Survey on Integrating Environmental, Social and Governance Factors and Climate Risks, in Asset Management

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Introduction

1. From March to September 2019, the Securities and Futures Commission (SFC) conducted an industry-wide survey[1] to understand how and to what extent licensed asset management firms and leading institutional asset owners consider environmental, social and governance (ESG) risks, particularly those relating to climate change. This report presents the key findings and discusses the way forward.
2. The survey forms part of the SFC's Strategic Framework for Green Finance, published in September 2018, which set out its priorities to encourage the consideration of ESG factors in the investment and risk management processes, facilitate the development of green or ESG-related products and enhance listed companies' reporting of environmental and climate-related information.
3. Climate change is an urgent, potentially existential source of financial risk for businesses. Extreme weather events have already disrupted supply chains, affected production capacity and increased business costs. In the transition to a lower-carbon economy, policy changes, social preferences and the emergence of green technologies may affect the viability of certain industries. This in turn will have serious knock-on effects on the pricing of financial assets in capital markets. These risks will likely intensify, although there is no way to be certain how and when they will materialise.
4. Investors need relevant information about ESG risks, especially those associated with climate change, in order to make informed investment decisions and allocate capital efficiently. They increasingly recognise that ESG factors are a proxy for overall management quality and long-term sustainability. Asset management firms which claim that they take ESG factors into account should make it clear how they do this.
5. At the global level, the SFC, together with a number of leading regulators and central banks, has acknowledged publicly that environmental factors, especially those related to climate change, are a source of financial risk. It is within the SFC's regulatory mandate to ensure that the asset management industry is resilient and responsive to these risks. Most importantly, asset management firms should have a clear understanding of how environmental and climate risks affect their portfolios before prematurely concluding that these risks are not financially material. Authorities in China and the European Union have already taken steps to introduce regulations in this area.
6. The SFC would like to thank the asset management firms and asset owners who participated as well as the Hong Kong Monetary Authority, Mandatory Provident Fund Schemes Authority and Insurance Authority for their support and suggestions.

[1] PricewaterhouseCoopers Limited (PwC) was engaged as a consultant to conduct the survey and analyse the findings. The survey methodology is set out in the Appendix.

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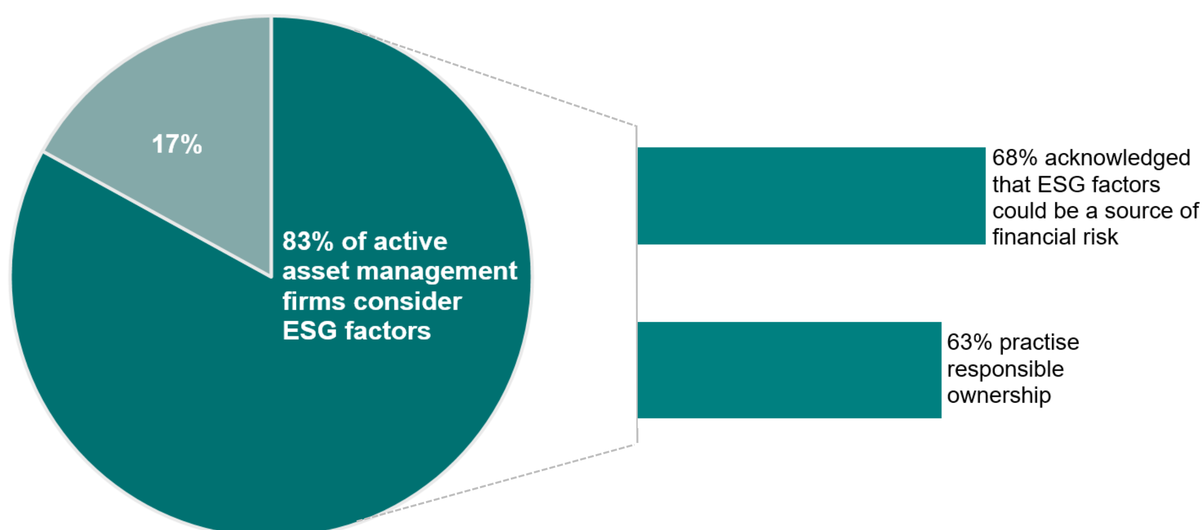
Key Survey Findings

