging
- Financial institutions increased resources and focus on green / sustainability products and services
- Circular economy
- Supply Value Chain
- **Beyond the "E", what about "S" and "G"**

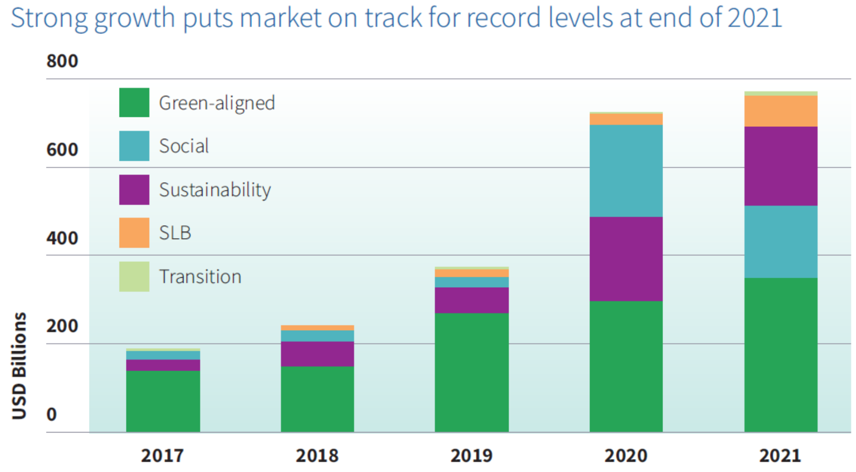
Pace of revolution has accelerated

With massive push to accelerate actions to reach the Net Zero target, more countries and corporations have committed to take action. **Investors and customers' awareness** on ESG related matters increased significantly, driving **demand for green and sustainability products ad services**. Financial service sector is key to the trillion dollar financing need.

ESG ecosystem is working to direct capital flows



Sustainable debt market – issuances doubled in volume in 2 years



Source: Climate Bonds Initiative; 2021 up to Q3 2021

How to fund these financing needs?

- The International Energy Agency estimated that the **annual investment** to support the energy transition needs to **increase from approx. USD 2 trillion** to approximately **USD 5 trillion by 2030** and **stay at similar level until at least 2050** to reach the net zero target.
- China, the world's biggest emitter of carbon dioxide, needs **140 trillion yuan (USD21.33 trillion)** of debt financing over the next 40 years to meet its net-zero emissions target*

* China International Capital Corp (CICC) estimates

China’s green bond market exhibited similar trend

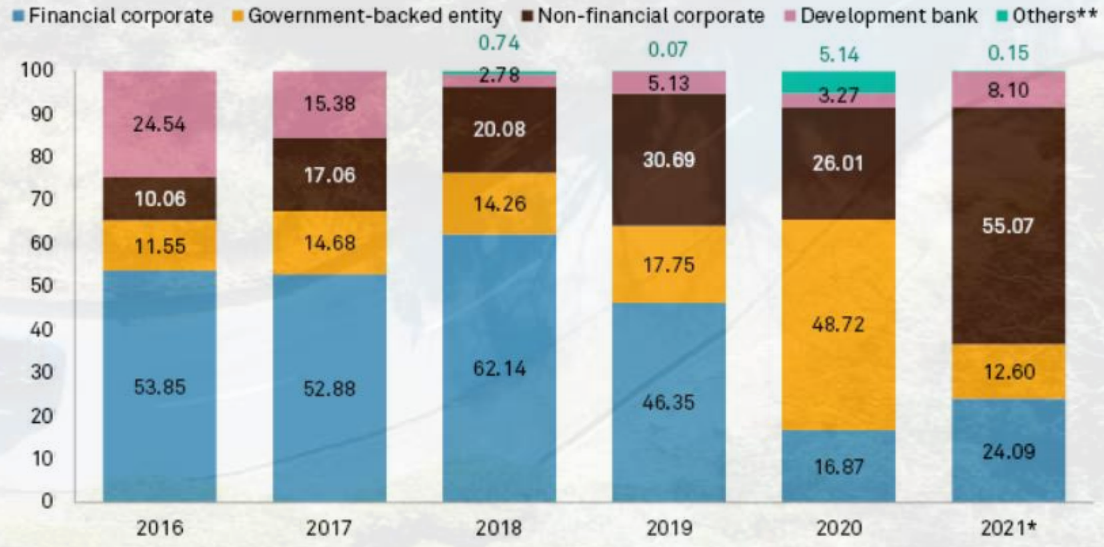
China's green bond issuance volume has also grown significantly in 2021 with the 2030/2060 commitments and focus on accelerated transition to a low-carbon economy.

