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Leading Global Capital Markets Towards a New Era

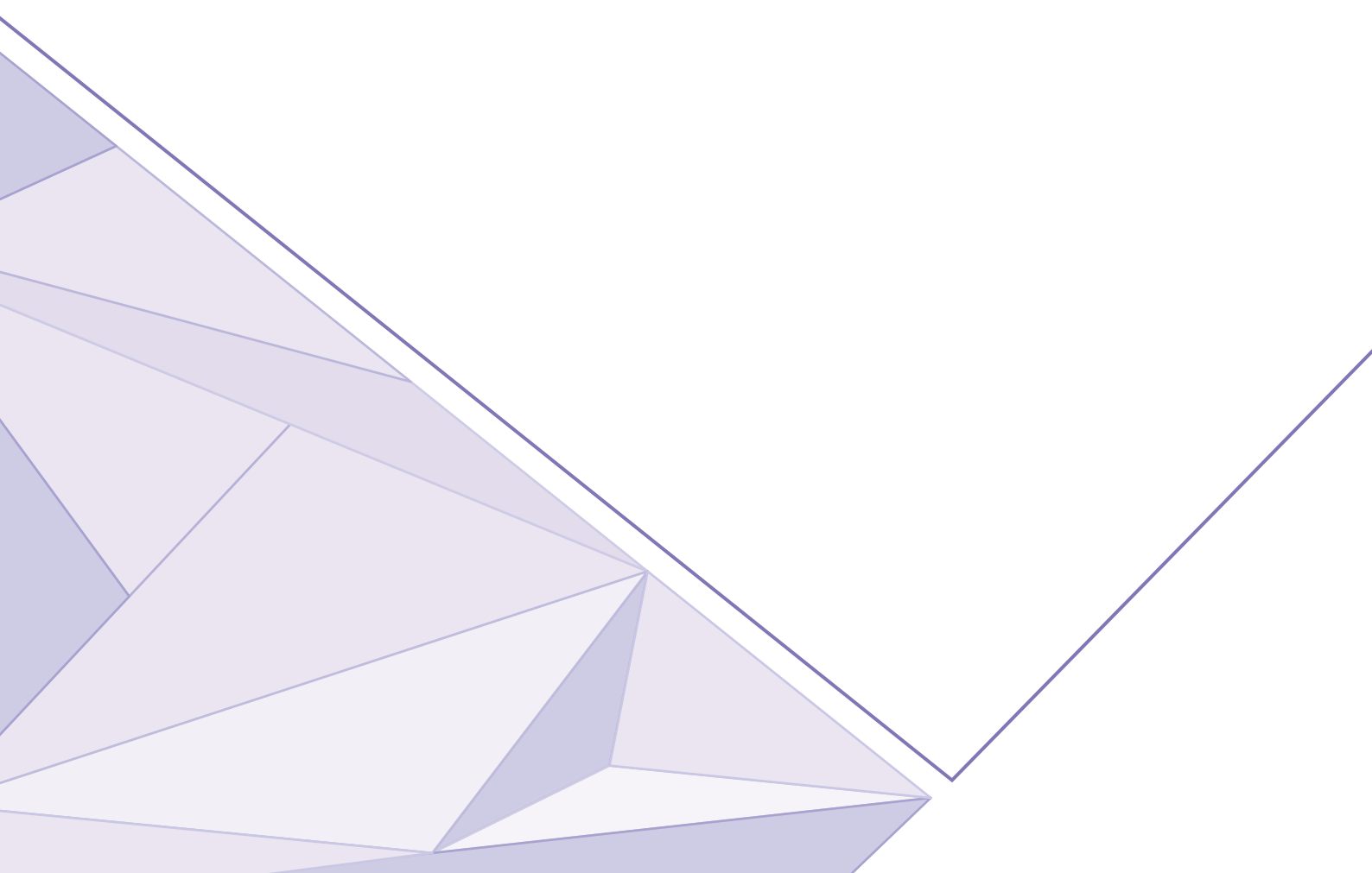
A Policy Review on Environmental, Social and Governance (ESG)
Reporting for Corporates and Investors in Hong Kong





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Executive Summary

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1. More and more businesses are realising that creating long-term shareholder value may actually be consistent with taking care of other stakeholders, including employees, consumers, suppliers, and communities at large, as well as the environment.
 2. In fact, businesses may be, on the one hand, negatively affected by the increasingly evident disruptions due to climate change; and on the other hand, may positively and collectively constitute an important piece of the puzzle in tackling climate change.
 3. Hong Kong is not immune to negative consequences of climate change. Coastal and low-lying areas have a high risk of flooding because of rising sea level and more frequent storm surges. Commercial districts in Hong Kong are among the riskiest areas, which are vulnerable to landslides as well due to increasing frequencies and severity of rainfalls with more powerful storms.
 4. International financial markets are aware of the risks of climate change. For example, central banks around the world are leading the way to make international financial systems more resilient to climate risks. Central banks, including the Bank of England, the European Central Bank and the People's Bank of China, formed the Network for Greening the Financial System to promote best practices in green finance and to develop tools for assessing climate risks in financial markets.
 5. Mainland China has demonstrated its commitment to steering its economy towards greener and more sustainable development, and therefore, green finance has been on its strategic agenda to encourage businesses to do and capital markets to fund green projects.
 6. In general, businesses should understand strategically at the senior level the potential risks and value creations with the uncertainties brought about by climate change, including regulatory regime changes and physical losses. At the same time, asset managers should understand implications of such balancing risks and rewards associated with climate change. Businesses and asset managers should create long-term values for their shareholders and asset owners respectively.
 7. In order to maintain and enhance Hong Kong's role as a pioneer and important international financial centre in China, Hong Kong needs to make sure that its regulatory regime is conducive to facilitating integration of environmental and social considerations into business and investment decisions by businesses and asset managers respectively. Therefore, regulatory regimes related to Environmental, Social and Governance (ESG) reporting of companies and ESG investment and fiduciary duties of asset managers are important and will be the focus of this report¹.

1. This report is a sequel to the report of Financial Services Development Council on ESG Investment, which was substantially contributed by Our Hong Kong Foundation. We encourage readers to study both reports to gain a more comprehensive view on this important subject.

Aspects of ESG Ecosystem Globally

8. While tighter regulations do not necessarily imply smarter and better regulations, Hong Kong tends to be more lax in building ESG regulatory regimes compared with other global counterparts.
9. Regulatory regimes for ESG reporting:

As shown in **Table 1** below, France and the United Kingdom (UK) require companies to mandatorily disclose ESG policies and indicators regarding carbon or greenhouse gas emissions. Additionally, ESG reports in France need to be verified by accredited independent third parties. The European Union (EU) employs a “comply-or-explain” approach for ESG policies disclosure, but mandatorily requires companies to disclose related key performance indicators (KPIs). Exchanges in Singapore, Hong Kong, Australia and Japan have adopted a “comply-or-explain” approach, where listed companies are required to either disclose their ESG policies or explain their non-compliance. Companies in the United States (US) only need to disclose ESG information if it is deemed material. Apart from the jurisdictions in **Table 1**, the China Securities Regulatory Commission has announced its plan to mandate environmental disclosure by 2020.

(Table 1) **Global Comparisons of Regulatory Regimes for ESG Reporting**

Jurisdiction	Institution	ESG Reporting Regulations Highlighted	ESG Policies Disclosure	ESG KPIs Disclosure
All European Union member states	The European Parliament and The Council of The European Union	EU Non-Financial Reporting Directive 2014/95/EU	Comply-or-explain	Mandatory
France	French Government	Article 225 of the Grenelle II Act	Mandatory	Comply-or-explain
		Article 173 of the French Energy Transition Law	Mandatory	Mandatory in carbon disclosure
United Kingdom	Government of the United Kingdom	The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013	Mandatory	Mandatory in greenhouse gas emissions
Singapore	Singapore Exchange Limited	Sustainability Reporting Guide	Comply-or-explain	Not specified
Hong Kong*	Hong Kong Exchanges and Clearing Limited	Environmental, Social and Governance Reporting Guide	Comply-or-explain	Comply-or-explain
Australia	Australian Securities Exchange Limited	Corporate Governance Principles and Recommendations (4 th Edition)	Comply-or-explain	Not specified
Japan	Tokyo Stock Exchange	Japan's Corporate Governance Code	Comply-or-explain	Not specified
United States	Securities and Exchange Commission	Commission Guidance Regarding Disclosure Related to Climate Change	Only if material	Not specified

*Please refer to section 5.1.1 for a more detailed discussion on ESG reporting requirements in Hong Kong regulations.

10. Regulatory regimes for fiduciary duty:

As shown in **Table 2** below, France was the first country to introduce mandatory requirements on investment managers to disclose their ESG investment policies, and require institutional investors, such as insurers, to disclose their ESG integration policies on a “comply-or-explain” basis. Institutional investors and asset managers in the EU, as well as asset managers in the UK, are required to disclose their ESG integration policies on a “comply-or-explain” basis. Certain types of pension funds in the EU and the UK are required to mandatorily disclose their ESG integration approaches. In contrast, Japan and Hong Kong only adopt a voluntary approach to requesting investors to monitor or engage investees on ESG issues.

(Table 2) **Global Comparisons of Regulatory Regimes for Fiduciary Duty**

Jurisdiction	Institution	Regulation	ESG Integration Policies
France	French Government	Article 224 of the ‘Grenelle II’ Act	Mandatory (investment managers)
		Article 173 of the French Energy Transition Law	Comply-or-explain (institutional investors)
All European Union member states	The European Parliament and the Council of the European Union	Shareholders Rights Directive II (SRD II)	Comply-or-explain (asset managers and institutional investors)
		Directive on Institutions for Occupational Retirement Provision (IORP II)	Mandatory
United Kingdom	Financial Reporting Council	Stewardship Code	Comply-or-explain (proposed in 2019) (asset managers)
	Government of the United Kingdom	Occupational Pension Schemes (Investment) Regulations	Mandatory
Japan	Financial Services Agency	Japan’s Stewardship Code	Not specified (voluntary in monitoring investee companies regarding ESG factors)
Hong Kong	Securities and Futures Commission	Principles of Responsible Ownership	Not specified (voluntary in engaging investee companies on ESG issues)

11. The global ESG investment market:

The global scale of ESG investment reached USD 30.68 trillion in 2018, soaring 131% since 2012 (Global Sustainable Investment Alliance [GSIA], 2015, 2019). The largest share of ESG investment was taken by Europe (46%) and the US (39%) respectively (GSIA, 2019). Japan had seen tremendous compound annual growth of 308% in its ESG investment since 2014, which brought its share of global ESG investment to 7% following Europe and the US (GSIA, 2019). While 2018 data is unavailable, 2016 data showed that other Asian regions accounted for only 0.23% of the global total (GSIA, 2017). As a global financial centre, Hong Kong shared only 0.06% of the global ESG investment in 2016 (GSIA, 2017).

ESG Reporting in Hong Kong: Problems and Recommendations

12. In Hong Kong, there is evidence to show that the ESG reporting of listed companies, as a whole, may need further improvements in the following three aspects:

i. Strategic Integration of ESG Considerations:

The integration of ESG considerations into governance, strategy and management system is limited in general, such that ESG reporting has simply turned into a “box-ticking” exercise in many circumstances;

ii. Identification and Materiality Assessment of ESG Risks:

Many companies are not very effective in identifying ESG risks or conducting materiality assessments, which results in limited disclosures; and

iii. Quality of Reporting:

ESG reports are generally not assured, whereas small and medium-sized companies lack the necessary capacity to produce quality ESG reports.

13. Current development in regulatory regime related to ESG reporting:

To enhance listed companies’ reporting of environmental information, the Securities and Futures Commission (SFC) aims to work with the Hong Kong Exchanges and Clearing Limited (HKEX) to explore alignment of climate-related disclosures in Hong Kong with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). HKEX has also included a section on the TCFD recommendations in its ESG reporting step-by-step guide.

One of the key aspects of the TCFD recommendations is to strengthen companies’ climate-related disclosures in areas of governance, strategy, risk management, and metrics and targets. Further alignment with the TCFD recommendations should help to improve the effectiveness of ESG reporting in Hong Kong.

14. Specifically, we recommend that:

- i. **HKEX should clarify in its Corporate Governance Code that the board is responsible for assessing material environmental and social risks and learning the latest developments in useful tools such as the TCFD recommendations.** ESG risk assessments should be integral to its strategic decision-making process at a high level. This would help companies internalise the strategic value of ESG reporting and hopefully reduce the “box-ticking” phenomenon.
- ii. **HKEX should expand the disclosure provisions of the ESG Reporting Guide to cover ESG governance, strategy, management and the process of materiality assessment.** This should lead to greater transparency of essential ESG information, which allows investors to have higher-quality dialogues with companies and better assess ESG risks and opportunities.
- iii. **HKEX should refine, and potentially narrow, the scope of the ESG Reporting Guide to help companies identify material ESG risks that are sector-specific, and offer sector-specific guidance to assist companies in quantifying environmental and social impacts on a “comply-or-explain” basis. In addition, certain important criteria in each sector-specific matrix should be reported on a “mandatory” basis.** This allows companies to focus resources on reporting the most material indicators relevant to their respective sectors, thereby enhancing the instrumental value while potentially narrowing the scope of their reports. In developing these sector-specific matrices and criteria, stakeholders should be consulted with and the ESG Reporting Guide should allow for a phased implementation.
- iv. **HKEX should encourage companies to assure the few important criteria to be reported mandatorily in (iii) and assurance costs should be subsidised by the Government.** This would build the credibility of ESG reports.
- v. **As an alternative to adopting the refined ESG Reporting Guide mentioned in (iii) and (iv), HKEX should allow other internationally recognised ESG reporting frameworks, such as Global Reporting Initiative Standards, the International Integrated Reporting Framework and the Sustainability Accounting Standards Board standards, to be used.** These standards are generally more stringent than the current, as well as the refined, ESG Reporting Guide.
- vi. **The Government should develop open-access datasets of environmental and social data, particularly of climate-related data and scenarios, to facilitate the assessment of ESG risks and opportunities.** The wider availability of data and scenarios would reduce companies’ cost of ESG reporting.
- vii. **The Government should conduct a Sustainable Development Goals review and formulate a clear plan for sustainable development in Hong Kong.** The review and plan of the Government should help companies identify sustainable development gaps relevant to local contexts.
- viii. **The Government, HKEX, and relevant public bodies should collaborate with relevant professional bodies and universities to support capacity building to foster an ecosystem of quality ESG reporting.** Capacity building of in-house personnel is particularly important for small and medium-sized companies to produce quality ESG reports.
- ix. **The Government should establish a cross-sector steering committee to formulate a clear blueprint for ESG reporting development, particularly for aligning ESG reporting requirements with the TCFD recommendations, in Hong Kong.** This should help Hong Kong to stay in the frontier of ESG reporting globally.

ESG Investment in Hong Kong: Problems and Recommendations

15. ESG investment includes integrating ESG factors into all types of investments, as well as theme-based ESG investment products.
16. The scale and awareness of ESG investment in Hong Kong are currently lagging behind other developed economies such as the EU and the US. The regulatory regime for investor disclosures in Hong Kong is also relatively lax, which is probably not helpful to facilitate further development in ESG investment.
17. Therefore, we recommend that:
 - x. **The SFC should align the current Principles of Responsible Ownership (PRO) with Principles for Responsible Investment (PRI) such that ESG considerations are integrated into investment processes.** In the current PRO, asset managers are to encourage investee companies to have ESG policies in place and to engage them on ESG issues, but in PRI, asset managers are to incorporate and integrate ESG issues into investment analyses and decision-making processes.
 - xi. **The SFC should require asset managers to report on the enhanced PRO in (x) on a “comply-or-explain” basis.** Asset owners should then be able to assess their exposure to ESG risks.
 - xii. **The Government and public bodies, including the Hong Kong Monetary Authority (HKMA), should integrate ESG factors explicitly into investment policies of public funds and require their external managers to adhere to higher standards than the current PRO.** These public funds should disclose investment policies related to ESG factors whereas external fund managers of these public funds, if any, should be required to do the same. They should also facilitate the enhancement of the current PRO in (x) and require their external managers to adhere to a higher standard of PRI before the PRO is enhanced.
 - xiii. **The Mandatory Provident Fund Schemes Authority (MPFA) should incorporate ESG factors into its monitoring process.** MPFA should consider requiring the trustees and their asset managers to have ESG integration policies.