Consideration of ESG factors, including climate change

7. Of the firms surveyed, 660, or 83% of those actively involved in asset management, considered at least one environmental, social and governance factor in order to understand a company's investment potential and facilitate better investment decisions and risk management. *(Chart 1)*
8. Furthermore, 68% of these firms clearly acknowledged that ESG factors could be a source of financial risk and have an impact on investment portfolios.
9. Most of the asset management firms surveyed were in favour of strengthening ESG disclosure rules for listed companies, as proposed by The Stock Exchange of Hong Kong Limited (SEHK) in May 2019, so that more high quality, decision-useful ESG and climate change-related information could be available for use in their investment and risk management processes.
10. Many are taking a more active approach to influence corporate ESG management by exercising their rights as shareholders. Of the 660 firms, 63% practise responsible ownership, for instance, through voting and corporate engagement.
11. Asset management firms with strong ESG practices pointed out that environmental factors, especially those related to climate change, will become more important in view of the Paris Agreement.[2]

Chart 1. Consideration of ESG factors, including climate change



[2] The central aim of the Paris Agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.

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Governance and oversight

12. To improve the financial performance of investment portfolios and satisfy client demand, 35% of the 660 asset management firms which considered ESG factors have implemented a consistent approach to systemically integrate ESG factors in their investment and risk management processes, rather than doing so on an ad-hoc basis. Some respondents have established governance and oversight measures, such as implementing an ESG policy approved by the Board, defining in the organisational chart the functions involved in integrating ESG factors in the investment process and designating board members to focus on ESG issues. *(Chart 2)*

13. Furthermore, some of these firms have processes in place for fundamental analysis and due diligence to ensure that ESG investment recommendations and products align with their own ESG investment approach. Others have ESG criteria and methodologies in place for portfolio construction and monitoring any deviations.

14. The remaining 65% of the asset management firms did not have any oversight measures in place. This raises questions about how they could apply an ESG investment approach consistently.

Chart 2. Examples of ESG governance and oversight measures

Board-approved ESG policy, which usually covers:

- A list of specific ESG factors considered
- A defined approach to integrate ESG in investment selection, management and monitoring
- A defined approach to assess and manage ESG risks and opportunities
- Disclosures of ESG investment activities and performance
- Active ownership and corporate engagement approaches and procedures
- A defined process to understand clients' ESG preferences and related investment strategies
- Effective controls to ensure adherence to ESG policy, including the escalation and resolution of issues

Clearly defined roles and responsibilities, with effective escalation and communication channels

Specific board members overseeing ESG investments, risk assessment and management of climate risks

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Investment management

15. Asset management firms which systemically integrate ESG factors most often use investment strategies such as negative and exclusionary screening, corporate engagement, shareholder action and ESG integration. More than half adopt multiple ESG investment strategies as their practices mature and more ESG data becomes available. *(Chart 3)*

16. However, there is a gap between the expectations of asset management firms and their clients, the asset owners. A majority of the asset owners surveyed indicated that asset managers do not engage with them to understand their ESG investment preferences. Also, some are not entirely satisfied with the ESG investment services provided by asset management firms. Discussion of climate risks is almost non-existent in client engagement and suitability assessment. The gap in expectations has widened due to the limited number of ESG investment product offerings in the local market.

Chart 3. Examples of ESG investment strategies

Strategy	Description
Negative / Exclusionary screening	Exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria.
Corporate engagement and shareholder action	Use of shareholder power to influence corporate behavior, including through communicating with senior management of companies, filing shareholder proposals, and proxy voting guided by ESG guidelines.
ESG integration	Systematic and explicit inclusion by investment managers of ESG factors into financial analysis.
Norms-based screening	Screening of investments against minimum standards of business practice based on international norms.
Positive / Best-in-class screening	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers.
ESG-themed / Thematic investing	Investment in themes or assets specifically related to ESG (eg, clean energy, green technology or sustainable agriculture).
Impact / Commuity investing	Targeted investments aimed at solving environmental or social problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear environmental or social purpose.

Risk management

17. Those asset management firms which systemically integrate ESG factors have put in place risk management controls, such as incident monitoring mechanisms to flag major ESG incidents, so that portfolio managers adjust investment portfolios as appropriate. ESG issues and their impact are also discussed at investment committee meetings.

18. However, when the focus narrows to the management of climate change-related risks, only 23% of the 660 asset management firms which considered ESG factors have processes in place to manage the financial impact of physical and transition risks[3] arising from climate change *(Chart 4)*. In contrast, the majority of asset owners surveyed expect asset management firms to identify, assess and manage climate risk. This indicates that there is also a gap between the expectations of asset owners and asset management firms when it comes to climate-related risk management.