Volume of Chinese green bond issuance ($B)*

Data compiled Oct. 12, 2021.
* Volume includes bonds aligned with international standards and bonds aligned with only local standards.
Internationally aligned green bonds are limited to those where at least 95% of proceeds are designated for green projects aligned with the Climate Bonds Taxonomy.
Source: Climate Bonds Initiative

Source: S&P Global

Chinese green bonds by issuer type (%)



Data compiled Oct. 12, 2021.
Green bond figures include data for both internationally aligned and nonaligned bonds.
* Represents data until Sept. 30, 2021.
** "Others" include "local government" and "other debt instrument" categories.
Source: Climate Bonds Initiative

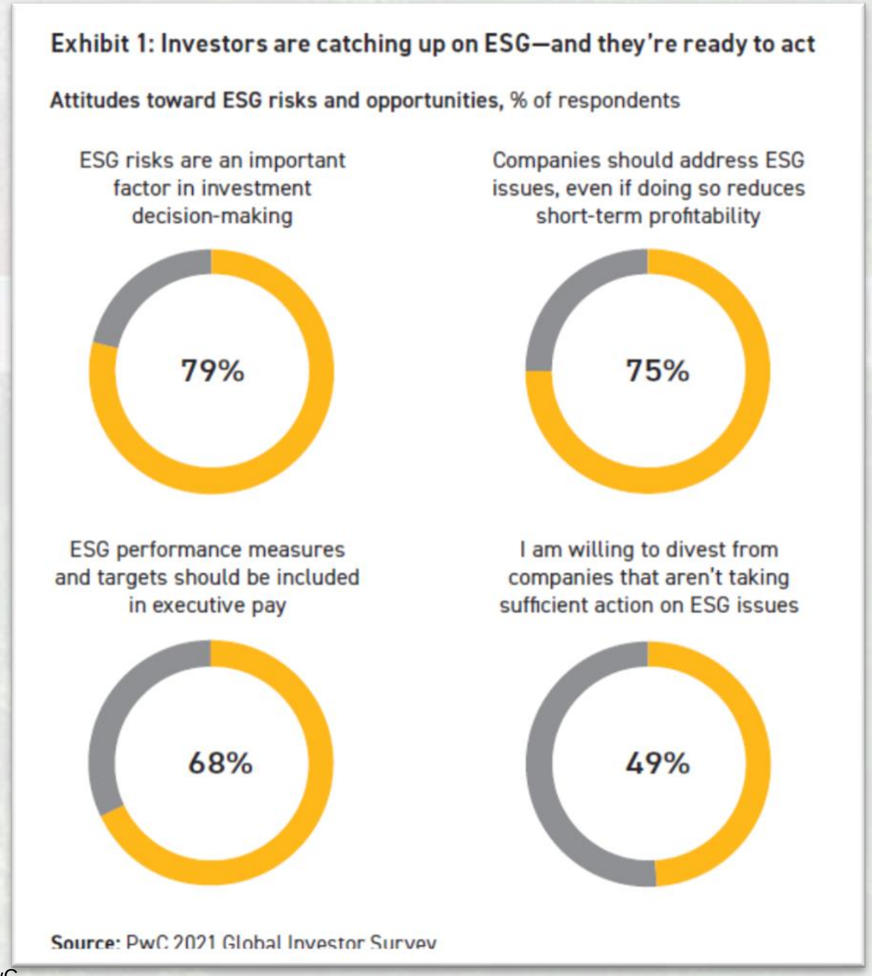
Source: S&P Global

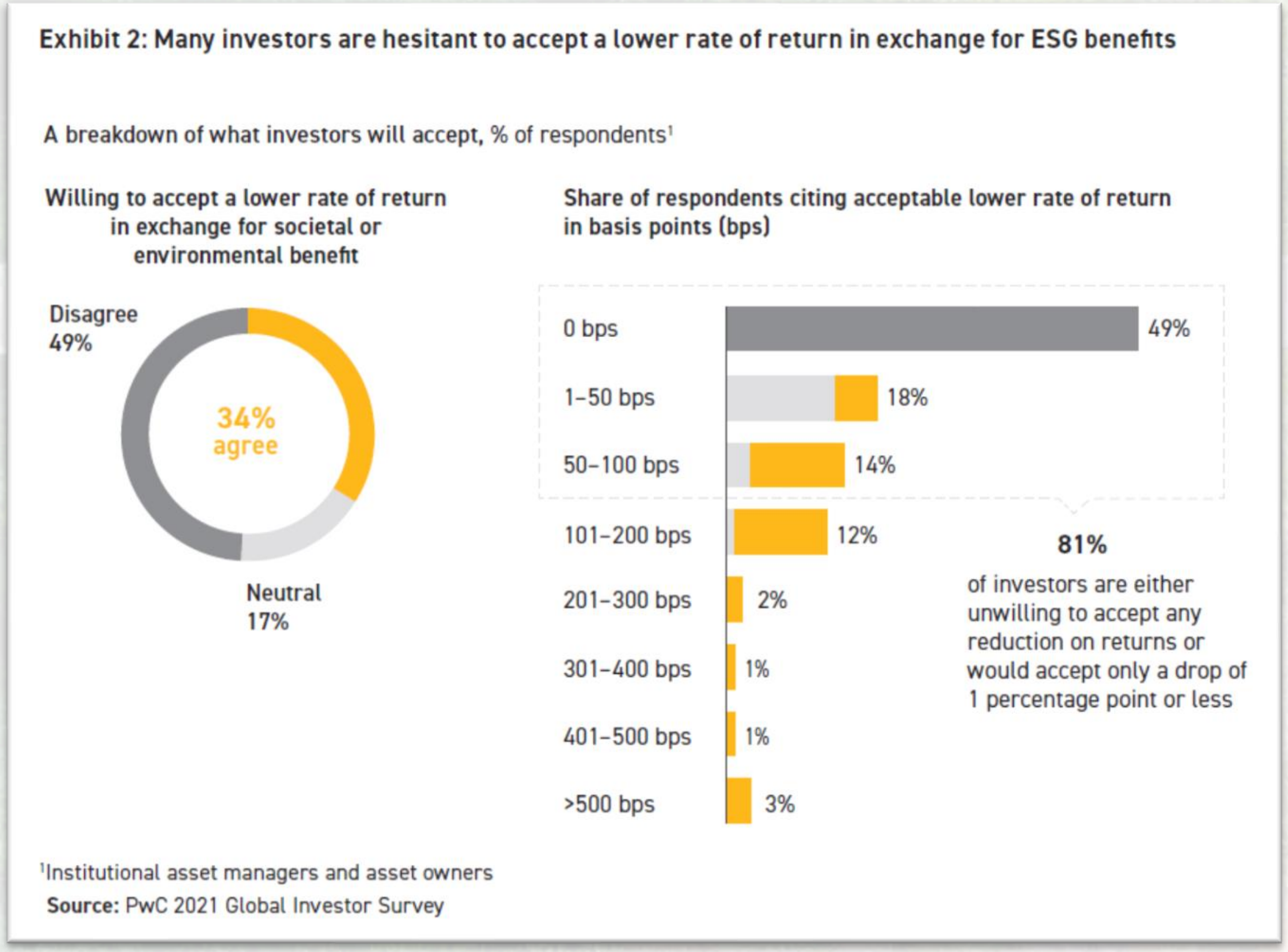
B

Why the growth in sustainable debt market?