Chapter 1
Introduction

Today's business environment goes far beyond the narrow confines of shareholder value. Corporations are expected to value the broader concerns of humanity in the half century since Milton Friedman said, "the social responsibility of business is to increase its profits." Business leaders are increasingly aware that the creation of long-term shareholder value is not mutually exclusive with solving the most pressing social and environmental issues that undermine the very outlook for human society, as sustainable business profit is always built on stability and prosperity.

Climate change has the most catastrophic potential out of all of today's pressing issues. It threatens to alter humanity's very existence to a degree never before experienced by our species. Disasters ranging from hurricanes and floods to fires and droughts are now more acute, catalysed by climate change and leading to greater losses in assets and lives. Persistent and irreversible changes such as sea level rise and biodiversity loss come with far-reaching implications on humanity's quality of life and living conditions.

Hong Kong is far from immune to the worsening negative impacts brought about by climate change. Coastal areas including Central, Admiralty, Wan Chai and Causeway Bay are expected to be affected by flooding as a result of climate change-induced sea level rise and more frequent storm surges, according to the summary report of Climate Adaptation and Resilience Conference 2018 (CARE2018, 2018). Commercial districts including Central will see growing landslide hazards due to heavier rainfall brought on by the growing frequency of super storms. Companies may remain ill-informed on the risks of physical property damage and potential losses arising from climate change. Understanding these associated risks is vital for companies, especially property developers, to sustain businesses in the long run.

The 2015 adoption of the United Nations (UN) 2030 Agenda for Sustainable Development and the Paris Agreement marked an important milestone on the road to a sustainable future. The Paris Agreement fixed global targets to limit average temperature rise to 1.5°C above pre-industrial levels. The ambitious goal is essential, as failure will result in catastrophic effects beyond remedy.

China's environmental regulations have advanced rapidly in recent years with a wave of regulations governing pollution, emission and waste discharge among others. While climate change and environmental degradation continue to present serious physical risks to companies, mitigating these environmental changes will require environmental regulation, accompanied by material risks with financial implications. In consequence, companies in misalignment with low-carbon and sustainability transition will be exposed to material transition risks.



Social issues arising from the quest for sustainability and just transition will also lead to regulatory changes posing significant risks to companies. Social tension will lead to unrest, ultimately undermining the stability needed for business to thrive. In a nutshell, consideration for environmental and social factors is of rising importance to build resilient business and investment strategies.

Environmental, social, and governance (ESG) investment has become a prominent tool across major markets in response to the challenges of sustainability. Assets managed under ESG investing strategies increased by 131% from USD 13.3 trillion in 2012 to USD 30.68 trillion in 2018 according to the Global Sustainable Investment Review (Global Sustainable Investment Alliance [GSIA], 2015, 2019). The total ESG assets accounted for 26.3% of the global total assets under management (AUM) in 2016 (GSIA, 2017).

ESG reports are the cornerstone of ESG investment, informing investors engaged in any ESG investment strategy. Regulators around the world actively incorporate ESG reporting into corporate disclosure requirements and Hong Kong has also developed its own ESG reporting requirements which will be detailed in subsequent sections.

The development of climate finance is regarded as a key to success in realising the Paris Agreement. As a global financial centre, Hong Kong has the potential for channelling global capital into ESG assets contributing to sustainable development. Unfortunately, Hong Kong shared only 0.06% of total global ESG investment in 2016, while Europe had 52.6% and the United States (US) held 38.1% in the same year (GSIA, 2017). Both ESG investing and reporting in Hong Kong remain in an early stage of development and much room remains for improvement.

This report explores how policymakers in Hong Kong can leverage finance to catalyse sustainable development. In the following chapter we will discuss the materiality of climate change and the significance of a just transition, followed by an in-depth discussion on ESG reporting, investment and value creation within the ESG ecosystem. A review of regulatory regimes across the global landscape and the latest developments in ESG reporting and investment will then be contrasted with Hong Kong's local experience. This report closes with a set of policy recommendations based on the analysis in preceding chapters.





Chapter 2
On the Horizon:
The Implications of Climate Change

Climate change tops today's global agenda as the scientific consensus on human-caused global warming becomes our reality. The world has never been more aware of the imminent impacts on ecosystems, economy and society. A changing climate will shape the way businesses operate in a multifaceted manner while businesses are starting to embrace the shift from shareholder to stakeholder models for value co-creation and sustainability. Against such a backdrop, the climate-related risks and opportunities for the finance sector are worthy of emphasis.

2.1 The State of a Hotter Planet

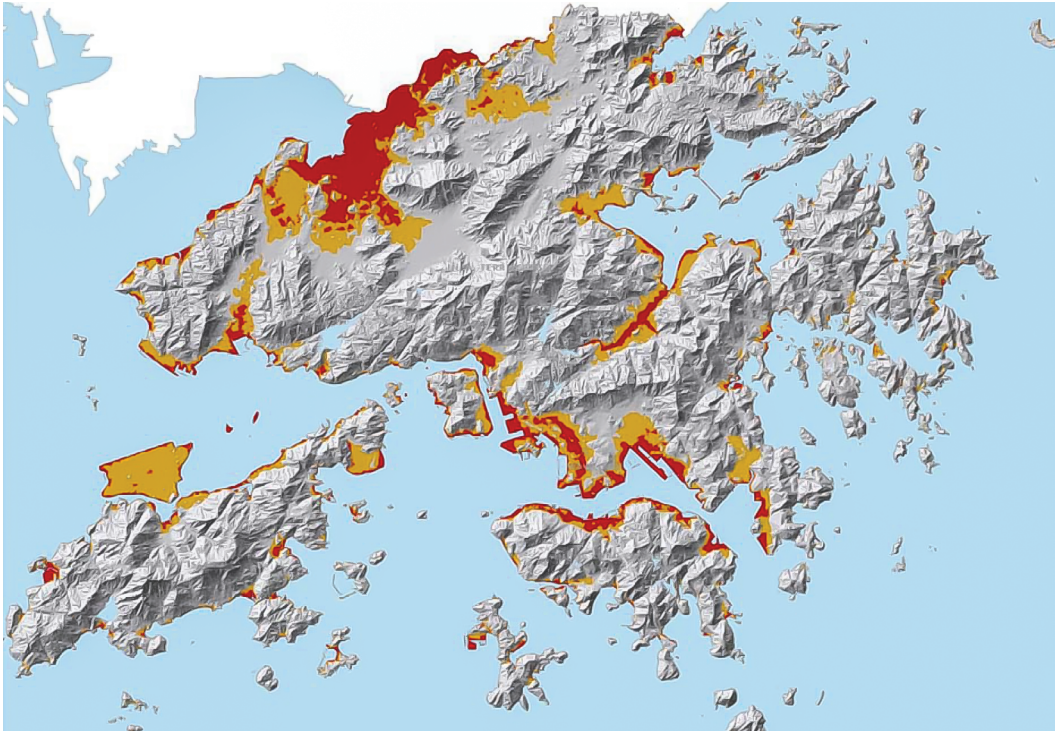
A marked upward trend in global temperatures has been witnessed over the last century. Global average temperatures already rose 0.87°C above pre-industrial levels in the decade 2006-2015 according to the Special Report of Intergovernmental Panel on Climate Change (IPCC, 2019) on global warming of 1.5°C (IPCC SR1.5). The scientific evidence supporting global warming as the result of human activity has never been more robust (National Aeronautics and Space Administration [NASA], n.d.).

Significant changes at land, sea and air are incurred with every degree of global temperature increase. The consequences cannot be overlooked. A 2°C upper threshold from pre-industrial levels was fixed for the Paris Agreement as the minimum safety line to avert the most catastrophic impacts of climate change. A 1.5°C scenario would lead to less acute environmental impacts and socio-economic consequences but this target requires ambitious climate action without delay (IPCC, 2019).

The unprecedented changes due to global warming are not limited by geography (Symon, 2013). The top 10 extreme weather events of 2018 including the Cape Town drought, California fires, Northern Hemisphere heatwave and Typhoon Mangkhut are estimated to have incurred costs ranging from USD 1 billion to USD 17 billion for each event, according to Christian Aid (2018).

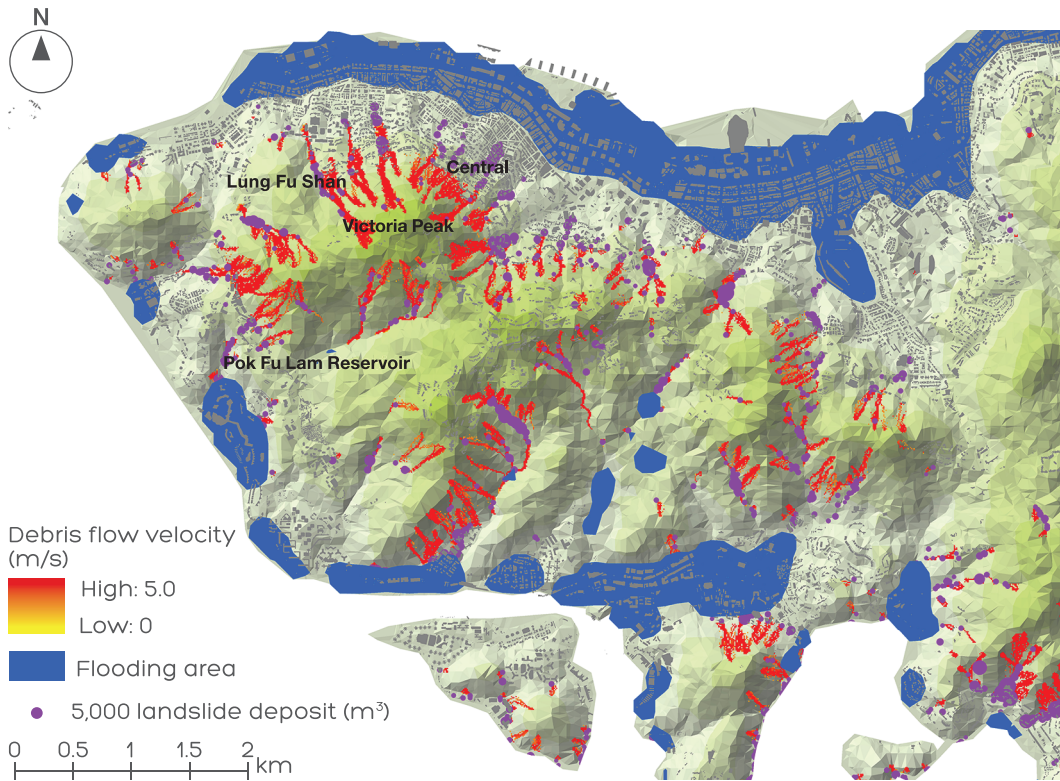
Hong Kong is not exempt from climate change's worst consequences due to its proximity to the sea and its track record of typhoons. A warmer climate results in rainfall events and heat waves of higher frequency and intensity. More frequent storm surges associated with tropical cyclones and a rising sea level are also expected (Environment Bureau, HKSAR Government, 2015b). In particular, Hong Kong's coastal and low-lying areas are vulnerable to flooding and cascading landslide hazards. The heat maps in **Figures 2.1** and **2.2** illustrate where high-risk zones overlap with major commercial districts such as Central, Admiralty and Causeway Bay as well as transit hubs like the Hong Kong International Airport.

(Figure 2.1) Areas Vulnerable to Storm Surge



Source: Environment Bureau, HKSAR Government, 2015a

(Figure 2.2) Areas Vulnerable to Cascading Hazards



Source: Zhang, 2018

Hong Kong's urban density presents even more worrisome problems when assessing the economic impacts of climate change. Many facets of the local economy are highly integrated and would suffer from major disruptions with cascading financial consequences.

Unique risks within the built environment include construction delays, property and infrastructure damage and asset value depreciation resulting from heat waves, flooding and storm surges. Hong Kong's logistics industry will have to contend with volume disruptions in global manufacturing output while airport and port operators will face enormous outlays to finance capital projects to fortify facilities. Utilities will have to retool to deal with more volatile power usage peaks and troughs as demand for cooling skyrockets during heat waves. The quality of life in Hong Kong is likely to deteriorate under extreme weather events. These events are invariably followed by greater probabilities for disease and contamination, leading to economic losses, compromised labour productivity and fatalities (Tracy, Trumbull, & Loh, 2006).

2.2 A Just Transition to a Low-Carbon World

A clear view of climate change's full impacts gives a sense of urgency to the actions needed on an unprecedented scale and at all levels for effective climate change mitigation and adaptation. The IPCC SR1.5 report highlights the need to significantly reduce carbon emissions to stabilise temperature increases within the lower limit of a 1.5°C scenario determined by the Paris Agreement (IPCC, 2019).

This requires a transition from business as usual towards low-carbon development in all sectors of the global economy with particular emphasis on, "energy, land, urban and infrastructure (including transport and buildings), and industrial systems" (IPCC, 2019, p.17).

A consensus on the world's decarbonisation trajectory is interlinked with the sustainable development agenda and the UN Sustainable Development Goals (SDGs) to integrate economic growth with due considerations for environmental protection and social inclusion (IPCC, 2019). The Paris Agreement emphasises the social dimension of climate change and the importance of enabling a transition that is "just":

"...Taking into account the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally defined development priorities." (UN, 2015, p.2)

Risks and opportunities co-exist and it is imperative to ensure a green transition is implemented on a just and inclusive basis. Climate change, for instance, will exacerbate poverty by influencing agriculture and food prices, with the potential to add 16 million to the number of people living in extreme poverty (Hoegh-Guldberg et al., 2018). Yet climate action can be a source of job creation and growth. 24 million new jobs will be created while 6 million jobs will be lost as the energy sector transitions to greater efficiency and renewable sources, resulting in a net gain of 18 million jobs by 2030 under a 2°C scenario, according to International Labour Organization (ILO) estimates (ILO, 2018).

Global climate action at the necessary speed and scale to meet the Paris Agreement goals carries both negative and positive implications spanning across economic, environmental and social dimensions. A multi-pronged approach to tackling climate change with comprehensive considerations is needed. Equal consideration for ESG factors is critical to building a thriving and inclusive economy in the age of climate change (Robins, Brunsting, & Wood, 2018). We next discuss the intersection of ESG factors with capital market and how ESG investment and reporting guides decision-making towards climate action.



Chapter 3
Leveraging ESG Investment for
Climate Action and Sustainability

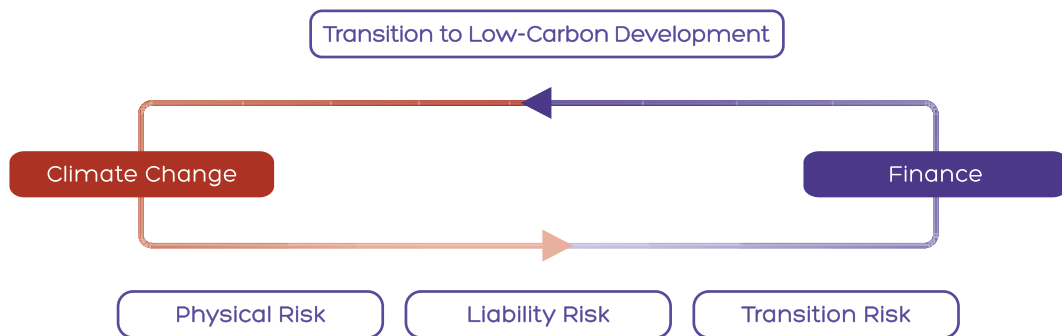
International financial markets are increasingly aware of the systematic risks to the global economy as a whole brought about by climate change. The finance sector plays an indispensable role in orienting capital flows into a low-carbon transition helped along by business and the public sector. ESG investment serves as a key tool to transform climate-related risks into opportunities while creating long-term value for investors and businesses.

3.1 Unravelling the Relationship between Climate Change and Finance

The world saw the first-ever corporate bankruptcy linked to climate change in 2019. Pacific Gas and Electric (PG&E), California’s largest utility, filed for bankruptcy over liabilities arising from disastrous wildfires in California as some have traced the wildfires to the company’s power lines (Gray & Bakke, 2019). Climate change has worsened the effects of drought in California such that each errant spark is more likely to turn into catastrophic disasters and PG&E failed to manage and mitigate the growing risk (Gray & Bakke, 2019). PG&E’s bankruptcy demonstrates the consequences of inadequate considerations of climate-related risks.

Global recognition of the downside risks of climate change is recent and has only entered mainstream debate within the last few years. Since late 2017, central banks, including the Bank of England, the European Central Bank and the People’s Bank of China have come together to form the Network for Greening the Financial System (NGFS) to promote green finance best practices and develop tools to assess climate risks within financial markets. The NGFS acknowledged, “climate-related risks are a source of financial risk,” in its first progress report published in October 2018 (NGFS, 2018, p.5), sending a strong signal that climate change is financially material and should be integrated into current decision-making and market mechanisms.

