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Environmental, Social and Governance (ESG) Strategy for Hong Kong

November 2018

CONTENTS

I. EXECUTIVE SUMMARY

1. Sustainable investment has been one of the fastest growing areas in recent years and has shifted from a niche area of investment into the mainstream. According to the Global Sustainable Investment Review 2016[1], assets managed under sustainable investment strategies totaled US$ 22.9 trillion – a 25% or US$ 4.6 trillion increase since 2014 – representing more than $1 in every $4 under professional management. In Japan alone, assets managed under sustainable investment strategies have increased from US$ 7 billion in 2014 to US$ 474 billion in 2016. Hong Kong is at risk of being left behind if it does not foster the development of an ESG ecosystem to capitalise on this opportunity.

2. What is ESG investing? ESG or sustainable investing generally refers to investment approaches that take into account environmental, social and governance ("ESG") factors. ESG factors (see Table 1 for examples) influence almost every aspect of a company's operations.

Table 1: A non-exhaustive list of ESG factors

ENVIRONMENTAL	SOCIAL	GOVERNANCE
• Air & water pollution	• Customer satisfaction	• Accounting standards
• Biodiversity	• Data protection & privacy	• Anti-competitive behaviour
• Climate change	• Diversity & equal opportunities	• Audit committee structure
• Deforestation	• Employee attraction & retention	• Board composition
• Ecosystem services	• Employee engagement	• Anti-bribery & corruption
• Energy efficiency	• Government & community relations	• Business ethics
• Hazardous materials	• Human capital management	• Executive remuneration
• Land degradation	• Human rights & indigenous rights	• Risk management
• Resource depletion	• Labour standards	• Independence of Chairman
• Waste management	• Marketing communication	• Succession planning
• Water scarcity	• Product mis-selling	• Whistleblower mechanism
	• Product safety & liability	
	• Supply chain management	

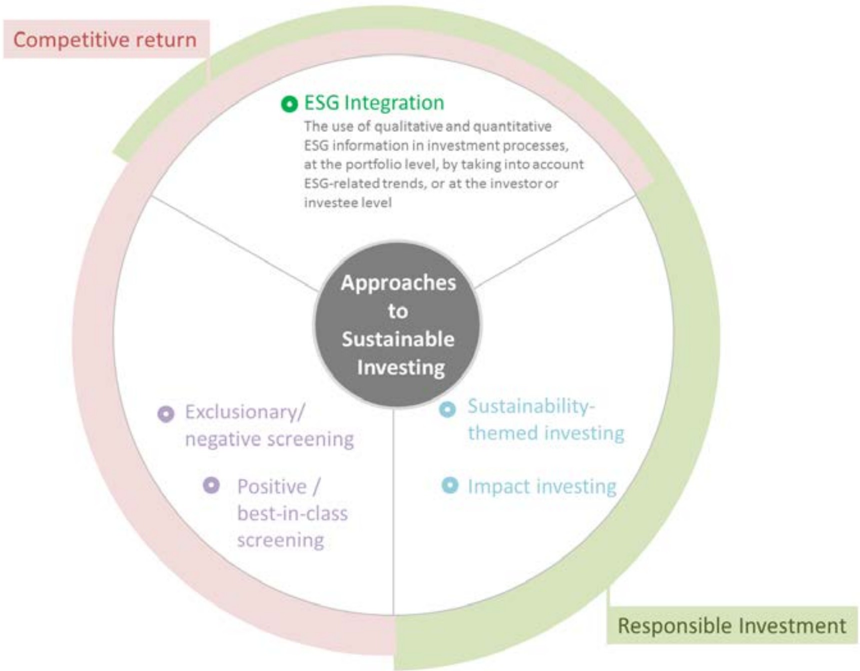
Adapted from Principles for Responsible Investment ("PRI")[2]

[1] Global Sustainable Investment Review 2016, Global Sustainable Investment Alliance (April 2017)

[2] ESG Monitoring, Reporting and Dialogue in Private Equity, Principles for Responsible Investment (2018)

3. Globally, there is a wide spectrum of approaches to ESG investing (see Diagram 1) that range from fundamental integration that aims to maximise risk adjusted returns, to value based investment where risk adjusted returns are balanced by the impact or alignment of the investment with investors' values. In this paper we focus on "ESG integration" as the most broadly applicable approach for businesses in Hong Kong and highlight the opportunity for businesses to maximise risk-adjusted returns, lower funding costs and attract new sources of capital.

Diagram 1: Globally-recognised approaches to sustainable investing



Adapted from PRI[3]

4. By integrating ESG factors into the decision-making process – from portfolio selection to management – investment managers and investee companies, as the key stakeholders within the ESG investment ecosystem, are able to enjoy the following benefits:

   (i) Enhance risk-adjusted returns through identification, mitigation or management of key risks: A Goldman Sachs investment research report found

[3] Understanding the impact of your investments: Measuring environmental and social performance, Principles for Responsible Investment (23 October 2013)

that the share price of companies in Asia ex-Japan with low ESG scores underperformed sector peers by c.100 basis points per annum.[4]

(ii) Lower funding costs: High ESG-rated companies generally experience lower levels of beta and thus lower costs of capital (both in terms of cost of debt and cost of equity capital), as supported by Deutsche Asset & Wealth Management[5] and MSCI studies[6].

(iii) Attract new sources of capital and assets under management ("AuM"): Globally, financial investors have increasingly expressed commitment to adopt ESG integration, which opens unprecedented sources of capital and assets to companies with a strong ESG profile.

Many developed economies have come to realise the importance and the potential of ESG investment, yet Hong Kong has seemed to be lagging behind in developing a robust ESG investment ecosystem to capture the associated benefits.