Investors’ view

PwC surveyed 325 investors globally, the majority of whom were self-identified active asset mana**gers** making investments for the long term. In a wide variety of ways, those investors expressed **commitment to ESG goals intheir investing and as a priority** for their portfolio companies. At the same time,**most (81% of) respondents** expressed **reluctance to take a hit on their returns exceeding 1 percentage point in the pursuit of ESG goals.**





Institutional investors form coalitions and engage with professional service firms to increase the pressure on ESG poor performers

75%

investors believe their companies have changed their voting and policies to pay more attention to ESG risk

2/3

of institutional investors believe ESG will become the "industry standard" within the next 5 years

20%

of all ETFs will be tied to ESG ratings by 2028, BlackRock forecasts

53

# of companies BlackRock took voting action against for lagging in action and disclosure on ESG issues

Investor Coalitions & Initiatives

Climate Action 100+
Global Investors Driving Business Transition

- Climate Action 100+ is an investor initiative launched in 2017
- Ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change
- > 500 investors with $47 trillion in assets under management are engaging companies to curb emissions, improve governance and strengthen climate-related financial disclosures

! Capital market exerts coordinated pressure on ESG poor performers

Voting & Engagement Services

GLASS LEWIS
SUSTAINALYTICS

- Glass Lewis provides information to institutional investors on relevant policy updates, company ESG ratings and proxy voting recommendations
- Supports 1,300 institutional investors in their proxy decisions
- The regulatory update service informs shareholders on ongoing legislative procedures at all levels and thus increase the focus for early regulatory adoption

! Proxy advisors increase market transparency and exert coordinated pressure on management boards

Change is inevitable

In the past 2 years, there has **been significant increase in awareness and actions** from ESG and climate change angle. Government, regulators, investors and consumers are pushing for actions and changes. Financial institutions and asset owners are doing **"screening" on corporates** from ESG angle. Corporates need to embark this journey to **stay competitive and relevant**.

Push and pull factors

Push factors

- Regulations
- International guidelines
- Investors' demands
- Customers' concerns
- Competitors
- Rating agencies
- Other stakeholders such as employees, suppliers and citizens

Pull factors

- **Risk mitigations** - physical and transition risks
- **Performance enhancement** – contribution to the bottom line
- **Value creation**
  - Business viability / sustainability
  - Intangible corporate value
  - Contributions to the society

Business Transformation

Governance

- Board oversight
- Management's role

Strategy

- Impact on the organization's businesses, strategy and financial planning
- Resilience of the organization's strategy

Disclosure and reporting

- Define short, medium and long-term KPIs
- Disclose qualitative and quantitative information

Risk management

- Risk identification and assessment processes
- Risk management process
- Integration into overall risk management

Outcomes

- **Strategic reinvention** balancing ESG with growth targets
- Clearer direction on where **future capital investments** should go into
- **Supply chain** resilience and value creation
- **Brand** building and reputation
- **Risk mitigation / Sustainable transition**
- Other **intangible values** (e.g. employee engagement)