(Figure 3.1) Relationship between Climate Change and Finance



As shown in **Figure 3.1**, finance sector is exposed to a variety of climate-related risks on the one hand, and constitutes an important piece of the puzzle to facilitate low-carbon transition on the other. Climate change impacts the financial sector mainly through the direct physical effects and changes associated with a low-carbon transition. The wider financial system's stability will be disrupted and have to balance higher rates of insurance claims, lower value of investments, economic disruption and higher risks of sovereign default. The Bank of England divides the downside risks of the financial sector related to climate change into three categories (Scott, van Huizen, & Jung, 2017) :

- i. **Physical risk results from extreme weather events and changing climatic conditions with direct impact on physical asset values as well as agricultural and labour productivity.**
- ii. **Liability risk is of particular relevance to the insurance industry and includes potential compensation for climate change-related losses and damage sought by insured companies or individuals.**
- iii. **Transition risk includes losses incurred from the re-valuation of assets due to changing policies, technology or market sentiment in the transition towards low-carbon development.**

International recognition of climate-related risks are mirrored at the national level. Mainland China has demonstrated a commitment by actively steering its economy towards greener and more sustainable development. China's latest initiatives include green finance's placement on strategic agendas to encourage businesses and capital markets to fund green projects.

Tackling climate change requires strong financial sector support for businesses and the wider economy. The magnitude and urgency of combating global warming requires significant funding beyond government budgets to realise a shared vision of this scale. The UN Conference on Trade and Development (2014) estimates an annual financing gap of USD 2.5 trillion to achieve the SDGs in developing countries alone. To investors, bridging this funding gap presents investment opportunities which should not be overlooked. Combating climate change in emerging markets represents USD 23 trillion worth of investment opportunities spanning green buildings, sustainable transport, renewables and climate-smart infrastructure, according to the International Finance Corporation report (Kerr, Maheshwari, & Sottong, 2016).

Hong Kong has always been a pioneering international financial centre in China and should adapt its regulatory regime to be conducive to the integration of environmental and social considerations into business and investment decisions. Regulatory regimes for ESG reporting and investment as well as the fiduciary duties of asset managers are the linchpins of any successful adaptation and will be the focus of this report.

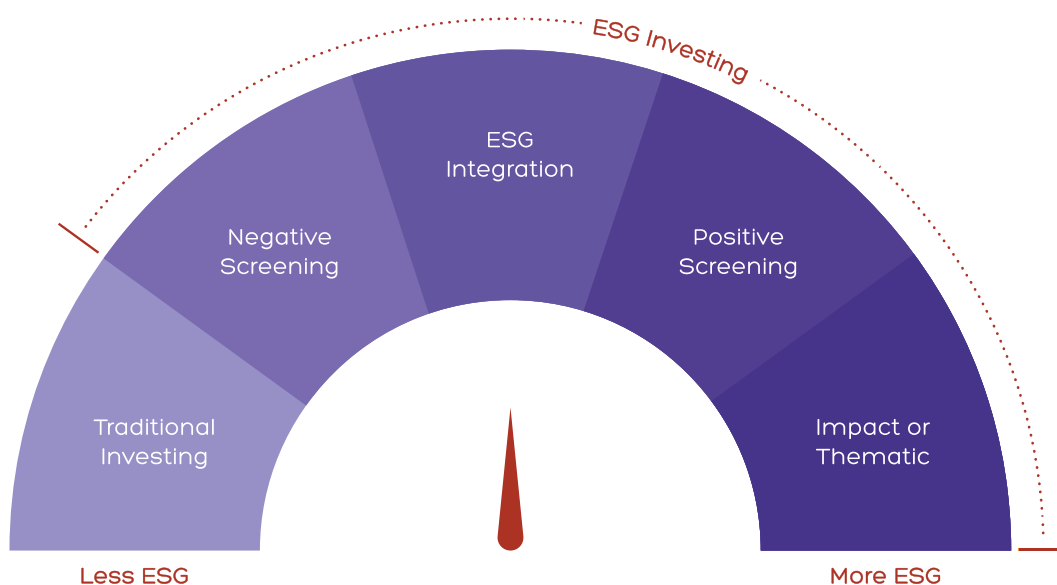
3.2 ESG Investment: Creating Long-Term Investor and Business Value

Businesses should have a strategic and senior-level understanding of climate change's potential risks and value creations based on the uncertainties brought about by climate change, regulatory responses and physical losses. Asset managers should also understand the risk-reward relationships associated with climate change. ESG serves as a good lens for businesses and asset managers to view long-term value creation for their shareholders and asset owners.

3.2.1 ESG Investment Gaining Traction

ESG investment is, broadly speaking, the incorporation of ESG considerations into investment processes. The term is often used interchangeably with sustainable investment, responsible investment, etc. There are various ESG investing strategies, including negative screening (exclusion of certain sectors or companies based on specific ESG criteria), ESG integration (systematic inclusion of ESG factors in financial analysis), positive screening (inclusion of certain sectors or companies for positive and outstanding ESG performance), and impact investing (investment with specific aim to solve certain social or environmental problems), as shown in **Figure 3.2**.

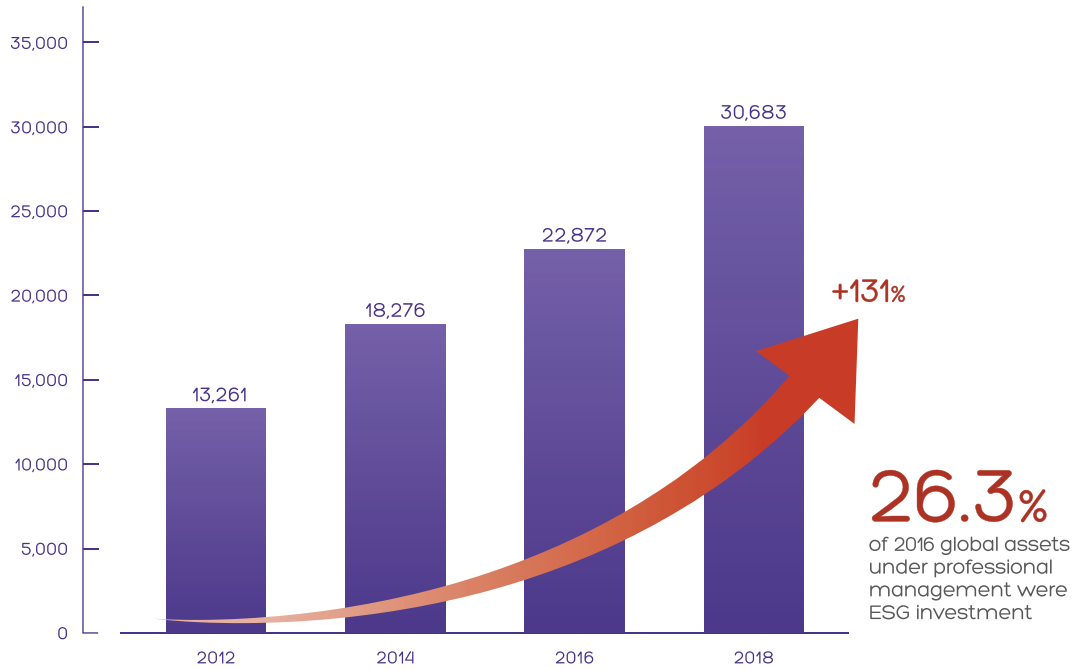
(Figure 3.2) **Spectrum of ESG Investing Strategies**



Source: Fidelity International, 2018

As global challenges of climate change unfold, many investors start paying attention to the long-term social and environmental impacts of their portfolios. The past few years have witnessed the rise of ESG investing across geographical boundaries, setting the stage for investor consideration of long-term ESG factors in their investment decisions while advancing sustainable development on the whole. As shown in **Figure 3.3** on page 20, global assets managed under certain ESG investing strategies reached USD 30.68 trillion in 2018, soaring 131% from USD 13.3 trillion in 2012 (GSIA, 2015, 2019). The total ESG assets accounted for 26.3% of the global total AUM in 2016 (GSIA, 2017).

(Figure 3.3) The Scale of Global ESG Assets (in USD bn)

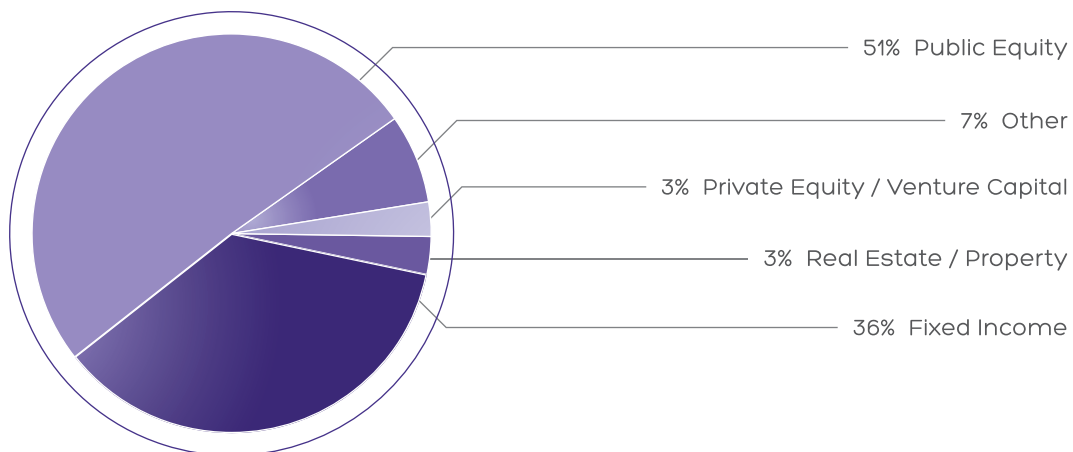


Source: GSIA, 2015, 2017, 2019

Note: There could be inconsistencies across years due to changes in methodologies and definitions, but not to an extent that would influence the overall trend of development.

Asset allocation of ESG investment has evolved over the years. In Europe and Canada, the share of bond grew from 39.5% in 2014 to a staggering 64.4% in 2016 (GSIA, 2017). In 2018, a majority of ESG investment took the form of public equity (51%), followed by fixed income (36%), as shown in **Figure 3.4**. The growth in fixed income was largely driven by the rise of green bonds, which grew from USD 38 billion in 2014 to more than USD 167 billion in 2018 (Climate Bonds Initiative [CBI], 2019).

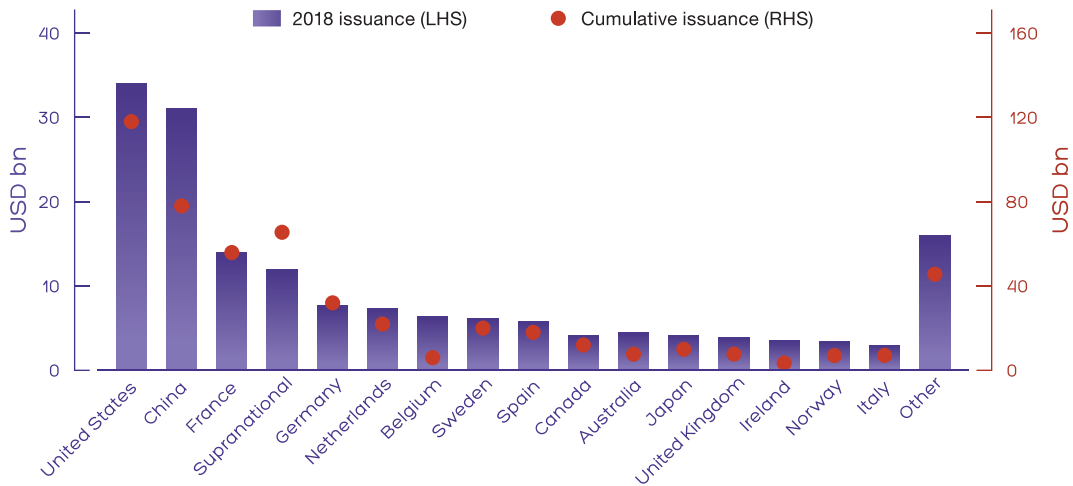
(Figure 3.4) 2018 ESG Asset Allocation in Europe, the United States, Japan and Canada



Source: GSIA, 2019

Since the signatory of Paris Agreement in 2016, green bond has gained popularity among government entities, development banks and private companies to finance climate change solutions such as renewable energy, green buildings and sustainable transports. As of 2018, there were more than 1,500 green bond issuances, with a majority coming from the United States and China as shown in **Figure 3.5** (CBI, 2019).

(Figure 3.5) 2018 Green Bond Issuance



Source: CBI, 2019

ESG integration has been a fast-growing investment strategy under the ESG investment spectrum while green bond is going mainstream. It is an investment approach where ESG factors are systematically integrated into investment managers' financial analysis. The size of assets managed under ESG integration strategies has increased by 69% from USD 10.4 trillion in 2016 to USD 17.5 trillion in 2018 (GSIA, 2019). It is the second largest ESG investment strategy following negative and exclusionary screening.

The movement towards ESG integration can be seen across the continents. The US, sharing 54% of global assets managed under ESG integration strategy with a scale of approximately USD 9.5 trillion in 2018, is considered the forerunner of ESG integration, followed by Europe and Canada (GSIA, 2019). With less than 2% of the total market share in 2016, Asia ex-Japan is significantly behind compared to other regions (GSIA, 2017) – a picture that we seek to change.

ESG reports are the cornerstone of ESG investment, informing investors engaged in ESG investment. ESG reporting is closely related to corporate social responsibility which evolved from traditional philanthropy and is now considered essential for long-term business success. Growing interest in the private sector's role in tackling sustainability challenges faced by society has generated literature examining the value of ESG information for investors and businesses of differing focuses.

3.2.2 The Value of ESG: An Investor Perspective

The focus on ESG issues emerged in the 1970s when a small segment of investors began accounting for the environmental and social practices of their investees (Richardson, 2009). Since then, an increasing number of empirical studies has shown that ESG performance is material to investors.

◀ Risk Mitigation

Asset managers and investors often incorporate ESG information into their investment processes to identify, manage and mitigate risk. From an asset management point of view, ESG or Corporate Social Performance (CSP) is considered a proxy of good corporate governance practices which are essential to the solid financial performance and positioning of a company. Poor governance or improper management of environmental and social matters such as carbon emissions or employee satisfaction may negatively influence the ability of a firm to conduct business to the extent that it could pose a huge financial risk to investors (van Duuren, Plantinga, & Scholtens, 2016).

To determine the ESG performance of a company, investors and scholars often rely on ESG ratings (used interchangeably with CSP in literatures) compiled by rating agencies or research institutes such as the MSCI, Bloomberg and Thomson Reuters. On the other hand, the risk profile of a company is usually explained by total stock volatility or the degree to which stock returns for a company vary over time. Unfortunately, existing literature rarely singles out stock volatility as a metric of ESG performance but measures risk mitigation based on risk-adjusted returns.

Discussion of ESG performance's impact on risk-adjusted return remains controversial. While a small number of studies (Edmans, 2011; Henke & Maehlmann, 2015; Jo & Na, 2012) show socially responsible investments and better ESG performance yielded better risk-adjusted returns, these studies are often criticised as not representative of the wider investment market due to a narrow focus on specific markets and limited sample sizes.

Prevailing empirical studies show there is no significant difference in risk-adjusted returns for portfolios based on ESG performance regardless of sectors and economies (Galema, Plantingam, & Scholtens, 2008; Humphrey & Tan, 2014; Humphrey, Lee, & Shen, 2012; Renneboog, Ter Horse, & Zhang, 2008).

Despite the lack of a broad consensus on ESG performance's impact on firms' risk exposure, there is growing emphasis placed on ESG integration among investors.

A recent study conducted by the CFA Institute shows 65% of the asset managers believe ESG integration helped manage investment risks (CFA Institute, 2017). A similar survey carried out by FTSE Russell found more than two-thirds (69%) of asset owners believe ESG considerations helped navigate long-term risk (FTSE Russell, 2018).



◀ Firm Value

A firm's market performance is equally important as its financial risk when it comes to investment decisions and it is argued that ESG or non-financial disclosures are material to investors. Several studies (Aouadi & Marsat, 2018; Chauhan & Kumar, 2018; Edmans, 2011) note value-relevant information might not be apparent in financial statements but could be found in ESG disclosures, especially in emerging markets with lower information transparency.