5. The slow uptake of the ESG integration momentum could also undermine Hong Kong's competitiveness in the long run as a leading international financial centre. According to a research firm Corporate Knights, Hong Kong Stock Exchange was ranked the 24th in 2017 among 45 stock exchanges based on the Hong Kong listed companies' ESG reporting, a drop from its 2014 ranking at the 17th.[7] London came in 4th (from 9th) and regional counterpart Singapore came in 16th (from 22nd), inducing a warning to Hong Kong's competitiveness in the waves of the growing awareness of ESG among global investors. With this in view, this paper aims at presenting the urgent importance for Hong Kong to develop a robust ESG investment ecosystem, within which both the private and public sectors should have a key role to play.

6. A major challenge to ESG integration often lies on the difficulty in changing corporate behaviour. To tackle this challenge, most of the developed markets have chosen to apply a combination of 'carrots and sticks' (i.e., incentives and regulations).

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4 ESG in GEMs - An emerging source of Alpha for EM PMs, Goldman Sachs (September 2017)

5 Sustainable Investing, Deutsche Asset & Wealth Management (June 2012)

6 Foundations of ESG Investing – Part 1: How ESG Affects Equity Valuation, Risk and Performance, MSCI ESG Research (November 2017)

7 Measuring Sustainability Disclosure, Corporate Knights (September 2017)

While bearing in mind that there is no easy solution to achieve the optimal balance between incentives and regulations, we have formulated the following ESG strategy for Hong Kong on the part of the policymakers. We recommend:

(i) The Government to take the leadership role in encouraging public funds' support for ESG integration;

(ii) The Hong Kong Monetary Authority ("HKMA") to scale up ESG requirements on their external investment managers;

(iii) The Mandatory Provident Fund Schemes Authority ("MPFA") to incorporate ESG factors into its trustee approval and monitoring process and to encourage trustees to take into account international ESG standards;

(iv) The Securities and Futures Commission ("SFC") to strengthen the emphasis on ESG through upgrading the Principles of Responsible Ownership to at least 'comply or explain';

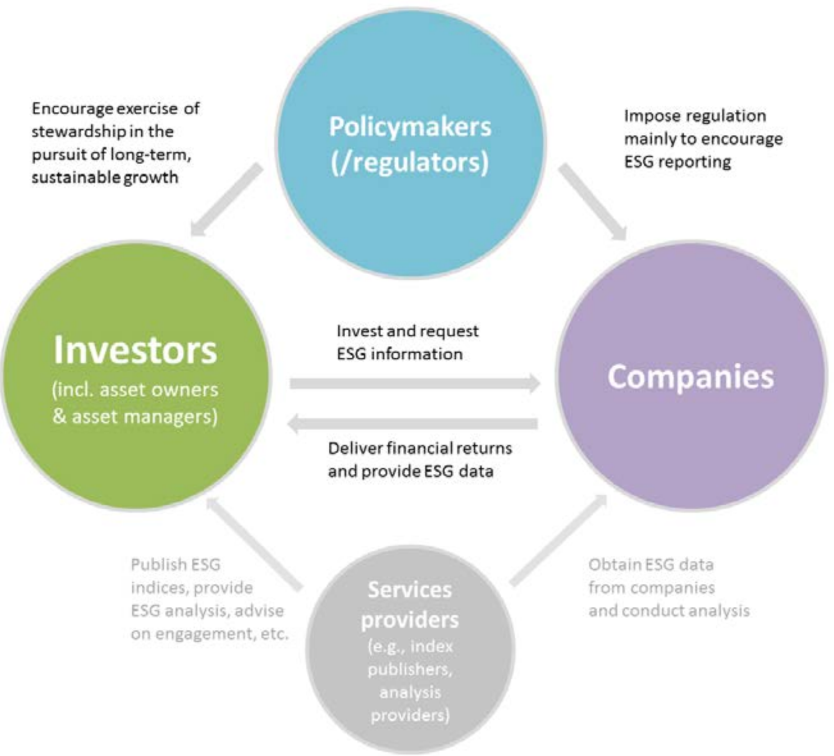
(v) The SFC and the other regulators to provide more guidance on ESG thematic investment products; and

(vi) The Stock Exchange of Hong Kong ("SEHK") to strengthen the emphasis on ESG for both listing applicants and listed companies.

II. INTRODUCTION TO ESG INVESTMENT ECOSYSTEM

7. In the ESG investment ecosystem, there are three main groups of key stakeholders: (i) financial investors; (ii) investee companies; and (iii) policymakers. Each plays an important and distinct role. Within such ecosystem, a large cluster of services providers, including sell-side research/brokers, ESG index publishers and ESG analysis providers, also critical in ensuring the ESG standards and needed support are in place (see Diagram 2).

Diagram 2: Relationships between key stakeholders in the ESG investment ecosystem



Financial investors

8. Financial investors, in the ESG investment space, are a broad term that covers both asset owners and asset managers – both public and private. In recent years, an escalating number of investors have placed heavier focuses on a company's ESG information when considering whether to commence or continue an investment in it.

9. Globally, institutional investors are becoming strong supporters for ESG investments. The reasons for institutional investors to integrate ESG vary: some are appealed by the long-term financial performance; some due to better risk management; and others

because they take a view about their social role. Meanwhile, institutional investors in some jurisdictions are subject to certain levels of regulatory obligations or fiduciary duty to consider ESG factors in their investment process.