19. The survey found that processes used to manage climate risks may involve:
    - incident monitoring mechanisms which flag major climate change-related incidents so that portfolio managers adjust investment portfolios as appropriate;
    - incorporating results from ongoing climate risk assessments in the development of the firm's investment strategies;
    - the use of scenario analysis according to the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) to assess the potential financial implications of climate risks on investment portfolios;
    - climate risk assessment procedures defined within the firm's risk management policy; and
    - senior management oversight of climate risk assessment and management strategy.

[3] Physical risks are those associated with climate change and related extreme weather events which may have financial implications for companies. Transition risks are those associated with the viability of a business during the transition to a lower-carbon economy due to factors such as policy changes, social preferences and technological developments.

Chart 4. Examples of climate-related risks[4] and potential financial impacts from the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) Final Recommendations Report

Type	Climate-related risks	Potential financial impacts
Transition risks	**Policy and Legal** - Increased pricing of greenhouse gas emissions - Enhanced emissions-reporting obligations - Mandates on and regulation of existing products and services - Exposure to litigation	- Increased operating costs (eg, higher compliance costs, increased insurance premiums) - Write-offs, asset impairment, and early retirement of existing assets due to policy changes - Increased costs and/or reduced demand for products and services resulting from fines and judgments
Transition risks	**Technology** - Substitution of existing products and services with lower emissions options - Unsuccessful investment in new technologies - Costs to transition to lower emissions technology	- Write-offs and early retirement of existing assets - Reduced demand for products and services - Research and development (R&D) expenditures in new and alternative technologies - Capital investments in technology development - Costs to adopt/deploy new practices and processes
Transition risks	**Market** - Changing customer behavior - Uncertainty in market signals - Increased cost of raw materials	- Reduced demand for goods and services due to shift in consumer preferences - Increased production costs due to changing input prices (eg, energy, water) and output requirements (eg, waste treatment) - Abrupt and unexpected shifts in energy costs - Change in revenue mix and sources, resulting in decreased revenues - Re-pricing of assets (eg, fossil fuel reserves, land valuations, securities valuations)
Transition risks	**Reputation** - Shifts in consumer preferences - Stigmatisation of sector - Increased stakeholder concern or negative stakeholder feedback	- Reduced revenue from decreased demand for goods/services - Reduced revenue from decreased production capacity (eg, delayed planning approvals, supply chain interruptions) - Reduced revenue from negative impacts on workforce management and planning (eg, employee attraction and retention) - Reduction in capital availability
Physical risks	**Acute** - Increased severity of extreme weather events such as cyclones and floods **Chronic** - Changes in precipitation patterns and extreme variability in weather patterns - Rising mean temperatures - Rising sea levels	- Reduced revenue from decreased production capacity (eg, transport difficulties, supply chain interruptions) - Reduced revenue and higher costs from negative impacts on workforce (eg, health, safety, absenteeism) - Write-offs and early retirement of existing assets (eg, damage to property and assets in "high-risk" locations) - Increased operating costs (eg, inadequate water supply for hydroelectric plants or to cool nuclear and fossil fuel plants) - Increased capital costs (eg, damage to facilities) - Reduced revenues from lower sales/output - Increased insurance premiums and potential for reduced availability of insurance on assets in "high-risk" locations

[4] The sub-category risks described under each major category are not mutually exclusive, and some overlap exists.

Disclosure

20. Although 660 asset management firms reported giving general consideration to ESG factors, a majority, 68%, indicated that information about their own ESG practices was not available. Even more did not disclose climate risk assessments.

21. All the asset owners surveyed agreed that, for the purposes of reducing greenwashing and identifying asset management firms with stronger ESG practices, more disclosure following a prescribed framework is needed from firms. The disclosures which asset owners find most useful go beyond marketing-style narratives of the ESG philosophy and policy statements. Asset owners look for outcomes and evidence of ESG impact in addition to financial performance, consistency between policies and practices, the rationale behind investment decisions and more supported analysis of asset-specific ESG risks, as well as the analytical tools used, results of corporate engagement and voting track records. *(Chart 5)*

Chart 5. Examples of ESG information disclosed by surveyed asset management firms