In considering the importance of sustainable financial return, investors and scholars investigated the causal relationship between ESG disclosure and a firm's market value which is commonly measured by Tobin's Q ratio. The ratio is a forward-looking measure of a firm's performance computed by the value it creates in the stock market and the worth of its assets (Tobin, 1978). The predominant rhetoric is that ESG disclosure and performance is in general positively related to the financial performance of a firm (Busch & Friede, 2018; Flammer, 2015). Researchers also postulate there is a positive relationship between the two factors where one standard deviation increase of ESG disclosure enhances Tobin's Q by 4.77% of the mean which is economically significant and an important result for investors (Yu, Guo, & Luu, 2018).

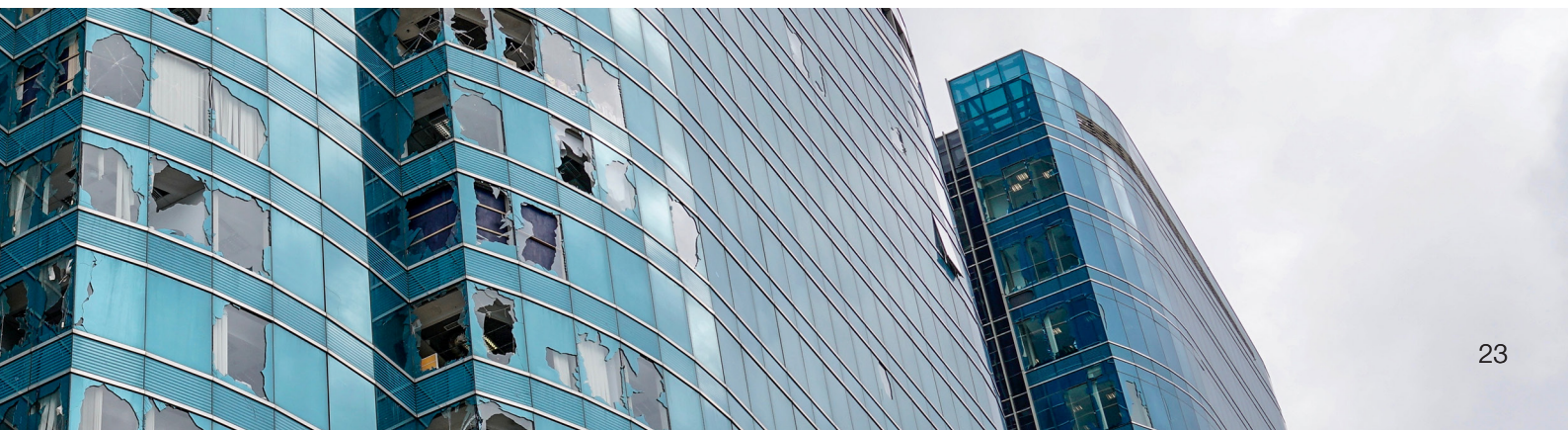
Scholars also analysed the respective impacts of environmental and social factors on firms' market value. Even though governance and social factors are thought to have greater impact on firms' market value than environmental factors, a second-order meta-analysis conducted by Busch & Friede (2018) concludes the relationship between ESG performance and firms' market value remains positive whether focus was on environmental or social issues, with no statistically significant differences detected between the two.

3.2.3 The Business Case in a Snapshot

The benefits of ESG reporting to businesses go beyond attracting investors and shareholders. Value also extends to stakeholders ranging from employees, customers, and the local communities where they operate.

Corporate reputation is an apt analogy. ESG disclosures and reporting is a mechanism for businesses to gain legitimacy, or the license to operate, from stakeholders by taking into account varying interests and demands beyond shareholder profit maximisation. Companies which disclose higher quality ESG information are perceived by stakeholders as more credible, further improving corporate reputation.

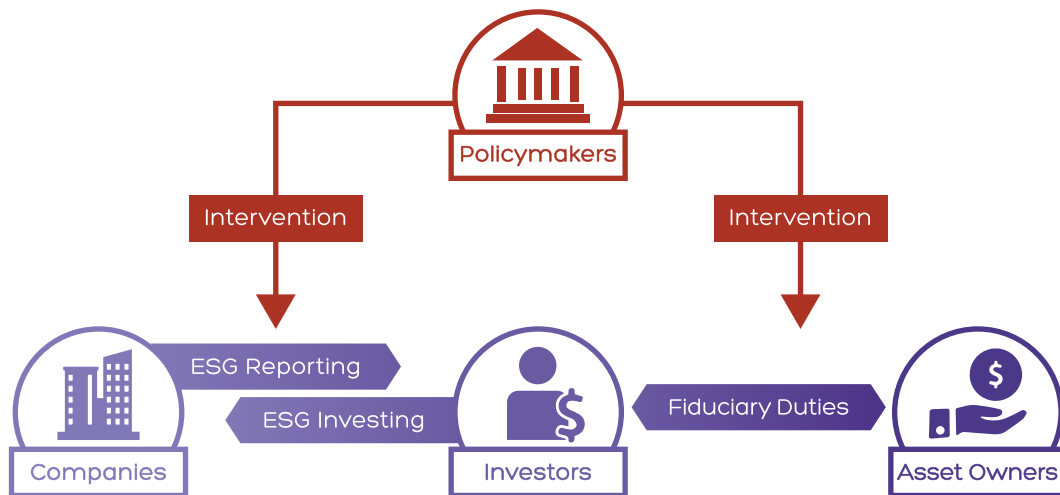
Higher quality assured sustainability and ESG reports are more likely to increase the reputation of the companies according to a logistic regression analysis of Spanish-listed companies conducted by Odriozola and Baraibar-Diez (2017). Odriozola and Baraibar-Diez's findings echo the prevailing attitude among global leaders and business professionals in a Boston College Center for Corporate Citizenship and EY (2013) survey. More than half of 579 respondents from a diverse range of industries said issuing sustainability reports helped improve corporate reputation. Respondents also observed increased employee loyalty, access to capital due to better reporting ratings, and more efficient decision-making processes.



3.3 ESG Ecosystem: Strengthening ESG Reporting and Investment

Stakeholders in the ESG reporting and investment ecosystem are typically divided into companies, investors, asset owners and policymakers. **Figure 3.6** gives a visual representation of the relationships between them.

(Figure 3.6) The ESG Ecosystem



◀ Companies

For the purposes of this report, companies refer to listed companies in general.

Social and environmental changes, partly brought on by business operations and development, in turn influence how they adapt and evolve. Companies are the primary source for ESG practice and performance disclosures through issuing public ESG reports. They may also provide exclusive information on request by investors to assuage ESG-related queries not fully addressed in publicly available ESG reports.

◀ Investors

For the purposes of this report, investors are defined as asset managers acting with capital entrusted to them.

Investors are increasingly aware of downside ESG risks, particularly climate risks, in their portfolios and beginning to factor these considerations into investment decisions. Apart from buying and selling, ESG investors can engage investee companies on material ESG issues and ensure that effective policies are in place to manage ESG risks.

◀ Asset Owners

For the purposes of this report, we define asset owners as parties which entrust capital to investors for professional investment decisions. Our definition of asset owners ranges from high-net-worth individuals to institutional investors such as pension funds, insurance companies and sovereign wealth funds. It should be noted some institutions play a dual role of asset owner and investor when they outsource management work to other investment managers and internalise asset management roles at the same time.

To ensure investment managers and institutions act in the interest of asset owners and beneficiaries, differing fiduciary duties are imposed across jurisdictions to clarify the responsibilities of investment managers and asset owner institutions. Since the launch of a ground-breaking 2005 report entitled “A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment”, consideration of ESG issues as part of fiduciary duties to ensure loyal and prudent investment management has become increasingly prominent and has already led to instances of regulatory change.

◀ Policymakers

ESG investment and reporting development may present a chicken and egg situation. Investors rely on company ESG information to inform their own ESG integration strategy such that uptake of ESG strategy is limited by a lack of high-quality and actionable ESG information provided by companies. On the other hand, companies have little incentive to divert resources into compiling high-quality ESG reports if investors have little interest in integrating ESG factors into their own investment decisions. This causal loop inhibits momentum accumulation to grow the ESG market, requiring external forces in the form of policy intervention.

In an ESG ecosystem, policymakers refer to a wide range of stakeholders who formulate policies influencing behaviour at the macro level. They include governments, financial regulators and stock exchanges. Collectively, they can promote ESG reporting and investment either as a facilitator or regulator by reducing relevant costs or increasing relevant benefits as well as imposing well-enforced regulations. Policymakers can catalyse development in an ESG ecosystem by intervening in two major areas:

- i. **ESG Reporting: reducing the costs of ESG reporting through policy instruments and imposing reporting regulations to demand further ESG disclosures from companies.**
- ii. **ESG Investment: using policy levers to improve benefits and reduce costs of ESG investment. Investment behaviour can also be influenced by regulating fiduciary duties.**

◀ Other Notable Ecosystem Players: Service Providers

Operating in and around the stakeholder groups within the ESG ecosystem are service providers with different professional skills who facilitate ESG reporting and investment at the micro level. For example, consultants provide reporting services in compiling information and report writing, third-party assurers provide assurance services on reports or specific indicators, and data providers compile and aggregate information into indices and ratings for investors.



Chapter 4

Promoting ESG Reporting and Investment: A Global Movement

In the age of climate change, as awareness around environmental and social sustainability among investors and corporates grows, policymakers across the world respond to the ESG traction chiefly by introducing:

- i. Corporate disclosure regulations to ensure standardised and transparent disclosure of ESG information.
- ii. Investor regulations including pension fund regulations and stewardship codes that encourage ESG integration into investment analysis and decision making.

We now examine the latest developments in ESG reporting and investment among differing regulatory landscapes.

4.1 Corporate Disclosure Regulations: Mainstreaming ESG Reporting

In 2016, governments in more than 75% of the world's top 50 economies have introduced or are considering corporate ESG disclosure requirements while stock exchanges and industry associations in more than half of those economies developed ESG reporting guidance (Principles for Responsible Investment [PRI] & MSCI, 2016). Alongside greater state and stock exchange regulations is the growth of ESG reporting by S&P 500 firms from 20% in 2011 to 85% in 2017 (Governance & Accountability Institute, 2018).

We next offer a comparative study of ESG reporting regulatory regimes in eight jurisdictions including Hong Kong. Our comparison excludes those disclosure regulations through specialist systems, i.e. reporting to the authority or regulator who demands certain ESG-related information and data, but focuses on mainstream corporate disclosures (e.g. through annual reports) with both investors and other stakeholders as the target audience.

Our key findings are summarised in **Table 4.1** on page 28.

(Table 4.1) Global Comparisons of Regulatory Regimes for ESG Reporting

Jurisdiction	Institution	ESG Reporting Regulations Highlighted	ESG Policies Disclosure	ESG KPIs Disclosure
All European Union member states	The European Parliament and The Council of The European Union	EU Non-Financial Reporting Directive 2014/95/EU	Comply-or-explain	Mandatory
France	French Government	Article 225 of the Grenelle II Act	Mandatory	Comply-or-explain
		Article 173 of the French Energy Transition Law	Mandatory	Mandatory in carbon disclosure
United Kingdom	Government of the United Kingdom	The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013	Mandatory	Mandatory in greenhouse gas emissions
Singapore	Singapore Exchange Limited	Sustainability Reporting Guide	Comply-or-explain	Not specified
Hong Kong*	Hong Kong Exchanges and Clearing Limited	Environmental, Social and Governance Reporting Guide	Comply-or-explain	Comply-or-explain
Australia	Australian Securities Exchange Limited	Corporate Governance Principles and Recommendations (4 th Edition)	Comply-or-explain	Not specified
Japan	Tokyo Stock Exchange	Japan's Corporate Governance Code	Comply-or-explain	Not specified
United States	Securities and Exchange Commission	Commission Guidance Regarding Disclosure Related to Climate Change	Only if material	Not specified

*Please refer to section 5.1.1 for a more detailed discussion on ESG reporting requirements in Hong Kong regulations.

4.1.1 Major Trends in ESG Reporting Regulations

◀ Disclosure Regimes and Requirements

The European Union (EU), France and the United Kingdom (UK) have the most highly developed regulations among the eight jurisdictions examined. Their disclosure regulations apply to both listed and unlisted public-interest entities of a certain size or sector in contrast to other jurisdictions whose regulations mainly focus on listed companies. France and the UK mandatorily require companies to disclose ESG policies and indicators detailing carbon and other greenhouse gas emissions. Both countries also require ESG disclosures in annual reports which is credited with improving the integration of ESG disclosure and financial reporting (Jeffwitz & Gregor, 2017). The EU employs a “comply-or-explain” approach for ESG policies disclosure but mandatorily requires companies to disclose related KPIs.

Exchanges in Singapore, Hong Kong, Australia and Japan have adopted a “comply-or-explain” approach, where listed companies are required to either disclose their ESG policies or explain their non-compliance. Companies in the US only need to disclose ESG information if it is deemed material. Apart from the jurisdictions in **Table 4.1**, the China Securities Regulatory Commission has announced its plan to mandate environmental disclosure by 2020.

◀ Involvement of Auditors and Boards

The UK and France have regulatory requirements on verification. France requires independent verification of disclosed data while the UK mandates disclosures “be audited for compliance with legal requirements and any material misstatements” (Jeffwitz & Gregor, 2017, p.10).

France is notable for requiring listed companies’ boards to appoint independent auditors while the UK requires board approval and signature on final disclosures. Singapore Exchange requires a board statement be included in ESG reports.

4.1.2 A Detailed Look at Selective Jurisdictions' Disclosure Requirements

◀ European Union

The EU passed in 2016 a directive on non-financial and diversity information disclosure in response to corporate sustainability concerns. The directive requires large public interest companies to disclose social, environmental and anti-corruption practices and provides great flexibility regarding specific information disclosed by companies (Directive 2014/95/EU, 2014).

The European Commission published a thorough guideline for non-financial information reporting to familiarise companies with reporting standards. The guideline includes specific KPIs and existing reporting frameworks, such as the UN Global Compact and OECD Guidelines for Multinational Enterprises (Communication from the Commission, C/2017/4234, 2017).

◀ United Kingdom

The UK was the first European country to regulate ESG reporting practices. The UK Financial Reporting Council published the first version of the *UK Corporate Governance Code* in 1992 which sets standards for good practices relevant to board leadership, remuneration and stakeholder accountability. Companies listed on the London Stock Exchange's Main Market are required to report on the same standards.

Another UK breakthrough is the *Strategic Report and Directors' Report Amendment of the Companies Act 2006*. The amendment compels UK-incorporated companies listed on the London Stock Exchange Main Market, European Economic Area regulated exchanges, the New York Stock Exchange (NYSE) or NASDAQ to disclose their management approaches on issues ranging from environmental performance, human rights, social and community involvement to diversity. Disclosure on specific metrics is also required, which includes Scope 1 and 2 carbon emissions as well as gender diversity at the board level, on the senior management team and throughout the company.

◀ United States

The US is one of the few advanced economies which lack regulatory requirements for ESG reporting. The most recent update to the legislation governing ESG disclosures was in 1996 when Congress amended the *Securities Act of 1933* to set voluntary disclosure only when, "necessary and appropriate in the public interest or for the protection of investors" (Securities Act of 1933, p.4).

Growing demand for standardised ESG disclosures prompted the Securities and Exchange Commission (SEC) to solicit public opinions through its 2016 Concept Release on Business and Financial Disclosure initiative ahead of evaluating and reforming corporate disclosure requirements (SEC, 2016). More than 80% of sustainability-related responses favoured improved ESG disclosures to understand companies' long-term performance potential (D'Aquila, 2018).

◀ Japan

Japan leads the way forward in Asia's sustainable practices improvement. The Japan Exchange Group established the *Corporate Governance Code* in 2015 requiring listed companies to disclose useful and valuable non-financial information such as ESG matters and business strategies to ensure effective corporate governance (Tokyo Stock Exchange, 2018).