10. The institutional investors that factor in ESG to their investment process include some of the world's largest, for example Norway's Government Pension Fund Global ("GPFG") and Japan's Government Pension Investment Fund ("GPIF"). The Norwegian GPFG has requested the 9,100 companies in which it holds stakes to submit data on issues such as water use and climate effects to the London-based non-profit organisation CDP in hopes of strengthening the companies' reporting.[8] Its policies, such as restricting investments in coal companies, pose significant influence on both the companies and other investors as GPFG owns on average 1.4% of all listed shares worldwide.[9] Japan's GPIF, being the largest public institutional investor in the world, has committed 3% of its stock portfolio (i.e., US$ 8.9 billion) to ESG-related index fund. GPIF's president Norihiro Takahashi also made it clear publicly that the Fund is planning to increase its ESG contribution to 10% in the long run (around US$ 29 billion). Other examples of ESG-conscious investors include the largest Australian superannuation fund (Australian Super) and the largest US pension fund (CalPERS) – both have clear ESG policies and dedicated ESG headcount.

11. The wind of change is also blowing across private financial investors. A number of the leading global asset owners have indicated their support towards the rise of sustainable investments.[10] Demand and interest from retail investors in other OECD jurisdictions, such as Australia, Canada and the US, is also strong and growing.

12. Global interest among institutional investors in ESG investment is increasing, yet the degree varies across regions. According to the 2017 survey result published by Schroders, while 33% of Asia's institutional investors and 48% of global institutional

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8 https://blogs.thomsonreuters.com/sustainability/2018/03/04/wealth-fund-goes-green-norways-firms-struggle-keep/

9 ibid

10 For example, BlackRock Chairman and CEO Larry Fink recently emphasised the importance of boards in articulating the long-term strategy which includes ESG and diversity factors (https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter). Legal and General Investment Manager, one of the largest managers of institutional assets in the UK, adopts ESG integration approach across all of its assets (i.e. for all of their funds). (http://www.lgim.com/uk/ad/press/2018/lgim-launches-a-future-world-fund-for-uk-retail-investors.html).

investors had increased their sustainable investment in the past five years, Hong Kong's figure was only 7%.[11]

Companies

13. The varied level of interest and awareness of ESG also happens among investee companies or other companies in general. Some companies are seen to have adopted ESG reporting and/or ESG integration in a serious manner, yet there are cases where ESG reporting is considered a box-ticking exercise. Amongst these, larger companies appear to allocate more resources on improving their ESG performance and reporting than smaller sized companies.

14. In Hong Kong, ESG reporting has become more widespread in the last few years – mainly due to the upscale of the regulatory requirements. Despite the increasing uptake, ESG reporting among the companies is of diverse quality – board's commitment to ESG and the companies' materiality assessment are often cited as the key differentiating factors.

Policymakers

15. Governments, regulators and stock exchanges from almost all developed economies are also seen to play a crucial role in building the ESG investment ecosystem, may it be in the form of laws, regulations and/or other incentives. According to a 2016 research report[12], there are now over 400 laws and regulatory standards in 64 countries requesting some sort of corporate sustainability reporting, a big leap from the 180 laws and regulatory standards identified in 44 countries in 2013. These laws and regulatory standards create not only the regulatory expectation that ESG reporting is becoming a mainstream, but also a recognition that the disclosure of ESG information is to a meaningful extent useful to the market players.

16. Beyond corporate reporting, a number of jurisdictions also have formulated pension fund regulations and stewardship codes to encourage investors to consider ESG issues.

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[11] Schroders Institutional Investor Study- Institutional perspectives on sustainable investing 2017, Schroders (September 2017). The study was carried out via a global survey during June 2017 covering 500 institutional investors from 15 different countries.

[12] Carrots & Sticks – Global trends in sustainability reporting regulation and policy, KPMG, GRI, United Nations Environment Programme, and Centre for Corporate Governance in Africa (May 2016)

As of 2016, at least 23 jurisdictions have, or are developing, some form of rules regarding pension funds and ESG criteria; 14 jurisdictions have, or are developing, guidelines on investors' exercise of ownership in the pursuit of long-term, sustainable growth.[13]

17. In Hong Kong, corporate governance reporting has over a decade of history while 'ESG' reporting could be said to become formally required since March 2014, when the new Companies Ordinance (Cap 622) came into effect. The Ordinance requires all Hong Kong incorporated companies (unless exempted) to include in the business review section of their annual directors' reports a high-level discussion of ESG matters.[14]

18. Taking this further, the SEHK requires listed companies to publish ESG reports, on an annual basis, under its ESG Guide, effective for the financial year starting 1 January 2016.[15] An ESG report should cover the listed company's ESG management approach, strategy, priorities and objectives and explain how they relate to the business. A listed company must report on the 'comply or explain' provisions of the ESG Guide.

19. The SFC's Principles of Responsible Ownership[16] also contains some relevance to ESG: investors should encourage their investee companies to have ESG policies; investors should also engage with investee companies if they have concerns about social and environmental matters. With a particular focus on green finance, the SFC also has issued a strategic framework in September 2018, outlining its action agenda in five interrelated areas, including corporate environmental and climate change-related disclosure, ESG integration in investment process, as well as product disclosure, listing and trading.[17]

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[13] Global Guide to Responsible Investment Regulation, PRI and MSCI (2016)

[14] The requirement is applicable to financial reporting years beginning on or after 3 March 2014. This disclosure requirement has also been incorporated into the Listing Rules of the SEHK which apply to all listed companies in Hong Kong.

[15] Appendix 27 to the Main Board Listing Rules and Appendix 20 to the GEM Listing Rules

[16] It is in a similar nature to what is called a "stewardship code" in other jurisdictions. The SFC's Principles of Responsible Ownership is non-binding and is voluntary.