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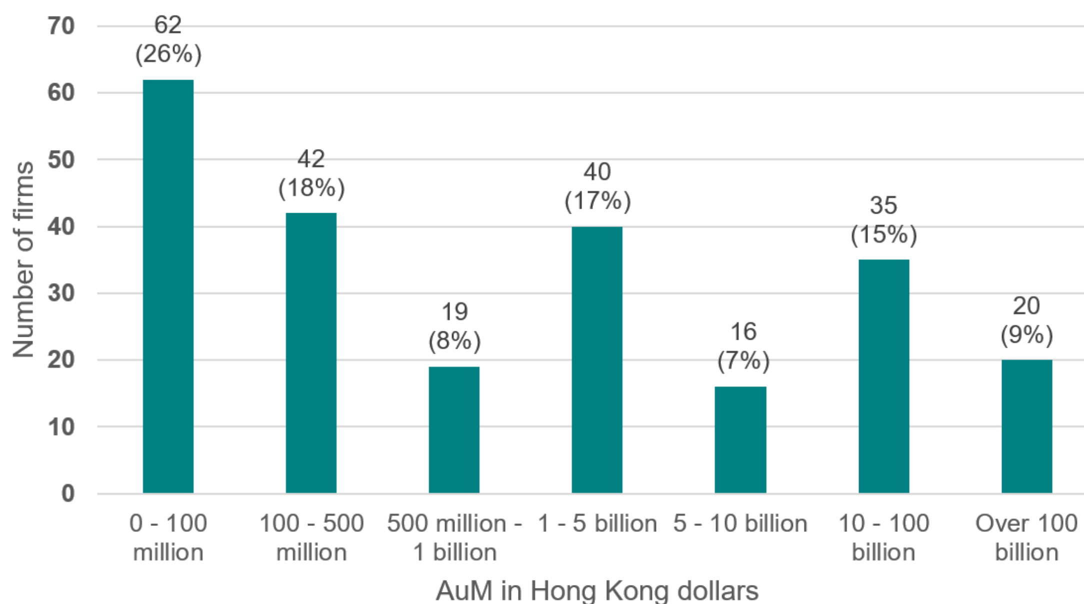
Market trends

22. Local asset management firms lag behind their counterparts with overseas-based parent companies in terms of ESG practices. The latter generally have stronger ESG investment processes relating to research and portfolio management, governance and oversight measures, and more of them support international initiatives such as the TCFD and the United Nations Principles for Responsible Investment.
23. However, 64% of the firms which are actively involved in asset management plan to develop or enhance their ESG practices in the next two years, regardless of whether they already consider ESG factors or not. During that time, many are also considering publicly disclosing more information about their ESG investment practices and how they manage climate risks.
24. Survey results also show that asset management firms of various sizes, including small firms in terms of AUM, have ESG investment processes relating to research and portfolio management. This is contrary to the general perception that developing ESG practices is resource-intensive and only large players can afford the cost. *(Chart 6)*

Chart 6. AUM of surveyed asset management firms with ESG investment processes relating to research and portfolio management



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Way Forward

25. ESG risks, in particular climate risks, could have a potentially material impact on underlying asset values, and in turn, an investment portfolio's performance and risk-return profile. Accordingly, the SFC takes a financial risk perspective when it looks at how the asset management industry considers ESG factors.

26. The survey found that there is significant interest among asset management firms to step up their ESG efforts and management of environmental and climate risks. This is a positive development. To help firms move forward and more closely align the SFC's regulatory regime with global standards, the SFC intends to deliver three outcomes in the near term:

    - To set expectations of asset management firms in areas such as governance and oversight, investment management, risk management and disclosure, focusing on environmental risks with an emphasis on climate change;
    - To provide practical guidance, best practices and training in collaboration with the industry and relevant stakeholders to enhance the capacity of asset management firms to meet the SFC's expectations; and
    - To establish an industry group to exchange views amongst the SFC and experts in environmental and climate risks, as well as sustainable finance.

27. These outcomes will complement the actions already taken by the SFC under its *Strategic Framework for Green Finance.* In April 2019, the SFC issued a circular to provide guidance which makes disclosures by SFC-authorised green funds more transparent and comparable. To increase their visibility, a central database of these funds will be available on the SFC's website by the end of 2019. The SFC has also been working closely with SEHK to strengthen ESG disclosure rules for listed companies.

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Appendix

Survey methodology

1. In the first part of the survey, an online questionnaire sent to asset management firms asked whether and how they integrate ESG factors, including climate change-related risks, into their investment and risk management processes. The questionnaire also covered firms' post-investment ownership practices and disclosures, as well as their expectations of Hong Kong listed companies' ESG and climate change-related disclosures. The questionnaire was sent in March 2019 to all 1685 firms licensed by the SFC for Type 9 (asset management) regulated activity. A total of 1124 firms responded to the questionnaire, of which 794 were currently active in asset management. Ten were selected to participate in follow-up interviews.
2. The second part of the survey targeted asset owners, such as sovereign wealth funds, family offices, financial institutions, pension funds and trusts, to understand their expectations of asset management firms' practices for ESG investment and climate risk management, as well as their expectations of Hong Kong listed companies' ESG and climate change-related disclosures. 14 asset owners participated in the survey and five were selected for follow-up interviews.

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