◀ China

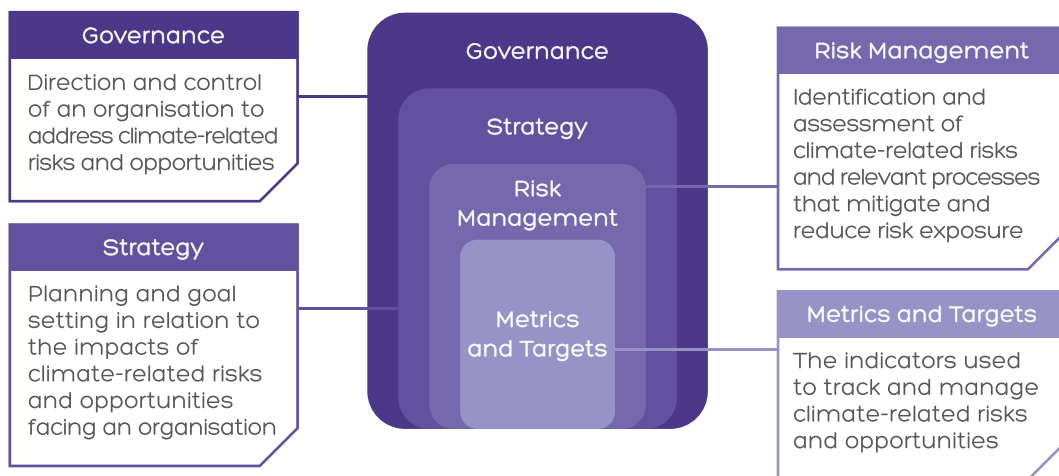
The Shenzhen Stock Exchange (SZSE) and the Shanghai Stock Exchange (SSE) selectively mandated ESG disclosures. SSE requires compulsory ESG disclosures from companies included in its SSE Corporate Governance Index, financial firms and companies listed in domestic and foreign stock markets. The SZSE only mandates ESG disclosures from Shenzhen 100 Index companies.

The China Securities Regulatory Commission is planning to require all listed companies and bond issuers to disclose environmental information such as carbon emissions and energy consumption associated with operations by 2020 (China Economic Net, 2018).

4.1.3 Recommendations of the Task Force on Climate-related Financial Disclosures

The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) are an important development in the area of ESG reporting. The task force was established in 2015 by the Financial Stability Board to develop a framework for climate-related financial risk disclosures primarily for financial market participants. The TCFD chaired by Michael Bloomberg published its final recommendations in 2017, which laid the ground work for a global convergence of climate-related disclosure standards covering governance, strategy, risk management, and metrics and targets (see **Figure 4.1**).

(Figure 4.1) Core Elements of the TCFD Recommendations



Source: TCFD, 2017a

The TCFD recommendations were well received by the international community. For example, 10 financial institutions from China and the UK launched a pilot programme taking reference to the TCFD recommendations and paving the path for further development of environmental reporting in China. The UK Parliament's Environmental Audit Committee recommends government to set deadlines for all listed companies together with large asset owners to report in line with the TCFD recommendations on a "comply-or-explain" basis by 2022 (UK Parliament, 2018). The European Commission will revise guidelines for non-financial disclosures by the second quarter of 2019 to better align disclosures with the TCFD recommendations (European Commission, 2018).

4.2 Investor Regulations: A Focus on Fiduciary Duties

Regulatory regimes governing investors and asset owners are taking stock of growing ESG momentum. Fiduciary duties are imposed, “to ensure that those who manage other people’s money act in the interests of beneficiaries, rather than serving their own interests” (Sullivan, Martindale, Feller, & Bordon, 2015, p.11). The most important two of these duties are:

- i. **Loyalty: Trustees should act in good faith and solely in the interests of the beneficiaries, avoid conflicts of interest and never act for their own interests or a third party.**
- ii. **Prudence: Trustees should invest as an ordinary prudent person would do with a professional degree of care, skill and caution.**

Since the launch of the ground-breaking report “A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment” (United Nations Environment Programme Finance Initiative [UNEP FI], 2005), consideration of ESG issues, particularly ESG risks, has been increasingly perceived as an integral part of fiduciary duties of investment managers and asset owners to ensure loyal and prudent investment. The UN-supported PRI network was launched in 2006 at the NYSE to support investors and asset owners worldwide to incorporate ESG factors into investment and ownership decisions. In particular, TCFD-based reporting is to become mandatory for PRI signatories in 2020 (PRI, 2019). The number of signatories has risen from 100 at its inception to more than 2,300.

The PRI network and other institutions including the UN Global Compact, UNEP FI and the UNEP Inquiry published a 2015 report titled “Fiduciary Duty in the 21st Century”, which aims to end the debate whether fiduciary duty is a legitimate barrier to ESG investment by clarifying the consistency between them (Sullivan et al., 2015). Significant momentum has been observed around the world that policymakers are revising regulations to explicitly incorporate ESG elements into fiduciary duty. We next compare and contrast fiduciary duty regulatory regimes in five jurisdictions including Hong Kong and our findings are summarised below in **Table 4.2** on page 33.

(Table 4.2) **Global Comparisons of Regulatory Regimes for Fiduciary Duty**

Jurisdiction	Institution	Regulation	ESG Integration Policies
France	French Government	Article 224 of the 'Grenelle II' Act	Mandatory (investment managers)
		Article 173 of the French Energy Transition Law	Comply-or-explain (institutional investors)
All European Union member states	The European Parliament and the Council of the European Union	Shareholders Rights Directive II (SRD II)	Comply-or-explain (asset managers and institutional investors)
		Directive on Institutions for Occupational Retirement Provision (IORP II)	Mandatory
United Kingdom	Financial Reporting Council	Stewardship Code	Comply-or-explain (proposed in 2019) (asset managers)
	Government of the United Kingdom	Occupational Pension Schemes (Investment) Regulations	Mandatory
Japan	Financial Services Agency	Japan's Stewardship Code	Not specified (voluntary in monitoring investee companies regarding ESG factors)
Hong Kong	Securities and Futures Commission	Principles of Responsible Ownership	Not specified (voluntary in engaging investee companies on ESG issues)

4.2.1 A Detailed Look at Different Fiduciary Duty Regulatory Regimes

◀ France

France remains a pioneer in ESG integration into fiduciary duty having imposed in Article 224 of the *Grenelle II Act* mandatory requirements for asset management companies to disclose how ESG factors are incorporated into investment policy and how voting rights have been exercised. Article 173 of the *French Energy Transition for Green Growth Law (French Energy Transition Law)* introduced carbon reporting for institutional investors including asset owners and investment managers on a “comply-or-explain” basis. Institutional investors are required to disclose in their annual report:

- i. The integration of ESG factors into their investment decisions;
- ii. The integration of climate-related risks, including both physical and transition risks; and
- iii. The alignment of actions and targets with the national and global goals of energy and ecological transition.

A significant characteristic of French regulation is that smaller investors, defined as investors with a total balance sheet of less than EUR 500 million, are exempt from detailed reporting and are only required to provide a general overview of their ESG investment policy (Mason, Martindale, Heath, & Chatterjee, 2016).

◀ European Union

In 2017 the European Parliament and Council amended the 2007 *Shareholder Rights Directive* to encourage long-term shareholder engagement. In the amendment (SRD II), EU member states are required to ensure institutional investors and asset managers develop and publicly disclose engagement policies which detail shareholder engagement in relation to ESG factors in their investment strategy on a “comply-or-explain” basis.

In its revision of the *Directive on Institutions for Occupational Retirement Provision (IORP II)*, the EU included a significant amount of ESG elements and clarified that incorporation of ESG considerations is consistent with the prudent person rule. In particular, IORP II imposes requirements on EU member states to require Institutions for Occupational Retirement Provision to:

- i. Have in place a system of governance which includes consideration of ESG factors;
- ii. Based on principle of proportionality, have in place an effective risk-management function and carry out and document their own risk assessment in relation to ESG issues; and
- iii. Review and disclose how ESG factors are considered in investment policy and approach (Directive (EU) 2016/2341, 2016).

◀ United Kingdom

The *UK Stewardship Code* requires asset managers to establish clear guidelines on when they will actively intervene on ESG issues and regularly assess the outcomes of doing so. Concerns rising from ESG issues are included as part of the instances when institutional investors may want to intervene, which clarifies the consistency between ESG engagement and fiduciary duty. Institutional investors are required under the Conduct of Business Rule 2.2.3 to disclose the nature of its commitment to the Code or alternative investment strategy where it does not commit to the Code (Financial Conduct Authority, 2019). In a proposed revision of the *UK Stewardship Code*, with consultation on it starting in January 2019, one key suggestion is the explicit inclusion of ESG factors. Signatories are expected to consider material ESG factors including climate change when fulfilling their fiduciary duties and explain specifically how they do so.

The Occupational Pension Schemes (Investment) Regulations 2005 requires occupational pension schemes trustees' statements of investment principles to disclose the extent (if at all) to which social, environmental or ethical factors are considered in the investment process. Its latest amendment, the *Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018*, also compels trustees to state how financially material factors and the extent to which non-financial factors are considered in the investment process, where it is clarified that financially material considerations include ESG considerations, particularly for climate change. Trustees are also required to state their engagement policies in relation to ESG matters.

◀ Japan

The Financial Services Agency's Council of Experts on the Stewardship Code published the *Japan's Stewardship Code* (also known as the Principles for Responsible Institutional Investors). Institutional investors are recommended to monitor investee companies in relation to a variety of factors including business risks and opportunities arising from social and environmental issues. While the Code is voluntary and a principle-based code of conduct rather than a law or a legally binding regulation, institutional investors who adopt the Code are required to follow each of its principles on a "comply-or-explain" basis.

◀ Hong Kong

The Securities and Futures Commission (SFC) established the *Principles of Responsible Ownership* (PRO) in 2016 to help investors better meet their ownership responsibilities. It recommends investors to encourage investee companies to set policies for ESG issues while engaging them on significant ESG issues and establishing clear engagement policies. PRO is voluntary and investors are encouraged to adopt PRO and disclose the adoption to their stakeholders.

◀ Other Developments

Other emerging momentum of integrating ESG factors into investor regulations has been observed. In Ontario of Canada, Regulation 909 under the *Pension Benefits Act* (PBA) requires pension funds to disclose whether ESG factors are incorporated into their investment policies and procedures and, if so, how those factors are incorporated. Yet, the Financial Services Commission of Ontario (2017) clarifies that the PBA does not require pension funds to establish distinct ESG policies, although they would have to disclose their stance on ESG factors even in the absence of such a policy.

In the US, California State *Senate Bill No. 964* requires the state's largest pension funds, namely the California Public Employees' Retirement System and the California State Teachers' Retirement System, to take climate risks into consideration when making investment decisions. It also requires pension funds to publicly report analysis of climate-related financial risks in their portfolio, including methodology and outcomes, by 1 January 2020 and every three years thereafter.

The *Singapore Stewardship Principles for Responsible Investors* (SSP) represents an industry-led movement to promote active and responsible stewardship on a voluntary basis. It encourages investors to engage investee companies on a full spectrum of issues including social and environmental considerations. SSP was developed by the SSP Working Group, which later evolved into the SSP Steering Committee. The Committee is an industry-led collaboration to promote and administer SSP. Committee membership is comprised of a number of industry members chaired by Stewardship Asia and with support from the Monetary Authority of Singapore and the Singapore Exchange.



Chapter 5

The Development of ESG Reporting and Investment in Hong Kong

5.1 Overview of Regulation for ESG Reporting and Investment in Hong Kong

Regulatory regimes for ESG reporting and investment are rapidly developing around the world while local momentum for a sustainable financial system and regulatory regime has been growing in Hong Kong.

5.1.1 Hong Kong's ESG Reporting Regulation

Hong Kong started its ESG reporting journey in recent years, following in the steps of its foreign counterparts. Hong Kong Exchanges and Clearing Limited (HKEX) introduced the ESG Reporting Guide (ESG Guide) as “Recommended Practice” in 2012 for the voluntary disclosure of ESG information (HKEX, n.d.). The guide was revised in 2016 following a 2015 market consultation and was structured to specifically address 11 environmental and social aspects including emission, employment and product responsibility. Each aspect requires its own general disclosures of policies and, in some cases, compliance with relevant laws and regulations as well as Key Performance Indicators (KPIs) for companies to report on. An important development is the new requirements for general disclosures on a “comply-or-explain” instead of purely voluntary basis.

Since 1 January 2017, the “comply-or-explain” requirements have been extended to cover KPIs in the environmental aspects. **Table 5.1** provides an overview of current HKEX ESG reporting requirements.

(Table 5.1) **The Structure of the ESG Disclosure Requirements of HKEX**

		“Comply-or-Explain” Provisions	Recommended Disclosures
Environmental	Emission	GD + KPI	
	Use of Resources	GD + KPI	
	The Environment and Natural Resources	GD + KPI	
Social	Employment	GD	KPI
	Health and Safety	GD	KPI
	Development and Training	GD	KPI
	Labour Standards	GD	KPI
	Supply Chain Management	GD	KPI
	Product Responsibility	GD	KPI
	Anti-corruption	GD	KPI
	Community Investment	GD	KPI

GD: General disclosures; KPI: Key performance indicators.

Source: HKEX, n.d.

Although not included in general disclosures or KPI requirements, the ESG Guide does state that disclosures, “should state the issuer’s ESG management approach, strategy, priorities and objectives and explain how they relate to its business” (HKEX, n.d., p.2). The guide also encourages discussion of, “the issuer’s management, measurement and monitoring system employed to implement its ESG strategy” (HKEX, n.d., p.2). More recently, the HKEX published in 2018 a step-by-step guide to facilitate better ESG reporting and provides guidance on stakeholder engagement, materiality assessment, report writing, etc.

Apart from the HKEX’s ESG Guide, the *Companies Ordinance* (Cap 622, Schedule 5, Section 2) (2014) also includes requirements for ESG discussion. All Hong Kong incorporated companies (unless exempted) must include a discussion on the company’s environmental policies, performance and compliance with relevant laws and regulations in addition to an account of the company’s relationships with key stakeholders in its business reviews of directors’ reports. The requirement was incorporated into Main Board Listing Rules (Appendix 16.28) and the Growth Enterprise Market Listing Rules (Rule 18.07A(2)(d)) and applies to all issuers on HKEX.

The 2018 publication of the Strategic Framework for Green Finance by the SFC is one of the most important developments in ESG reporting in Hong Kong. The Strategic Framework sets enhanced environmental reporting among listed companies as a top SFC priority with the aim of improving climate-related disclosures in alignment with the TCFD recommendations. Furthermore, the HKEX also included a section on the TCFD recommendations in its 2018 step-by-step guide to ESG reporting.

5.1.2 ESG Investment Regulation in Hong Kong

The SFC laid out the PRO in 2016 outlining principles and guidance to help investors determine how best to meet their ownership obligations. The PRO include recommendations for investors to encourage investee companies to institute ESG policies and to actively engage with them on significant ESG issues while setting clear engagement policies (SFC, 2016). The PRO are non-binding and voluntary, but investors are encouraged to adopt the PRO and disclose the adoption to stakeholders. The Mandatory Provident Fund Schemes Authority (MPFA) issued, in November 2018, a circular encouraging Mandatory Provident Fund (MPF) trustees to consider ESG factors in investment decision-making process and disclose ESG approach to scheme members.

The SFC’s Strategic Framework for Green Finance also addressed the investment side of green finance. ESG reporting aside, a number of challenges have been identified which are unlikely to be resolved by the market alone, including insufficient disclosure from asset managers and a lack of clarity of their obligations. The SFC is committed to conducting a survey of asset managers and asset owners in major aspects of sustainable investing to facilitate the development of sustainable investment. The survey will assess interviewees’ commitment, investment processes, post-investment ownership practices and reporting of ESG performance.

5.2 The ESG Reporting Performance of Hong Kong-Listed Companies

ESG reporting has become a common practice of listed companies in the past few years as a result of the latest regulatory requirements. Progress has been uneven, with the quality of reporting varying despite a high level of compliance, according to the HKEX (2018a). While the best examples provide excellent detail and clarity, many disclosures were treated as “box-ticking” exercises with a minimal level of compliance. A review of Hong Kong-focused ESG studies took issue with the strategic integration of ESG considerations, ESG risk identification and materiality assessment, and the quality of ESG reporting.

5.2.1 Strategic Integration of ESG Considerations

The depth of ESG reports is gauged by the level of detail provided in a business context and covers information including board involvement, business strategy and management systems in relation to ESG issues. In-depth reporting allows investors to assess companies with a more forward-looking approach. Sustainability-aware investors increasingly care about the financial implications of a company’s long-term ESG outlook. This is in line with traditional long-view investors’ scrutiny of long-term financial performance rather than solely focusing on quarterly results.

ESG-related disclosures detailing board involvement, business strategy, and management systems inform investors’ assessments of a company’s long-term ESG performance. Firstly, board involvement in ESG issues ensures ESG considerations are incorporated into top-level decision making processes while telegraphing ESG values downward through the company. The cornerstone of a vibrant and persistent ESG corporate culture begins at the board level. Secondly, a clearly articulated ESG strategy serves as the master plan to lay out long-term ESG goals while setting milestones to achieve the goals. The master plan also serves as a baseline to evaluate future ESG development. Thirdly, policies, processes and procedures to ensure tasks are fulfilled to achieve ESG goals can be developed into management systems, which are valuable for determining whether a company can faithfully implement its ESG strategy.