[17] Strategic Framework for Green Finance, SFC (21 September 2018)

III. THE VALUE PROPOSITION

20. ESG investment has been gaining major traction globally in the last several years. According to the Global Sustainable Investment Review[18], from 2014 to 2016, the total sustainable and responsible investment assets rose from US$ 18 trillion to almost US$ 23 trillion, with Europe taking over half of the portion (US$ 12 trillion) and Japan achieving the substantial growth in the past two years (6689.6%) (see Table 2).

Table 2: Growth of Socially Responsible Investment (SRI) assets by region (2014 & 2016)

Region	Performance in 2014 (US$ billion)	Performance in 2016 (US$ billion)	Growth
Europe	10,775	12,040	**11.7%**
United States	6,572	8,723	**32.7%**
Canada	729	1,086	**49.0%**
Australia/ New Zealand	148	516	**247.5%**
Asia (excl. Japan)	45	52	**15.6%**
Japan	7	474	**6689.6%**
Total	**18,276**	**22,890**	**25.2%**

Source: Global Sustainable Investment Review 2016

Enhance risk-adjusted returns

21. For many investors, return is the single most important focus when making investment decisions. However, return alone is only part of the equation — a higher return in efficient markets is only possible by accepting higher risk. This may not be the desired investment strategy for all investors.

22. ESG integration plays an important role in risk identification, mitigation and management. Throughout this process, company management and their boards are able to identify value creation opportunities. A series of research papers have provided mounting evidence – academic and empirical – to support this claim. In a joint study carried out by the University of Oxford and an investment management

[18] See footnote 1

firm Arabesque Partners, over 200 of the highest quality academic studies were investigated and it was found that companies that neglected ESG factors were exposed to tremendous risks and hence subject to potentially substantial negative financial impacts.[19] According to the study, as of March 2015, the 10 largest fines in history settled by corporates concerning ESG-related issues had amounted to US$ 45.5 billion. Their findings suggested that companies with strong sustainability scores show better operational performance and are less risky, and that investment strategies that incorporate ESG issues outperform comparable non-ESG strategies.

23. A study conducted by the Bank of America, in 2017, found a similar relationship between ESG and risk management: companies that adopt good ESG practices exhibit lower risks, in terms of price volatility, earnings volatility and bankruptcy risks. Amongst other findings, companies with the highest ESG ranking only has a 32% median change in earning-per-share ("EPS") volatility over the next five years, which is a stark contrast to the worst-performing ones with 92% median change (see Table 3).[20]

Table 3. Subsequent five-year median change in EPS volatility by overall ESG percentile ranks

Overall ESG Rank (from worst to best)	Long-term Growth Rate	Dividend Yield	Median change in EPS volatility over next 5 years (%)
1st - 20th percentile (worst)	6%	0%	**92%**
21st - 40th percentile	8%	1%	64%
41st - 60th percentile	8%	1%	65%
61st - 80th percentile	9%	2%	37%
81st - 100th percentile (best)	9%	2%	**32%**

19 From the Stockholder to the Stakeholder – How Sustainability Can Drive Financial Outperformance, Oxford University and Arabesque Partners (September 2014)

20 ESG Part II: A Deeper Dive, Bank of America Merrill Lynch Global Research (June 2017)

24. Through identification, mitigation and management of key risks, ESG integration is increasingly seen as a tool to maximise the "risk-return trade off". Kumar et al. found that companies incorporating ESG factors in their operation tend to deliver better risk-adjusted returns. Assessing a total of 966 companies – of which 157 were in the Dow Jones Sustainability Index – their research demonstrated that companies incorporating ESG factors would see lower stock performance volatility than those that do not. At the same time, while the degree of impact would differ from one industry to another, companies adopting ESG factors would also deliver higher returns.[21]

25. Empirical figures provided by the global index company MSCI align with the above findings. According to the figures as of August 2018, both the MSCI ACWI ESG Leaders (best-in-class) and the MSCI ACWI ESG Universal (ESG weighted) indexes have outperformed the traditional parent market capitalisation index, the MSCI ACWI (All Country World Index).[22] Similarly, a Goldman Sachs investment research report found that the share price of companies in Asia ex-Japan with low ESG scores underperformed sector peers by c.100 basis points per annum between 2010 and 2017 over rolling 3 year holding periods.[23]

26. The link between ESG and positive return is also of great relevance to fixed income. According to Barclays, most of the portfolio pairs studied indicated a generally positive return premium for the 'ESG factor' in corporate bond markets.[24]

27. These findings echoed the goal and construct of the United Nations-supported Principles for Responsible Investment ("UNPRI"), which considers that 'ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted returns and is therefore firmly within the bounds of investors' fiduciary duties'.[25]

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[21] ESG factors and risk-adjusted performance: a new quantitative model, Kumar, N.C.A., C. Smith, L. Badis, N. Wang, P. Ambrosy & R. Tavares. Journal of Sustainable Finance & Investment (4 October 2016)

[22] MSCI ACWI ESG Leaders Index Factsheet and MSCI ACWI ESG Universal Index Factsheet, MSCI (August 2018)

[23] See footnote 4

[24] Sustainable Investing and Bond Returns, Barclays (2016)

[25] The Principles for Responsible Investment, United Nations Environment Programme Finance Initiative (2005)

Lower funding cost

28. Deutsche Asset & Wealth Management, based on the aggregation of the findings and data of 100 review studies, concluded that strong corporate commitment to ESG is positively correlated to a lower cost of capital (including both cost of debt and cost of equity capital).[26]