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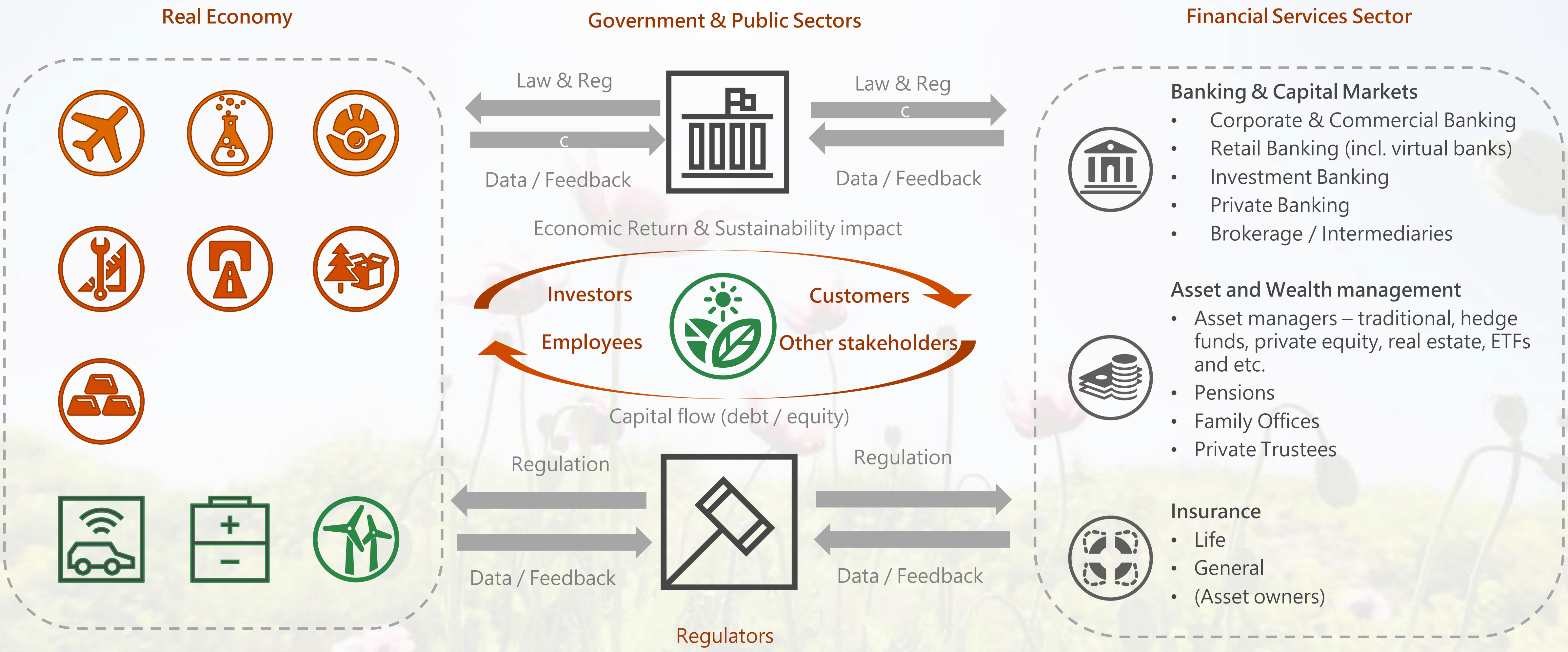
ESG ecosystem

ESG and climate risk ecosystem

The current momentum is focusing on how to direct public and private funds into projects or assets which are going to support the various sustainability and climate goals by 2050 / 2060.



Financial regulatory landscape in Hong Kong

In July 2020, the Hong Kong Monetary Authority ("HKMA") invited selected authorized institutions to participate in a **pilot climate change stress testing** ("CRST). A year later, the HKMA published the consultation document on Supervisory Policy Manual **GS-1 "Climate Risk Management"** in July 2021 while SFC issued the conclusion paper on **"Management and Disclosure of Climate-related Risks by Fund Managers"** in August 2021.

HONG KONG MONETARY AUTHORITY
香港金融管理局

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

All Authorised Institutions

➢ GS-1 Climate Risk Management

Governance	Designates dedicated personnel or committee to be responsible for climate related risks at the management level.
Strategy	Formulate the climate strategy over both the short and long time horizon to cater for the unique nature of climate risks.
Risk Management	Identify & measure, conduct scenario analysis, monitor & report, and mitigate & control climate-related risks.
Disclosure	Start planning for the first TCFD disclosure by mid 2023 and devise steps to work towards full TCFD compliance by 2025.

➢ Pilot Climate Risk Stress Test

1. The HKMA' s Scenarios
2. Scenario Extrapolation
3. Transmission Mechanism
4. Quantification of Financial Impact

Fund Managers

➢ Management and Disclosure of Climate-related Risks by Fund Managers*

	Requirements	Fund managers	Effective
Two-tier approach	Baseline requirements	All fund managers (FMs)	Large FMs – August 2022 Other FMs – November 2022
	Enhanced standards	Large fund managers (AUM of HK$8 billion or above)	Large FMs – November 2022

	Baseline requirements (All fund managers)	Enhanced standards (Large fund managers only)
Governance	Integrate climate-related issues into board and management roles and responsibilities	
Investment management	Identify and factor climate-related risks** into the investment management process	
Risk management	Identify, assess, manage, and monitor climate-related risks for each investment strategy	• Scenario analysis** • Portfolio carbon footprints**
Disclosure	Disclose the above requirements to fund investors and review disclosures at least annually	• Engagement policy • Portfolio carbon footprints

- Fund managers managing collective investment schemes and those serving clients with climate-related investment mandates - including managers who delegate functions to sub-managers. (The AUM of discretionary accounts will be excluded)

** Where relevant and material

Source: HKMA, SFC

ESG and climate risk development in Hong Kong

Hong Kong's Climate Action plan 2030+ is expected to achieve "peak carbon" by 2020 and absolute carbon emissions will be reduced to 26-36% by 2030 from the 2005 level. In the Chief Executive's 2020 Policy Address, Hong Kong is committed to achieve carbon neutrality by 2050.