Despite these benefits, disclosures of strategic integration of ESG considerations remain limited in Hong Kong.

◀ Board Involvement

Hong Kong-listed companies' board involvement in ESG governance remains unclear at best. More than 80% of the companies disclosed nothing regarding their highest level of accountability for ESG and only 13% reported their boards were responsible for ESG performance according to a 2017 KPMG survey of 366 HKEX-listed companies (KPMG, 2017). The survey also found the level of disclosure detail varied with some simply stating ESG was a general responsibility of the board but providing no details like ESG governance structure, composition of any ESG committee and relevant work undertaken by responsible parties.

More recent evidence suggests persistently low rates of board participation in ESG governance. A 2018 BDO survey of Hong Kong-listed companies found only 26% had director-level commitments to ESG governance (BDO, 2018). This should not be taken as an improvement in light of the 2017 KPMG survey due to differences in sampling methodology. Instead, the findings are indicative of a continued low rate of board involvement in ESG governance. HKEX launched, in 2018, a report on ESG reporting of locally listed companies and regarded board involvement as one key area for improvement.

◀ ESG Strategy

There is strong evidence that ESG factors remain weakly integrated among Hong Kong-listed companies' business strategies. A 2018 KPMG survey of 212 Hong Kong-listed companies' C-suite executives and senior managers found only 37% integrated ESG issues into their strategic planning process (KPMG, CLP, & Hong Kong Institute of Chartered Secretaries, 2018), suggesting that ESG remains a peripheral issue for a significant proportion of listed companies. BDO's 2018 survey found only 32% of companies reported ESG strategies while 17% had ESG goals and only a paltry 1% held discussions on challenges in ESG strategies implementation (BDO, 2018). The lack of articulation of ESG strategy, goals and challenges reveals ESG reporting remains compliance-driven, rather than a result of embedded ESG strategy which creates value for the company.

◀ Management System

High-level commitments and strategic plans are hollow without effective management systems to implement plans and fulfil commitments to manage relevant ESG risks and opportunities. Operational disclosure, however, remains limited. While 54% of the companies provided examples of actions and measures taken to deal with ESG issues, only 27% explained how they managed ESG issues through descriptions of relevant management systems, according to a 2017 KPMG survey. Only 2% went further to include ESG goals and targets in their performance management (KPMG, 2017).

Limited disclosure is not surprising when considering such systems were not in place in most listed companies. KPMG's 2018 survey found that 43% of the interviewed executives reported ESG components were incorporated into policies and risk management systems and only 41% had ESG-related KPIs to track performance (KPMG et al., 2018). Taken together, a lack of strategic ESG integration at the highest corporate level and the voluntary nature of disclosures has bred a lacklustre reporting environment.

5.2.2 ESG Risk Identification and Materiality Assessment

The range of specific ESG issues is not uniformly important to all companies, which are exposed to differing ESG risks by virtue of their differing operations and nature. In the climate change context, some businesses are more significantly impacted than others. The key concern in ESG risk identification is not comprehensiveness but materiality. A relevant and significant ESG report is more valuable than a bulky one.

◀ Identifying ESG Risks

Hong Kong-listed companies may not be effective in identifying ESG risks. A 2017 KPMG survey found only 16% of companies identified one or more ESG risks as principal risks in their business reviews (KPMG, 2017). Natural disasters and climate change were the most commonly identified ESG risks with 6% of companies recognising its threats to their operations. Talent acquisition and retention and environmental regulations came second together at 5%, followed by product responsibility at 4% (KPMG, 2017). It was also consistent with the EY's findings in 2018 that more than 60% of companies only reported on minimum requirements of the HKEX's ESG Guide, without consideration for materiality (EY, 2018).

Surprisingly, the finance sector had the lowest rate of ESG risk identification. Only one surveyed firm out of 50 financial services companies referred to "staff attraction and retention" risk as their main ESG concern (KPMG, 2017). This reveals a lack of awareness or competence among financial firms in identifying material ESG risks in light of their inevitable exposure through their clients and portfolios.

A low level of ESG risk identification could be a result of the absence of material ESG risks or a failure to identify them. The second situation poses problems for both investors and investee companies. Investors cannot make informed investment decisions while investees are poorly prepared to manage material risks which were not properly identified or prioritised in the first place.

Separating the absence of material ESG risks and the inability to identify them requires learning whether a sound materiality assessment is incorporated into the ESG risk identification process.

◀ Materiality Assessment

Materiality is, "the threshold at which ESG issues become sufficiently important to investors and other stakeholders that they should be reported" (HKEX, n.d., p.2). Materiality assessment in short is how material ESG issues are identified. At the assessment's core is the engagement of external and internal stakeholders to glean insights on the relative importance of ESG issues.

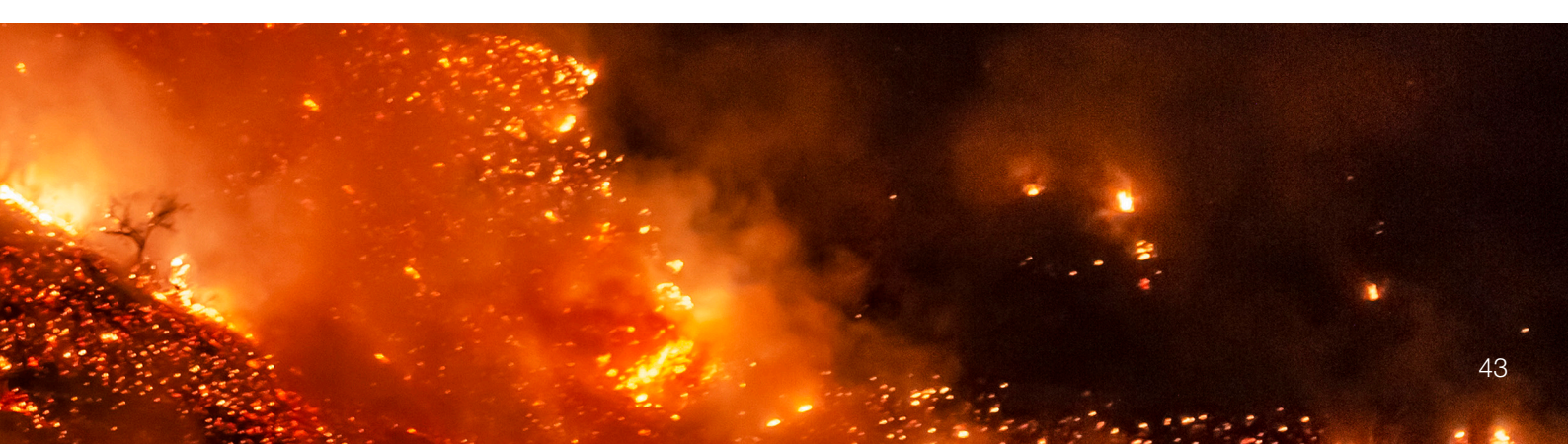
The disclosure of materiality assessment process remains limited among Hong Kong-listed companies. Only 33% of companies disclosed their materiality assessment process, according to a 2017 KPMG survey (KPMG, 2017). HKEX conducted a 2018 review of 400 randomly selected issuers' ESG reports including their materiality assessment disclosures. Materiality assessments were conducted by 57% of issuers but only 52% provided details about stakeholder engagement and their assessment process. "The quality of the disclosures was varied, with some describing their engagement process clearly with a materiality matrix demonstrating their work whilst others may contain lengthy narratives that were vague and difficult to read," the HKEX wrote (HKEX, 2018a, p.9).

It is then difficult to determine if low levels of ESG risk identification among Hong Kong-listed companies are due to a low level of ESG risk exposure or a failure to identify existing material ESG risks. Investors can hardly know if they are fully informed of material ESG risks identified through a solid materiality assessment process. The fact that 43% of companies did not report using materiality assessment while many which did disclose vague information about their processes could be interpreted as a sign that materiality assessments remain underutilised. Investors may perceive the lack of information as an indication that the company has not fully assessed its exposure to material ESG risks (KPMG, 2017). This explains why HKEX strongly recommended companies not only conduct materiality assessment but also disclose their materiality assessment process in ESG reports (HKEX, 2018a).

◀ Relationship between Materiality Assessment and Strategic ESG Integration

A company's specific list of material ESG issues should be the product of strategic planning rather than a product independent of a company's business context. In planning processes, companies identify what material ESG risks they are exposed to and formulate strategies to address them. Materiality assessment is not an isolated process that simply serves reporting purpose. Instead, it is an exercise incorporated into strategic planning to ensure that material ESG risks are sufficiently identified and managed to mitigate risks and create value for the company.

ESG reporting as a regular practice must move from compliance-driven to strategy-driven. The HKEX recognises that there is no "one-size-fits-all" method of compliance for ESG reporting (HKEX, 2018a, p.13). Different companies are exposed to different ESG risks depending on a wide range of factors. While it is helpful to have a minimal level of ESG disclosure requirement set by policymakers, its scope is not likely to cover the majority of potential ESG issues. Companies should go beyond minimal compliance levels and should instead disclose material ESG information based on solid ESG strategies derived from sound materiality assessments. It falls to policymakers to encourage and facilitate companies to go beyond a box-ticking approach and actively identify, manage, and report ESG risks and opportunities to create value for both investors and investee companies.



5.2.3 Quality of ESG Reporting

If the preceding two sub-sections cover “what to report”, the quality of ESG reporting is a matter of “how to report” and the decision-usefulness of ESG disclosures. In this section we focus on three major issues: credibility, comparability and capacity.

◀ **Credibility**

Credibility is the accuracy and robustness of reported ESG information which influences investors’ confidence when considering ESG factors in investment decisions.

Concerns over credibility are not solely the result of possibly fraudulent ESG accounting but can arise from inappropriate processes or flawed ESG assessment methodology due to a lack of expertise and talent. Much like financial reporting, external assurance by a reputable third party can provide greater credibility.

The International Federation of Accountants (IFAC) defines an assurance engagement as a process through which, “a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria” (IFAC, 2012, p.16).

While third-party verification of ESG reports as a whole may not be as well-established as traditional financial auditing, selected areas have been developing for years. Carbon auditing is one such better-established ESG assurance area and interest in assured ESG disclosures is growing (Global Reporting Initiative [GRI], 2013). Investors are increasingly interested in assurance of greenhouse gas emissions data and climate risks, which could impose material financial impacts on their investments. A 2017 investor survey found 45% of respondents cited, “questionable data quality and lack of assurance,” as barriers to factoring ESG information into investment decisions (CFA Institute, 2017, p.18). Assurance of ESG disclosures is an important prerequisite for producing decision-useful ESG reports which will catalyse ESG investment.

It remains uncommon to seek external assurance to enhance ESG disclosure credibility among Hong Kong-listed companies. A KPMG survey (2017) found only 8% of Hong Kong-listed companies sought third-party assurance while a BDO survey found only 7% of respondents did the same (BDO, 2017). Furthermore, greater uptake of external ESG assurance might be nipped in the bud, with only 4% of firms seeking external assurance in BDO’s 2018 follow-up survey (BDO, 2018).

Low uptake of external assurance impedes acceptance of the accuracy and robustness of ESG information and limits ESG integration into investment and risk management processes.

◀ Comparability

Comparability concerns whether the same ESG indicator measures the same thing across different companies. To compare two companies reporting on the same indicators but based on differing definitions would be misleading. The SFC recognises the challenge of comparability in ESG disclosures due to the diversity of local disclosure requirements and international reporting frameworks (SFC, 2018). Another underlying factor is that the HKEX's current ESG Guide does not set out specific methodologies for measuring KPIs. Although HKEX has tied its disclosure requirements to a number of international guidelines and standards as reference for companies, it is up to individual companies to decide how they calculate KPIs. As a result ESG reporting remains fragmented and largely incomparable.

A 2017 CFA Institute investor survey found half of respondents cited, "lack of comparability across firms," as a barrier to using ESG information in investment decisions (CFA Institute, 2017, page. 18), which was the second mostly cited barrier. It is imperative that policymakers set comparable, quantitative ESG metrics to create a body of comparable ESG data.

◀ Capacity

The lack of capacity for high-quality ESG report production remains at the root of the unsatisfactory performance of ESG reporting.

Regardless of policy levers, it is unrealistic to expect substantial improvement in ESG reporting if capacity remains insufficient across the ESG ecosystem. A lack of capacity is especially prominent among smaller companies, which is highlighted by a significant discrepancy in ESG reporting performance between listed companies of large and small market capitalisation.

The disclosure of ESG integration into governance, strategy, and management systems remains shallow on the whole but large listed companies do a better job than their smaller counterparts. Large companies were more likely to have board involvement in ESG governance, with 30% of companies with a market capitalisation in excess of HKD 10 billion having board-level ESG accountability compared to an average of 13%, according to a 2017 KPMG survey. In contrast, only 2% of companies with a market capitalisation below HKD 1 billion claimed board accountability for ESG performance (KPMG, 2017).

ESG integration into business strategy was also more common among large listed companies. 52% of companies with a market capitalisation in excess of HKD 10 billion interviewed in the 2018 KPMG survey integrated ESG factors into strategic planning compared to an average of 37% for all companies (KPMG et al., 2018). Integration among smaller companies ranged from 28% to 32% (KPMG et al., 2018).

Finally, company size and disclosure levels were closely linked in terms of management systems. KPMG's 2017 survey found 34% of all companies with a more than HKD 10 billion market capitalisation reported on their ESG management systems while less than a quarter of companies with less than HKD 1 billion market capitalisation did (KPMG, 2017). This can be attributed to large companies experimenting with well-established ESG management systems in contrast to poor uptake by smaller companies. 53% of surveyed companies worth more than HKD 10 billion said they incorporated ESG elements into their policies and risk management systems while 56% said they have KPIs set to track ESG performance. ESG-based policy and risk management was only used by 47% of companies worth less than HKD 1 billion while only 26% of the same cohort set ESG-linked KPIs.

The pattern of performance carries over to ESG risk identification and materiality assessment. Large companies are better at identifying ESG risks in business reviews compared to smaller peers. A quarter of surveyed companies worth more than HKD 10 billion recognised one or more ESG risks in their reports, according to the 2017 KPMG survey. In contrast, only 11% of companies worth less than HKD 1 billion reported one or more ESG risks (KPMG, 2017).

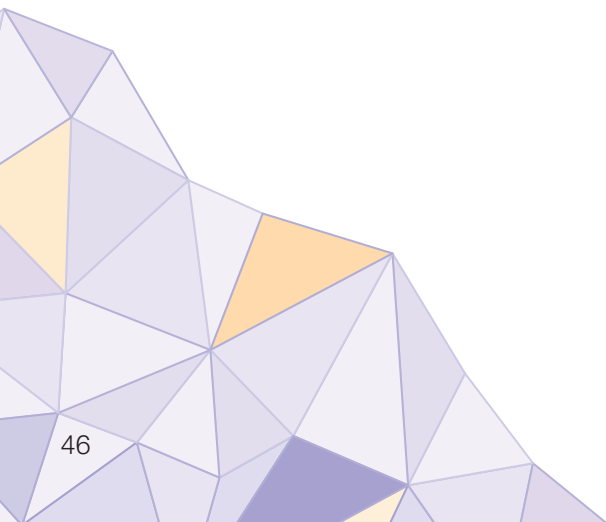
While large companies might be exposed to more material ESG risks than smaller companies, missing disclosure of materiality assessment methodology from small companies makes it difficult to prove this conclusion. There is a stark contrast in the disclosure of materiality assessment methodology between large and small listed companies. Materiality assessment processes were disclosed by 58% of companies worth more than HKD 10 billion in the 2017 KPMG survey in contrast to only 13% for companies worth less than HKD 1 billion (KPMG, 2017).

It is reasonable that the discrepancy in ESG reporting performance stems from smaller capacity of small companies for ESG reporting. Large listed companies are better positioned to absorb the associated costs of ESG reporting as well as obligations to adhere to ESG reporting provisions, which pose a significant burden on smaller firms. This leads small listed companies to adopt a “box-ticking” approach to complying with the minimal standards while saving costs at the expense of quality ESG reporting.