29. Recent research from MSCI also provided similar indications. Comparing the average beta of ESG quintiles from 2007 to 2017, MSCI found that high ESG-rated companies experienced lower levels of beta and thus lower costs of capital, in the context of the capital asset pricing model. Conversely, companies with low ESG ratings were more likely to experience major risks incidents (such as major drawdowns) and hence suffer from higher costs of capital.[27]

Attract new sources of capital and AuM

30. As explained above, ESG integration has a positive correlation with the medium to long-term risk-adjusted return of a company. Because of this (as well as other reasons), more and more investors, especially those oriented in long-term investments such as pension funds, sovereign wealth funds, foundations, real long-term savings, are starting to or continuing to look for companies with a strong ESG profile to invest in. Earlier this year, Morgan Stanley surveyed 118 large global asset owners and found that 84% of them are at least 'actively considering' integrating ESG criteria into their investment process. While public equities and real assets are seen as the sectors with the most attractive ESG investing opportunities, the interest in ESG investing holds across different asset classes, including fixed income and private equity.[28]

31. Financial investors' increasing commitment to ESG investment also presents a compelling case that companies with a strong ESG profile have higher probability to attract new source of capital and assets, in addition to the conventional investment portfolio. As of September 2018, more than 2,000 asset owners, investment managers and service providers have become the signatories to the UNPRI, representing over

[26] Sustainable Investing, Deutsche Asset & Wealth Management (June 2012)

[27] Foundations of ESG Investing – Part 1: How ESG Affects Equity Valuation, Risk and Performance, MSCI ESG Research (November 2017)

[28] Sustainable Signals – Asset Owners Embrace Sustainability, Morgan Stanley Investment Management and Morgan Stanley Institute for Sustainable Investing (2018)

US$ 68 trillion in AuM. Many of them have published their ESG policies as well as their ESG integration processes. This signatory initiative has become even more meaningful upon its launch of watch-list system in May this year: signatories failing to show they are taking their responsible investment commitment seriously enough would be placed on a watch-list and have two years to make improvement or face the risk of being delisted and publicly identified. In other words, for some, lip service no longer works and now needs to be translated into substantial action.

IV. CURRENT STATE OF HONG KONG MARKET

32. In this Section, we will present the current state of Hong Kong from the perspective of its readiness to capture the globally increasing ESG investment. Particularly, are Hong Kong companies making their ESG information sufficiently available and up-to-standard to facilitate international institutional investors' decision-making?

Demand for ESG integration

33. Sustainable investment has become one of the fastest growing areas in recent years and has shifted from a niche area of investment into the mainstream. According to the Global Sustainable Investment Review 2016, sustainability investment has grown to US$ 22.9 trillion in 2016. Asia (excluding Japan) was only 0.2% (US$ 52 billion) of this growing investment pool and, within this, Hong Kong accounted for 26% (US$ 13.5 billion) – after Malaysia's 30% and ahead of South Korea and Mainland China's respective 14%. [29]

34. Asset managers and hedge fund firms generally foresee a positive outlook of the ESG investment market. The Alternative Investment Management Association, another global membership organisation, together with Cayman Alternative Investment Summit, surveyed 80 major hedge fund firms (with approximately US$ 550 billion total AuM) last year. Over 55% of them saw an increased investor interest in responsible investment in the past 12 months.[30] Another survey, by Schroders, shows that more than two-thirds of the global institutional investors (including pension funds, foundations and sovereign funds) believe sustainable investment will grow in significance by 2022.[31]

35. Given the trend that institutional investors globally have growing interest in sustainable investment, their demand for quality ESG information will naturally increase. Institutional investors make up a significant portion of the Hong Kong investment market. According to the SEHK's Cash Market Transaction Survey 2016[32],

[29] See footnote 1

[30] From Niche to Mainstream – Responsible Investment and Hedge Funds, Alternative Investment Management Association and Cayman Alternative Investment Summit (May 2018)

[31] See footnote 11

[32] Cash Market Transaction Survey 2016, SEHK (July 2017)

53% of the total securities market turnover is generated by local and overseas institutional investors (See Charts 1 and 2). That means, institutional investors contributed to about US$ 1.06 trillion of the market turnover. If the individual Hong Kong listed companies that are seen to be competing with global peers do not step up their efforts in managing their ESG risks, institutional investors may lose faith in the Hong Kong companies and hence allocate their capital to another market.