Government

- **Climate Action Plan 2050 (i.e. 4 strategies –** net-zero electricity generation, energy saving and green buildings, green transport, and waste reduction**)**
- Started the **Government Green Bond Programme** in 2018. The borrowing ceiling is doubled to HK$200 billion in 2021.

Incentive & Support

- HKSAR launched the Green and **Sustainable Finance Grant Scheme** in 2021, providing subsidy for eligible bond issuers and loan borrowers to cover their expenses on bond issuance and external review services.

Innovations

- Bank for International Settlements Innovation Hub and HKMA are investigating how **tokenized green bonds** can improve sustainable investment.
- The Steering Group is assessing the **feasibility of developing Hong Kong as a regional carbon trading centre** to strengthen collaboration in the Greater Bay Area.

Regulations

- The Hong Kong Monetary Authority and Securities and Futures Commission initiated the establishment of the **Green and Sustainable Finance Cross-Agency Steering Group** with 5 other local regulators / government bodies.
- New / Proposed **climate risk management framework and disclosure requirements** applicable to relevant **financial services players** will be in force in the next 2 years.
- **New climate risk related disclosure requirements** to **companies listed on Hong Kong Stock Exchange** effective from July 2020.

Capacity Building

- The Steering Group launched the **Centre for Green and Sustainable Finance** to develop strategies and roadmaps to promote capacity building and develop data repository and analytics capability.

D Challenges, Risks and Auditor’s Role

Some of the key challenges that we are facing today

Based on our interactions with various regulators, industry associations, investors and financial institutions, the lack of globally accepted framework, regulations and definition of "green" created significant challenges in performing analysis and supporting effective decision making. Green washing is also a concern. The fast evolving industry and regulatory developments further exaggerate the challenges at hand.

Data

- ESG related **data lacks consistency** which makes it very hard to interpret and compare between companies, sectors and territories.
- This is driven by the **lack of consistent reporting and disclosure standards and frameworks.**
- Asset managers who have focus on China found that **data coverage for China is not sufficient**.
- **Lack of correlation between ESG ratings** provided by different rating agencies.

ESG Reporting

- Based on PwC 2021 Global Investor Survey, only about 1/3 of investors, on average, think the quality of the reporting they're seeing is good enough. Simply put, **investors cannot easily differentiate between companies on ESG-related performance**.
- Investors **question whether much of today's ESG reporting gives them the relevant, reliable, timely, complete, and comparable information** they need for effective decision-making.
- Any one volunteers the **"bad news"** in the disclosure?

New and Evolving Regulations

- Regulations are **evolving at a very fast pace.**
- With **a complex supply chain**, the **knock on impacts can be very far reaching.**
- Financial institutions not only needing to understand the implications of the regulations that impact themselves, they also need to understand the **regulations that are impacting their investments and companies that they are financing.**
- **Shortage of talent** requiring significant investments in upskilling

Green Washing

- Is it really green? How green is it?
- **Lack of common definition of the "green"**
- Green assets / projects **may not equate "safe" assets**. There are still risks involved.
- Still need to **evaluate the corporates as a whole** – overall business strategy, quality of governance and management, viability of business model, performance and etc.

Time horizon

- Some of the ESG elements, particularly, climate risk have a 20 – 30 years time horizon. **Significant uncertainty** is involved in any financial projections and etc
- However, **transition risks** should not be ignored.
- Balancing **short term profitability and long term business viability** is key.

Transformation of the Real Economy

- The real economy is struggling to strike a balance between recovery from the impacts of COVID-19, complying with climate-related regulations and **demonstrating the economic value** of green sustainable projects.
- There is also a **lack of awareness and willingness** among **small-and-medium size** enterprises to transform
- Some sectors are not moving as fast as where the capital flows are re-directing to; increasing the risk of green washing.
- Laggers may **lose competitveness and relevance** in the industry.

Thank you

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