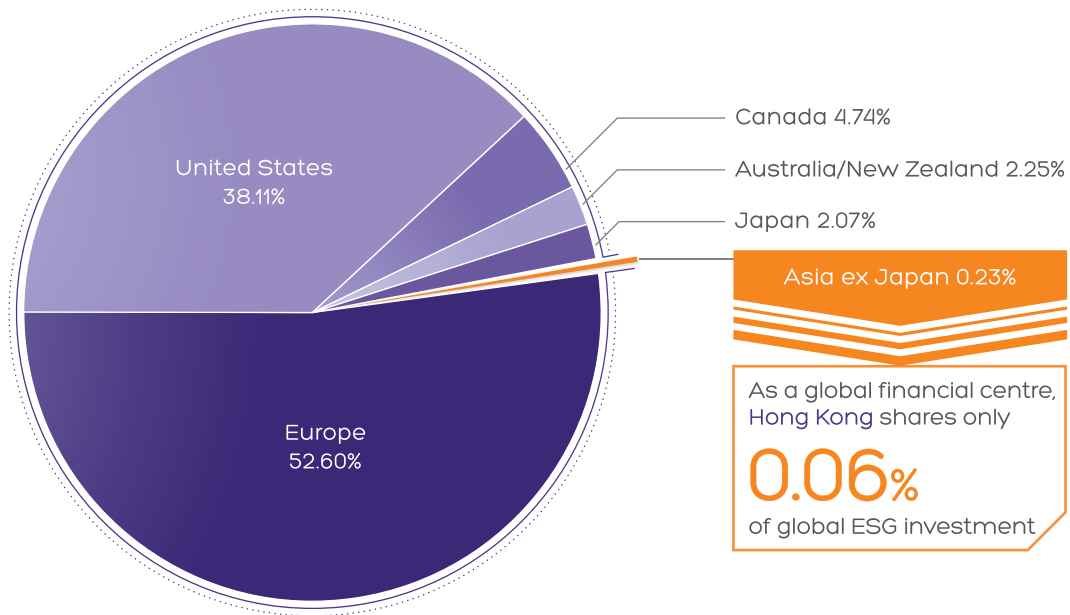
5.3 The Development of ESG Investment in Hong Kong

The past few years have witnessed the rise of sustainability-based investing across geographical boundaries, setting the stage for investor consideration of long-term ESG factors in their investment decisions while advancing sustainable development on the whole. According to GSIA, assets managed under ESG investment strategies increased 131% in six years, from USD 13.3 trillion in 2012 to USD 30.7 trillion in 2018 (GSIA, 2015, 2019).

As shown in **Figure 5.1**, statistics from 2016 show that Europe and the US were the biggest worldwide contributors in terms of ESG investment (GSIA, 2017). Although Hong Kong was one of the largest markets in Asia ex-Japan, accounting for 26% of the regional assets, its share was only 0.06% of global ESG investments (GSIA, 2017). Hong Kong lags behind global leaders in ESG investing despite its role as one of the world’s leading international financial centres.



(Figure 5.1) Regional Share of Global ESG Investment in 2016



Source: GSIA, 2017

More than 230 respondents representing asset owners, managers, banks, corporates, thought leaders, the public sector and regulators took part in a 2018 survey by RS Group to share their views on why ESG development remained stagnant in Hong Kong (RS Group, 2018). The top issues identified as curtailing further ESG investment growth were:

- i. A lack of market understanding and awareness regarding ESG investment**
12% of respondents had an interest in sustainable finance but did not know how to begin, indicating an imminent need to build awareness and knowledge within the investment community prior to a take-off of ESG investment.
- ii. A perceived concessionary financial return on ESG investment**
Some respondents suggested a prevailing preference for pure profit-seeking behaviour and short investment horizons embedded in Hong Kong's business culture hindered bottom-up changes in favour of ESG investment.
- iii. A lack of government policies to promote ESG investment**
A supportive policy environment was cited as a primary market catalyst to the further development of the sustainable finance market in Hong Kong.



Chapter 6 Policy Recommendations

6.1 Policy Recommendations for ESG Reporting

Recommendation 1

HKEX should clarify in its Corporate Governance Code that the board is responsible for assessing material environmental and social risks and learning the latest developments in useful tools such as the TCFD recommendations.

The HKEX's current ESG Guide places the responsibility for ESG strategy and reporting on the board, but the Exchange's Corporate Governance Code does not clarify these responsibilities. HKEX should strengthen the board's role in ESG governance and reporting by clarifying these responsibilities through the Corporate Governance Code.

The current ESG Guide states the board is responsible for ESG strategy, reporting and evaluating related risks while ensuring the presence of appropriate and effective ESG risk management and internal control systems (HKEX, n.d.). Yet these views are not incorporated into the Corporate Governance Code, which lists board responsibilities as financial reporting, auditing, general risk management, internal control and delegation. ESG risk management should be considered part of risk management but remains peripheral in practice. ESG strategy and reporting are not listed among board responsibilities at all. An alignment between the ESG Guide and the Corporate Governance Code will rectify any confusion and cement the board's role in ESG oversight.

Some overseas policymakers have already included explicit ESG elements in their corporate governance codes. The Australian Securities Exchange's (ASX) Corporate Governance Principles and Recommendations holds boards responsible for monitoring the adequacy of risk management frameworks in dealing with sustainability and climate change risks (ASX Corporate Governance Council, 2019). In France, the board's duties for promoting long-term value creation by considering its environmental and social impacts and monitoring environmental and social risks were explicitly incorporated into the Corporate Governance Code of Listed Corporations in 2018 (AFEP/MEDEF, 2018). The French code also requires directors to be provided with training in environmental and social responsibility if considered necessary (AFEP/MEDEF, 2018). Japan's Corporate Governance Code requires companies to take appropriate measures to address sustainability issues, including environmental and social matters (Tokyo Stock Exchange, 2018). The Japanese code also requires boards to ensure that ESG disclosures are as valuable and useful as possible (Tokyo Stock Exchange, 2018).

In the latest amendment of Hong Kong's Corporate Governance Code, which took effect on 1 January 2019, the board's ESG responsibilities remain undefined. An alignment between the ESG Guide and the Corporate Governance Code will strengthen the board's role in ESG governance and reporting. In line with capacity building to be discussed in Recommendation 8, HKEX should also encourage directors to receive ESG training relevant to the specific features of the companies they serve.

Recommendation 2

HKEX should expand the disclosure provisions of the ESG Reporting Guide to cover ESG governance, strategy, management, and the process of materiality assessment.

The current ESG reporting performance of Hong Kong-listed companies limits the value of ESG information in advising investment decision. HKEX highlighted the importance of the headlined disclosures (HKEX, 2018a), and should go further to expand disclosure provisions to cover ESG governance, strategy, management system, and materiality assessment methodology.

In line with strengthening the board's role in ESG governance, HKEX should require companies to report information of ESG governance including the roles of board, the overall governance structure in managing ESG risks and opportunities and the process of formulating ESG-relevant policies. HKEX should also encourage companies to disclose ESG-relevant background, experience and expertise of board members to facilitate assessments of board capacity in carrying out ESG roles and responsibilities.

The current ESG Guide recommends that, “[t]he ESG report should state the issuer’s ESG management approach, strategy, priorities and objectives and explain how they relate to its business” (HKEX, n.d., p.2). But the recommendations are not included in “comply-or-explain” provisions or in recommended disclosures. This results in a low level of disclosure of relevant information among companies. HKEX should clarify the requirement by including it in disclosure provisions.

Materiality is included in HKEX’s ESG Guide as a major reporting principle. Companies are to adhere to the principle by identifying material issues through materiality assessment but not required to disclose relevant processes and methods. Consequently, some companies claim adherence without explaining how they have arrived at their specific range of material issues (HKEX, 2018a). HKEX’s analysis report on ESG disclosure strongly recommends, “issuers to not only carry out stakeholder engagement and materiality assessment but also disclose that process in the reports” (HKEX, 2018a, p.13). HKEX should go further to include reporting of materiality assessment process and methods in disclosure provisions.

Recommendation 3

HKEX should refine, and potentially narrow, the scope of the ESG Reporting Guide to help companies identify material ESG risks that are sector-specific, and offer sector-specific guidance to assist companies in quantifying environmental and social impacts on a “comply-or-explain” basis. In addition, certain important criteria in each sector-specific matrix should be reported on a “mandatory” basis.

Significant challenges remain for investors to integrate rigorous and standardised ESG information into financial analysis and decision making. The quality of ESG disclosures vary across industries and companies of different sizes due to multiple constraints faced by companies. This often leads to inconsistent, scattered, and incomparable reporting which hinders investors in ESG integration and creates the persisting communication gaps in ESG information between investors and companies (PwC, 2019).

Stock exchanges connect companies with investors and are in a unique position to bridge gaps by strengthening transparency and efficiency of capital flows and aligning global markets towards long-term value creation to achieve sustainable development (UN SSE Initiative, 2017). HKEX’s ESG Guide is a regulatory tool to establish minimum parameters for ESG reporting (HKEX, 2018b). The value added by current provisions, however, are insufficient to enhance overall reporting quality among Hong Kong-listed companies. Reporting front-runners which adopt more advanced international standards such as the GRI framework can easily fulfil requirements without extra effort but middle-tier companies and latecomers lack incentives to exceed minimum disclosures and fully realise the value of ESG reporting.

HKEX should improve the current ESG Guide with sector-specific approaches. Our recommendation focuses on sector-specific approaches since companies in the same industry face similar ESG risks and opportunities. Imposing more stringent and well-defined requirements on ESG disclosures at the sector level enables investors and other stakeholders to conduct meaningful examination of material ESG data on a comparable basis without being overwhelmed by data. Small and medium-sized companies are more likely to be reporting latecomers and will benefit from having sector-specific guidelines and standards on what and how to report material ESG issues. This will ultimately reduce regulatory burden and compliance costs while significantly enhancing reporting quality.

Strengthening ESG reporting practices in a sector-specific direction echoes the well-received development of sector-specific guidance for ESG disclosures by international organisations, such as GRI G4 Sector Disclosures, Sustainability Accounting Standards Board (SASB)’s standards and KPIs for ESG 3.0 published by DVFA Society of Investment Professionals in Germany in conjunction with the European Federation of Financial Analysts Societies (EFFAS). HKEX is advised to keep abreast of the latest developments of international standards and incorporate best practices in Hong Kong.

HKEX should refine and narrow the scope of the ESG Guide by tailoring recommendations regarding material ESG risks in a sector-specific manner for companies. The SASB Materiality Map identifies four highly material issues affecting more than half of companies in the real estate sector including energy, water, product design and lifecycle management as well as the physical impacts of climate change (The SASB Foundation, n.d.). International frameworks of this nature provide a foundation for HKEX to further refine its current 11-aspect ESG Guide into a curated list of what is the most material to companies and meaningful to investors for higher-quality reporting.

HKEX should also offer sector-specific guidance to assist companies in quantifying environmental and social impacts on a “comply-or-explain” basis. This adds value to companies as well as investors which require quantitative ESG information for investment modelling and analysis. A consistent approach for quantification suggested by HKEX can strengthen the robustness and comparability of valuations as ESG factors are further integrated. This will ultimately facilitate more effective market decision-making. Important criteria in each sector-specific matrix should be reported on a mandatory basis. Carbon-related disclosures, for instance, have become mandatory in France and the UK as shown in **Table 4.1** in Chapter 4. HKEX can consider mandating disclosures on carbon emissions among sectors with the most significant impacts on climate change.

A sector-specific upgrade of the ESG Guide allows companies to focus resources on reporting the most material indicators relevant to their respective sectors. This enhances the instrumental value of their reports while potentially refining report scope. Stakeholders should be consulted on creating sector-specific matrices and criteria and an updated ESG Reporting Guide should be implemented in phases.

Recommendation 4

HKEX should encourage companies to assure the few important criteria to be reported mandatorily in Recommendation 3 and assurance costs should be subsidised by the Government.

External assurance of ESG reporting is instrumental in enhancing transparency and building confidence in the ESG investment market. Assurance is a measure which helps ensure the credibility of ESG reporting, standardise quality reporting practices and ultimately propel growth in ESG investment. Better quality data on a comparable basis translates into improved financial analysis and decision making for investors. Companies which obtain third-party assurance can differentiate themselves from peers which fail to embrace ESG reporting, bringing added value to early adopters with enhanced stakeholder confidence.

The benefits of assurance are widely accepted since it is a common practice for financial disclosures mandated in most markets. So far, European markets, in particular France and the UK, have imposed regulatory requirements on external assurance of ESG reporting. External assurance should be proactively incorporated into HKEX's current ESG Reporting Guide as part of regular ESG disclosure requirements.

Assurance requirements which ensure accuracy, integrity and quality of ESG disclosures will address Hong Kong's ESG reporting quality issues discussed earlier. We recommend HKEX to encourage companies to assure important KPIs. For instance, industries most impacting climate change should have their carbon disclosure verified. HKEX can also make reference to international frameworks, such as standards of International Auditing and Assurance Standards Board, for proper guidance on companies' external assurance.

Over time a similar approach can be applied on a wider scope, such as mandating assurance for other metrics, qualitative information or management process. As supply grows to meet the demand for credible ESG data and information alongside strengthened regulations, we expect local assurance standards to develop towards a better alignment of ESG reporting practices with the expectations of investors, companies and stakeholders.

The Government should consider subsidising assurance costs during early implementation phases to assuage financial burden concerns stemming from mandatory external assurance. As standardisation and transparency strengthens, companies will see the value added outstripping costs incurred.

Recommendation 5

As an alternative to adopting the refined HKEX ESG Reporting Guide mentioned in Recommendations 3 and 4, HKEX should allow other internationally recognised ESG reporting frameworks, such as GRI Standards, the International Integrated Reporting Framework and the SASB standards, to be used.

Greater consistency of reporting practices remains a key challenge in global ESG reporting due to unconsolidated international and local frameworks for sustainability and integrated reporting. A universal framework will take many years to come but companies should adopt either international or local frameworks most suitable to their industry, business model and regulatory requirements.

HKEX's current ESG Guide customises disclosure guidance for the local market but there are concerns about its compatibility with internationally recognised ESG reporting frameworks such as the GRI Standards, the International Integrated Reporting Framework and the SASB standards. Even if current HKEX provisions were refined in accordance with Recommendations 3 and 4, the ESG Guide would still be less stringent than international standards in general.

HKEX acknowledges, "adopting international reporting standards or guidelines that contain comparable provisions to the ESG Guide should be sufficient compliance with the Guide without the need for further explanation" (HKEX, 2018b, p.1). But without further clarification in the ESG Guide, reporting front-runners among Hong Kong-listed companies which opt for international or industry-specific standards are saddled with extra compliance costs to meet ESG Guide requirements. Meanwhile, companies new to ESG disclosures are not motivated to adopt higher reporting standards beyond HKEX's minimal listing requirements.

HKEX is advised to recognise other international ESG reporting frameworks as an alternative to adopting refined provisions for its current ESG Guide. This approach offers flexibility for companies which have already been employing advanced practices and performances in reporting to reduce their regulatory burden while providing more choices for latecomer companies to continuously improve their reporting practices. The Singapore Exchange adopts a similar approach where it does not provide separate ESG guideline but endorse any sustainability reporting frameworks as long as the issuers, "state the name of the framework(s), explain its reasons for choosing the framework(s) and provide a general description of the extent of the issuer's application of the framework(s)" (Singapore Exchange, 2016, p.4).

Recommendation 6

The Government should develop open-access datasets of environmental and social data, particularly of climate-related data and scenarios, to facilitate the assessment of ESG risks and opportunities.

Quality environmental and social data are key inputs in any sophisticated ESG analysis and reporting but can be prohibitively expensive for companies to collect individually. This is particularly the case for reporting in accordance with the TCFD recommendations which involve scenario analysis and climate-related financial implication disclosures. It is recommended the Government should develop open-access environmental and social datasets, particularly climate-related data and scenarios, to facilitate ESG risk and opportunity assessments.

Reporting in accordance with the TCFD recommendations companies would face enormous costs of developing climate-related datasets that are not readily available in the market, as significant challenges remain in utilising existing datasets and scenarios that are publicly available. The TCFD recognises, “most scenarios have been developed for global and macro assessments of potential climate-related impacts that can inform scientists and policy makers... [which] do not always provide the ideal level of transparency, range of data outputs, and functionality of tools that would facilitate their use in a business or investment context” (TCFD, 2017b, p.11).

For example, existing transition scenarios mostly do not provide sector or activity-specific results for differing energy mixes under modelled future conditions. There are also difficulties in using global climate models to accurately plot extreme weather events such as floods and droughts at micro levels. Without precise local data, ESG analysis risks lapsing into a garbage-in-garbage-out exercise (TCFD, 2017b).