Chart 1. Distribution of cash market trading value by investor type in 2016

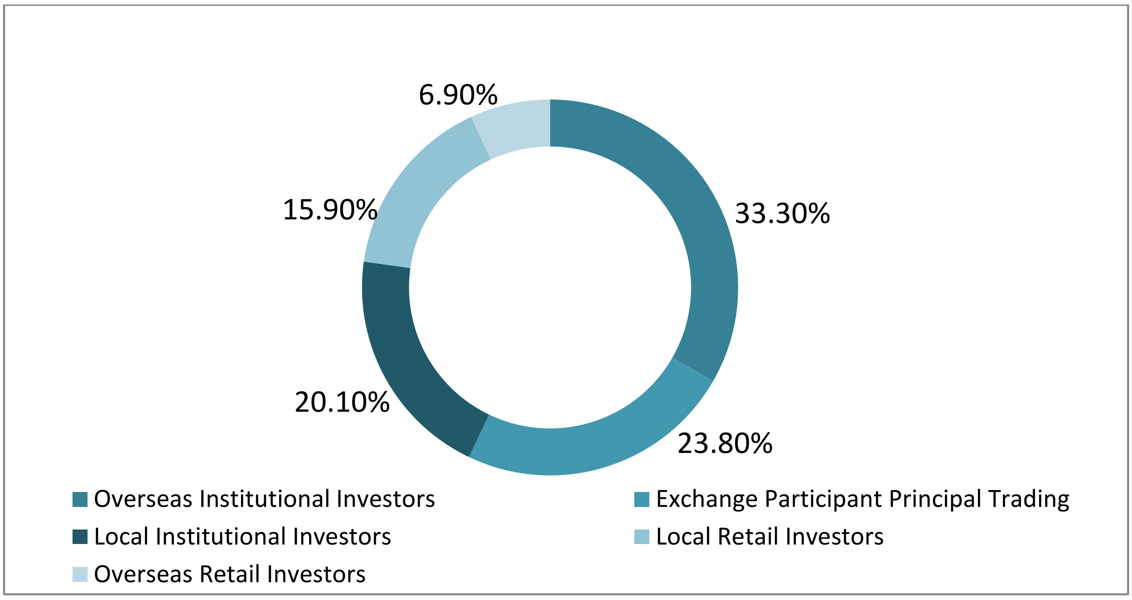
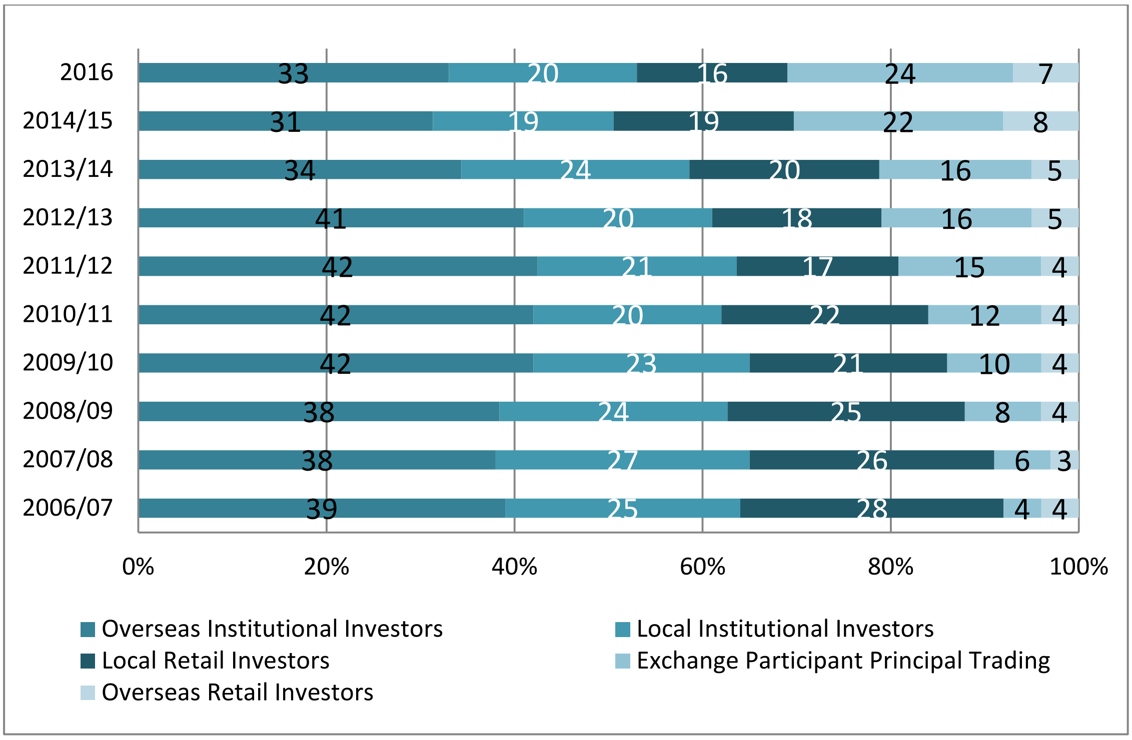


Chart 2. 10-year trend in the distribution of cash market trading value by investor type



Supply of ESG disclosure

36. As spelled out in paragraphs 15 to 19, Hong Kong's rules and regulations for ESG reporting have been in play for several years. Whilst it is encouraging to note that more and more companies are adopting ESG reporting, the quality of their ESG disclosure has plenty of room for improvement.

37. A KPMG 2017 survey[33] reveals that many of the listed companies (including Main Board and GEM Board ones) have yet to demonstrate significant awareness or effective management of ESG risks. A number of limitations have been identified, including: (a) ESG risks are very often not considered principal risks, (b) the board engagement in ESG governance remains unclear in most cases, (c) companies seldom report the methodology used in identifying material ESG issues, (d) listed companies tend to be less transparent about negative issues[34], and others.

38. In 2018, KPMG conducted another survey, together with CLP Holdings and The Hong Kong Institute of Chartered Secretaries, of over 200 business leaders in Hong Kong on their views on ESG. While nearly 70% of business leaders acknowledge that ESG is essential or good for business, only 37% believe that ESG has been integrated into their strategic planning.[35] Findings of another survey, by BDO[36], in 2018 are along similar lines: only 26% of the 400 surveyed companies have top level commitment and management on ESG.

39. SEHK also recently published its review results on listed companies' ESG reports – the first review of its kind by the regulator. At one end there was some excellent reporting, both in terms of detail and clarity, while at the other end, there were some ESG reports that appeared to show that a 'box-ticking' approach had been adopted.

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33 The ESG journey begins – 2017 ESG reporting survey of Hong Kong listed issuers, KPMG (November 2017)

34 According to the survey, only 18% of the companies have disclosed negative incidents; up to 29% have not disclosed certain compliance information; and 19% have not even followed the 'comply or explain' rule on one or more ESG aspects.

35 ESG: A view from the top, KPMG, CLP Holdings Limited, and The Hong Kong Institute of Chartered Secretaries (September 2018)

36 https://www.bdo.com.hk/en-gb/news/2018/bdo-survey-second-year-esg-reports-show-little-improvement-in-level-of-disclosure-and-limited-gover

Boards' commitment to ESG and the companies' materiality assessment are the key areas to improve, amongst others.[37]

Is Hong Kong ready to capitalise on the expanding ESG investment market?

40. Within the region, Hong Kong is not a late starter in promoting ESG reporting and indeed in terms of corporate governance reporting Hong Kong can crown itself as one of the pioneers. However, one should note that the competition has become unprecedentedly stronger in the recent couple of years. Global and regional peers have stepped up tremendous efforts in improving ESG performance, ESG reporting and the ESG investment ecosystem as a whole.

41. According to a research firm Corporate Knights, Hong Kong Stock Exchange was ranked the 24th among 45 stock exchanges based on the firm's ESG reporting in 2017, a drop from its 2014 ranking at the 17th.[38] London came in 4th (from 9th) and regional counterpart Singapore came in 16th (from 22nd), inducing a warning to Hong Kong's competitiveness as a leading international financial centre. If Hong Kong continues with its current pace, there would be a high chance that the supply of ESG disclosure and other ESG investment infrastructure cannot align with the increasing global demand. Institutional investors would, in turn, switch to other ESG-developed markets which could better fit their evolving appetite.

42. Meanwhile, it is equally important for Hong Kong companies to maintain their competitiveness in the Greater China market. Following China A shares' partial inclusion to some mainstream MSCI indexes in June 2018, these Chinese constituents' ESG track records have started to become under the radar of institutional investors and other stakeholders. Based on MSCI's forecast, while newly added companies (to the indexes) usually take some time to adapt to the expanded market, Mainland China's case may stand out because the evolution of ESG awareness among the corporate community is believed to be promoted from the top.[39] Hong Kong companies therefore should be more proactive in adopting ESG integration and

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[37] Analysis of Environment, Social and Governance Practice Disclosure in 2016/2017, SEHK (May 2018)

[38] Measuring Sustainability Disclosure, Corporate Knights (September 2017)

[39] Can China A Share Issuers Adapt to ESG Realities?, MSCI ESG Research (June 2018)

improving their ESG performance if they do not wish to be left behind in the Greater China portfolio.

V. RECOMMENDATIONS

43. ESG investment is an investment market segments that Hong Kong cannot afford to lose. It is encouraging to note that some rules and regulations, coupled with training and investor education, are already in place to promote ESG reporting. Further, Hong Kong Exchanges and Clearing Limited has, in June 2018, become a partner of the United Nations Sustainable Stock Exchanges Initiative in hopes of promoting the sustainable development of capital markets and of encouraging responsible investment.

44. After all, ESG integration involves a change of corporate behaviour. We believe more can be done, especially on the part of the policymakers, to help companies and financial investors consider and integrate ESG factors, and hence collectively develop a robust ESG investment ecosystem for Hong Kong.

(i) Government should take the leadership role in encouraging public funds' support for ESG integration

45. As stated, ESG integration is not only beneficial to companies but is also influential to the competitiveness of an international financial centre. For attracting investments and enhancing sustainable development, governments from around the world have started to see ESG as a subject with relevance to public policy.

46. For Hong Kong, the HKSAR Government has set its foot in demonstrating the commitment to promoting sustainable investing through its plan to issue the inaugural government green bond in 2018/19. This policy initiative is well-received in the market, domestically and internationally, and to carry this forward the Government should take the leadership role in encouraging public funds to support ESG integration.

47. Among the various different public funds, the Exchange Fund is one of which with the most significant size. As of 30 June 2018, the total assets of the Exchange Fund amounted to about HK$ 4 trillion. Against the background that the HKMA, under the delegated authority of the HKSAR Financial Secretary, is responsible for the use and for the investment management of the Exchange Fund, the HKMA's express support for ESG integration would serve as a meaningful signal to the market –

encouraging other investors to consider ESG factors in their decision-making process and thus pushing for a change in the ESG investment atmosphere.

48. While we understand that the HKMA faces the difficulty in specifying a percentage of commitment in its investment portfolio on ESG thematic investments, in contrast to what the Japan's GPIF has done[40], a broad policy statement expressing the Authority's support for ESG integration and ESG investment suffices to demonstrate to global players that Hong Kong has the architecture to embrace the development of sustainable investing. With this pioneering statement in the Hong Kong market, other domestic investors will likely follow and start considering ESG integration in their portfolios where appropriate. An example of this approach can be drawn to the French central bank's recent adoption of responsible investment charter which will govern the management of some €20 billion of assets.[41]

49. Similar move made by other public funds in Hong Kong, aside from the Exchange Fund, would also be helpful in inducing a more robust development of the ESG investment ecosystem.

(ii) HKMA should scale up ESG requirements on their external investment managers

50. For the management of the Exchange Fund, the HKMA has *encouraged* the appointed external fund managers for its Hong Kong equity portfolio to adopt the SFC's Principles of Responsible Ownership in managing the investments.[42] The front offices and the Risk Management and Compliance Division of the HKMA also have incorporated ESG factors into various internal procedures for making and monitoring investment activities.[43]

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[40] We attempted to explore the feasibility of the Exchange Fund to make a significant investment in local ESG projects, mirroring what Japan's GPIF is trying to do. However, we understand there is the difficulty because of the mandate of the Exchange Fund that its investments have to be mainly in the form of marketable interest-bearing instruments and equities in certain foreign currencies.