Governments in Canada and the US actively provide data and tools to build businesses' climate resilience. The Canadian Climate Information Portal was launched in 2018 to centralise useful climate information. The Portal is administered by the Canadian Centre for Climate Services which is an official source of reliable climate information, data, and tools. The Portal includes historical and future climate information as well as other climate variables such as temperature, precipitation and snow cover. The American Partnership for Resilience and Preparedness (PREP) was developed in September 2016 as a tool to help corporations make long-term infrastructure decisions by improving climate resilience planning. PREP is an open-source data platform which allows users to access highly credible climate, physical and socioeconomic datasets including temperature, precipitation, drought, flood, social vulnerability, coastal energy facilities, landslides and sea level rise. The data is sourced from various institutions and agencies such as NASA and help map and visualise a specific region's vulnerability while tracking indicators most relevant to business through customisable dashboards.

We recommended the HKSAR Government to reference these international initiatives and best practices. The Commerce and Economic Development Bureau and its executive arm, the Hong Kong Observatory, should develop open-access climate-related databases and scenarios based on local data for businesses to assess their climate risks and opportunities for better climate change adaptation and mitigation planning. Meanwhile, the Government should not constrain itself from pursuing stronger collaboration with the international community and China when developing databases and scenarios. Hong Kong's cross-border networks make the Greater Bay Area a logical partner in broadly aligning methodologies to enhance comparability of climate-related analysis. These datasets and models would be of prime importance for producing decision-useful information and analyses for investors operating at local, regional, national and international levels.

While the provision of climate-related data is key to facilitating business reporting in accordance with the TCFD recommendations, the Government should also explore compiling and providing other environmental and social datasets which help companies assess general ESG risks and opportunities.

Recommendation 7

The Government should conduct an SDG review and formulate a clear plan for sustainable development in Hong Kong.

As a milestone development framework, the UN SDGs are gaining traction in contemporary ESG reporting. The SDGs provide a comprehensive framework for evaluating environmental and social impacts within the context of the global agenda towards sustainable development. The Government should conduct a systematic and comprehensive review of SDG progress to identify gaps and signal where business can contribute to sustainable development in Hong Kong.

Urban centres such as New York City are already starting to evaluate and report their progress towards implementing SDGs. A comprehensive review of SDG progress with localised goals and indicators enables local companies to identify sustainable development gaps and measure their impacts with official indicators. For example, if the Government identified a significant gap in sustainable consumption and production (SDG 12) in terms of food losses (SDG target 12.3), a food and beverage sector company could incorporate the SDG into its strategy and reporting by formulating policies to reduce food losses along its supply chain and then measuring food loss reduction levels before reporting on the impacts of their policies.

Going a step further, the Government should formulate a clear blueprint for reaching SDGs while demarcating business risks and opportunities. Public policy can significantly impact businesses and clear and credible policy signals serve as an important starting point for identification of material transition risks and opportunities. For example, if the Government is committed to increasing investments in energy efficiency as a percentage of GDP to a certain level (SDG indicator 7.b.1), energy companies are presented with the business opportunity to create and provide corresponding solutions. The Government should leverage SDGs as a tool to communicate its plans for sustainable development and signal potential material ESG risks and opportunities to encourage local companies to adopt SDG framework for their own strategy and reporting.

SUSTAINABLE DEVELOPMENT GOALS



Recommendation 8

The Government, HKEX, and relevant public bodies should collaborate with relevant professional bodies and universities to support capacity building to foster an ecosystem of quality ESG reporting.

Another key to enhancing the general quality of ESG reporting is capacity building across the ESG ecosystem. The Government, HKEX and relevant policymakers should collaborate with professional bodies and universities to support capacity building to lay the ground work for quality ESG reporting.

Strengthening ESG reporting practices to better inform decision-making and engender positive impacts has time and cost implications for preparers and end-users. Preparing and utilising better reports require specialist knowledge and expertise in a diverse range of subject areas from climate change to gender inclusion. Enhancing general ESG reporting performance through capacity building will involve four major stakeholder groups:

- **Board of Directors:**

To strengthen the role of boards in ESG governance, it is important to ensure directors have an essential understanding of ESG reporting and how they can carry out their duties for better disclosures.

- **Reporting Practitioners:**

ESG reporting practices are progressing towards greater sophistication and report preparers including in-house staff and external consultants need technical skills such as carbon accounting and social impact assessment.

- **Auditors and Assurers:**

Increasing concerns about the reliability of ESG data requires the market to be served by talent equipped with relevant skills such as carbon auditing to meet rising assurance requirements.

- **The Investment Community:**

Investors are the end-users of ESG data and play an important role in driving demand for quality ESG reporting. It is important to build investors' capacity to engage companies for appropriate ESG disclosures.

The Government, HKEX and other policymakers should collaborate with relevant professional bodies to expand capacity building offerings and reduce potential costs incurred from capacity building. Professional bodies such as The Hong Kong Institute of Directors and The Hong Kong Institute of Chartered Secretaries shall be encouraged to integrate more ESG content into their continuing professional development programmes. In particular, company secretaries should be provided with opportunities to opt for ESG education while complying with 15-hour training requirements under Listing Rules since they may be the primary in-house personnel tasked with ESG reporting in listed companies of smaller sizes where dedicated in-house ESG reporting personnel is absent.

Universities and professors with relevant expertise should be actively engaged to help develop capacity-building programmes. Academic support backed by robust research and evidence will be the foundation for building effective training programmes. For example, the EFFAS runs a Certified EFFAS Environmental Social and Governance Analyst programme, which was developed by a group of experts including a professor of capital markets and management, who is also the chair and academic director of the programme (EFFAS, n.d.).

Recommendation 9

The Government should establish a cross-sector steering committee to formulate a clear blueprint for ESG reporting development, particularly for aligning ESG reporting requirements with the TCFD recommendations, in Hong Kong.

The development of ESG reporting will be an incremental process much like traditional financial reporting. It will take time to develop standards and build capacity for effective ESG reporting. Expectations that ESG reporting will be of the highest calibre within a short period have been proven unrealistic. It is important to enable communication between different sectors and manage expectations of various stakeholders in the field when coordinating efforts in the incremental development of ESG reporting.

The Government should establish a cross-sector steering committee to formulate a clear blueprint for the incremental development of ESG reporting, particularly for the implementation of the TCFD recommendations in Hong Kong. Policymakers should engage stakeholders in the field to understand challenges and develop a consensus on specific reporting and assurance requirements, standards and guidelines before formulating supportive policies which facilitate higher-quality ESG reporting. A cross-sector steering committee will provide a platform which enables communication and consensus building to steer the development of ESG reporting. The committee should include members from across the ESG ecosystem including policymakers, listed companies, asset managers, service providers and professional bodies. Members representing different financial and non-financial sectors, particularly those specified in the TCFD recommendations, should also be included. The committee should also engage the international community actively and factor in cutting-edge international developments while performing its functions and duties.

The committee can play a significant leadership role in implementing most of the recommendations set out in this section. One particularly important task for the committee will be formulating a way forward for the incremental development of ESG reporting in Hong Kong. A clear plan allows companies and other stakeholders to efficiently devote resources and build capacity to meet and leverage advancing ESG reporting requirements. In particular, the implementation of the TCFD recommendations involves multiple stages starting from qualitative disclosures of how climate-related issues are relevant and considered in companies' governance to strategy and risk management practices. From there, quantitative disclosures of data which have not already been collected and reported are made before technically sophisticated disclosures like strategy resilience under different climate-related scenarios and relevant financial implications are produced. It is expected disclosures will mature as, "understanding, data analytics, and modelling of climate-related issues become more widespread" (TCFD, 2017a, p.41). A clear timeline of when and how the TCFD recommendations will be incorporated into ESG reporting requirements is important for companies to plan ahead, establish relevant management and monitoring systems and build reporting capacity to meet increasing demand for ESG information.

6.2 Policy Recommendations for ESG Investment

Recommendation 10

The SFC should align the current Principles of Responsible Ownership (PRO) with Principles for Responsible Investment (PRI) such that ESG considerations are integrated into investment processes.

The UN-supported PRI is an influential global investor network with more than 2,300 signatories representing more than USD 80 trillion in AUM (PRI, n.d.-a). Participation in the PRI is voluntary and requires signatories to report annually on their responsible investment activities and how they meet the six principles, which emphasises the importance of fully integrating ESG issues into investment analysis and decision-making processes, ownership policies and practices, as well as reporting and disclosure.

The strong focus is placed on ESG integration as it plays an indispensable role in boosting responsible investment efforts. It entails possible actions ranging from “address ESG issues in investment policy statements”, “support development of ESG-related tools, metrics, and analyses” to “advocate ESG training for investment professionals” (PRI, n.d.-c). ESG integration practices around the world are on the rise. More than 80% of PRI’s signatories took ESG factors into considerations when directly managing assets while more than half considered constructing ESG integrated portfolios, according to PRI’s Annual Report 2018 (PRI, n.d.-b).

On the regulatory front, ESG integration is also a key element for investor disclosure regimes in the EU, France and the UK as summarised in **Table 4.2** in Chapter 4.

ESG integration is crucial to overcoming barriers to the ESG market’s further development, particularly in Hong Kong. The SFC’s current PRO recommends investors should, “encourage their investee companies to have policies on ESG issues and engage with investee companies on significant ESG issues that have the potential to impact on the companies’ goodwill, reputation and performance” (SFC, 2016, p. 3). The current PRO merely focuses on corporate engagement rather than ESG integration, weakening investor motivations to fully consider ESG risks and opportunities in a systematic way to guide selection and realisation of investments.

To grow ESG investment in Hong Kong, the SFC should revise the PRO by expanding ESG integration beyond engagement practices to cover aspects such as investment analysis, decision-making process, reporting and disclosure. This can better align investment practices with PRI and the latest regulatory developments across the world. More specifically, the SFC should consider clarifying that ESG issues are the value drivers for the long-term success of the investee companies and falls under investors’ fiduciary duties.

Recommendation 11

The SFC should require asset managers to report on the enhanced PRO in Recommendation 10 on a “comply-or-explain” basis.

The global regulatory landscape is rapidly evolving as investor interest in ESG soars. Among mainstream investors, their commitments to sustainable investment have been gradually turned into reality as ESG integration gains prominence in both regulations and practices. Maintaining Hong Kong’s competitiveness and position at the top of global finance calls for a proactive role in nurturing a well-functioning ESG market. The starting point will be an adjustment of regulatory regimes and approaches to investor disclosure on ESG integration.

Building on enhanced PRO detailed in Recommendation 10, the SFC is advised to require asset managers to disclose their level and methods of ESG integration on a “comply-or-explain” basis at a minimum. More stringent enforcement rather than voluntary disclosure is required as ESG factors become an integral part of institutional investors’ fiduciary duties as clarified by the PRI (Sullivan et al., 2015).

The regulatory improvement will bring Hong Kong closer to more advanced regulatory regimes in the EU, France and the UK, where at least a “comply-or-explain” approach is already or to be imposed on asset managers and institutional investors, as detailed in **Table 4.2** in Chapter 4.

Stronger leadership and implementation will contribute greatly to the policy objective of promoting ESG integration (PRI & MSCI, 2016). A “comply-or-explain” approach stimulates greater drive for asset managers to consider ESG factors in their investment research and decisions while companies would be rewarded for high standards of ESG performance and reporting by gaining favour among investors. As transparency on ESG integration strengthens, asset owners will be able to better assess their exposure to ESG risks and identify investing opportunities while contributing to sustainable development agenda.

Recommendation 12

The Government and public bodies, including the Hong Kong Monetary Authority (HKMA), should integrate ESG factors explicitly into investment policies of public funds and require their external managers to adhere to higher standards than the current PRO.

The HKSAR Government, is one of the world's largest asset owners (White, 2018) and should take the lead for ESG investment in Hong Kong. Excluding other public funds, the HKMA managed HKD 4.059 trillion in assets in its Exchange Fund as of 31 December 2018. The fund is made up of HKD 320 billion in placements from the HKSAR Government funds and statutory bodies while HKD 1.174 trillion is derived from the Government's fiscal reserves. The Government should strengthen the integration of ESG factors into public funds management, notably through the Exchange Fund, to lead by example in developing ESG investment.

The Financial Secretary is authorised to, "with a view to maintaining Hong Kong as an international financial centre, use the Fund as he thinks fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong," according to the *Exchange Fund Ordinance* (1997). As central banks around the world acknowledge that climate change imposes material risks on financial systems and threatens stability, due consideration of climate risks and other ESG risks should be incorporated into the Exchange Fund's management. The Government should also leverage the Exchange Fund to catalyse the development of ESG investment to maintain Hong Kong's status as a leading international financial centre. Stronger integration of ESG considerations into the management of the Exchange Fund is in line with its mandate.

The HKMA should accelerate its own ESG requirements and disclosures. While HKMA has already encouraged Hong Kong equity portfolio external fund managers to adopt the SFC's PRO (HKMA, 2018), it should extend requirements from voluntary to "comply-or-explain". The HKMA should also explicitly require external managers to integrate ESG factors into investment decisions and disclose how they do so before the PRO is revised in accordance with Recommendation 10 since the current PRO only focuses on engagement with investee companies in relation to ESG issues. As front offices and the Risk Management and Compliance Division have already incorporated ESG factors into various internal procedures for making and monitoring investment activities, appropriate disclosures of the ESG practices and frameworks of HKMA would serve as a role model for the market.

Meanwhile, the Government should require other public funds such as the Grant and Subsidised Schools Provident Funds and the Quality Education Fund managed under the Treasury to integrate ESG factors into their investment decisions.

Recommendation 13

The MPFA should incorporate ESG factors into its monitoring process.

The purpose of a pension fund is to deliver the best long-term investment returns with an assumed level of risks to provide retirement income security for its members. This is completely in line with the emphasis of ESG investment on creating sustainable investment return. The EU IORP II Directive requires pension funds classified as Institutions for Occupational Retirement Provision to include ESG factors in governance and risk assessment and to disclose whether and how ESG factors are considered in the investment approach (Directive (EU) 2016/2341, 2016).

The International Organization of Pension Supervisors (IOPS), which the MPFA is a governing member, issued Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds in January 2019 for public consultation. The Guidelines are voluntary and non-binding. They provide supervisory authorities with guidance and its implementation is subject to the structure of private pension systems and the principle of proportionality. The preliminary recommendations for supervisory authorities include:

- Requiring the governing body of pension funds to consider material ESG factors and incorporate them into the pension fund’s investment and risk management process;
- Requiring the governing body and asset managers of pension funds to integrate ESG factors into their investment strategies on a “comply-or-explain” basis; and
- Requiring the governing body or asset managers of pension funds to disclose how they integrate ESG factors into investment and risk management process (IOPS, 2019).

Supervising investors who manage the pensions of 85% of Hong Kong’s working population with total assets of HKD 813 billion as of December 2018 (MPFA, 2019), the MPFA should actively promote integration of ESG factors among MPF trustees.

The MPFA should issue guidelines on how MPF trustees should integrate ESG factors into investment and risk management process once market conditions mature and technical hurdles surrounding the quality and comparability of ESG data are cleared. MPF trustees should then be required to disclose whether and how ESG factors are considered in their investment and risk management approaches. As the ESG ecosystem continues to mature, the MPFA can consider requiring integration of ESG factors into investment and risk management process on a “comply-or-explain” basis.

The MPFA should closely follow international standards and best practices in integrating ESG factors into pension fund management and, when appropriate, consider developing ESG labels that recognise and encourage best practices among trustees to improve transparency and facilitate informed decision by MPF scheme members.

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Our Hong Kong Foundation is a non-government, non-profit organisation, dedicated to promoting the long-term and overall interests of Hong Kong through public policy research, advocacy and engagement. Pooling together local, mainland and international talent, the Foundation studies Hong Kong's short, medium and long-term development needs, offering multidisciplinary public policy recommendations and solutions to foster social cohesion, economic prosperity and sustainable development.

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Bernard Charnwut Chan is a deputy to the National People's Congress of China, a non-official member of Hong Kong's Executive Council (2004-09 and from 2012) and the Convenor of the Non-Official Members of the Executive Council (from 2017). He is also a former member of Hong Kong's Legislative Council (1998-2008).

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Hong Kong Green Finance Association

The aim and mission of the HKGFA is to gather industry experts and provide policy suggestions to the HKSAR Government and other regulators in developing green finance in the city. The HKGFA will promote concepts of green finance and green investment. In addition the association will lead research and development of green finance products, methodologies and tools, positioning Hong Kong to become a major international green finance centre.

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