[41] According to the Responsible Investment Charter of the Banque de France (March 2018), the French central bank is committed to enhancing the inclusion of ESG factors in investment decisions, improving the measures and the development of the contribution of asset portfolios to the environmental transition, and reporting on the progress made in reaching objectives and replicating the best practices of other institutional investors.

[42] Annual Report 2017, HKMA (2017), pp.133

[43] ibid

51. The move that HKMA encourages external managers to adopt the Principles of Responsible Ownership presents a positive sign to the market, but we believe more could be done on the part of the HKMA as the Principles are merely voluntary after all. It is also not known to the market as to how much weight the ESG factors are assigned in the HKMA's internal monitoring process of its investment activities.

52. Amid the increasing interest among global institutional investors in ESG investment, the HKMA should play a more proactive role in promoting ESG investment to the domestic investors so that they can capture the potential of this fast growing area of investment. To effectively set the tone for the market (especially domestic investors) for ESG investment, the HKMA should strengthen its ask on ESG when selecting and monitoring external managers of the Exchange Fund by upgrading the level of obligation from voluntary to 'comply or explain', i.e. external managers need to report to the HKMA that either it has adopted the Principles (or other acceptable international ESG standards) or provided an explanation for why it has not adopted. The advantage of the 'comply or explain' approach is that it affords external managers the room to develop their practice and decide on the extent of their uptake of ESG in their investment decisions.

(iii) MPFA should incorporate ESG factors into its trustee approval and monitoring process and encourage trustees to take into account international ESG standards

53. The core mission of pension funds is pronounced: to deliver the best outcome (usually in terms of portfolio profitability) with an assumed risk level, according to their fiduciary responsibility. In recent years, more and more pension funds are noted have incorporated ESG factors into their decision-making process for better risk-adjusted return.

54. The MPFA is the statutory body established to regulate and supervise privately managed provident fund schemes in Hong Kong. As of December 2017, the total assets of the Mandatory Provident Fund ("MPF") system amounted to HK$ 843.5 billion, and about 85% of the working population in Hong Kong was covered by the

MPF system.[44] Among the 469 constituent funds in the MPF system, only one of them has explicit ESG elements (the Green Fund of AIA MPF).

55. The MPFA also has the statutory function to approve and regulate trustees of the registered MPF schemes. In May 2018, the MPFA spearheaded the Governance Charter for MPF Trustees, under which all MPF trustees pledged to "act in the best interests of members", amongst others. However, there is no specific mention in the pledge of trustees' consideration/integration of ESG factors into their investment process.

56. According to the Organisation for Economic Cooperation and Development ("OECD"), Hong Kong is one of the jurisdictions that do not require pension funds to disclose their approach to ESG investing, whereas pension funds in many other jurisdictions, such as Australia, Belgium, France, Germany, Italy, Mexico, the Netherlands, Spain, Sweden and the United Kingdom, are required to.[45] To this extent, the MPF system in Hong Kong seems to be lagging behind in making contribution to the local ESG development compared to its foreign counterparts. While we understand that the MPFA has to take a prudent regulation approach as after all the MPF covers a large majority of the working population of Hong Kong, we believe the MPFA could be more expressive for its vision in sustainable investment, by demonstrating it in the trustee approval and monitoring process.

57. As one of the governing members of the International Organisation of Pension Supervisors ("IOPS") [46], the MPFA could also act as an impetus in encouraging trustees to take into account the relevant international ESG standards. The IOPS is now developing draft guidelines to integrate ESG factors in the supervision of pension fund investment. If developed, the guidelines are likely to be not mandatory but are expected to encourage pension funds of the member jurisdictions to better consider ESG factors in some way.[47] Once the guidelines come into play, the MPFA should

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44 As at 31 December 2017, equities, bonds, and deposit and cash account for 70%, 18%, and 12% of MPF assets respectively, and these assets are mostly allocated to the Hong Kong market (59%), followed by North America (15%) and Europe (13%).

45 Investment governance and the integration of environmental, social and governance factors, OECD (2017)

46 List of IOPS Members and Observers, IOPS (accessed on 20 November 2018)

47 https://www.top1000funds.com/2018/08/pension-funds-want-esg-guidelines/ , as cited by IOPS official website under the News & Event section (http://www.iopsweb.org/)

examine positively their applicability to the Hong Kong market and the MPF environment and where appropriate, encourage trustees to take into account the relevant international ESG standards.

(iv) SFC should strengthen the emphasis on ESG through upgrading the Principles of Responsible Ownership to at least 'comply or explain'

58. As the regulator of the securities and futures markets, the SFC could play a key role in contributing to the sustainable investment market by strengthening the emphasis on ESG practices. In 2016, the SFC published the Principles of Responsible Ownership as a piece of guidance for investors[48] with regard to their ownership responsibilities. The seven non-binding principles encourage investors to carry out their ownership responsibilities by engaging with investee companies, amongst others. One of the principles highlights the need for investors to 'encourage their investee companies to have policies on environmental, social and governance (ESG) issues' and discuss with these companies on 'significant ESG issues that have potential to impact on companies' goodwill, reputation and performance'.

59. In September 2018, the SFC announced its plan to conduct a survey of asset managers and asset owners on how and to what extent ESG factors are integrated into investment process.[49] The SFC also emphasised that the survey does not merely focus on asset managers and asset owners' engagement with investee companies, but would also cover their commitment, investment process, post-investment ownership practices and reporting of ESG performance. The next step and timeline are yet to be crystallised, but we would strongly recommend the Commission to take more rapid and proactive action given the fast-evolving ESG investment market globally. In order for Hong Kong to remain competitive in sustainable investing, the SFC should consider upgrading the Principles of Responsible Ownership to beyond the voluntary level, say at a minimum to the 'comply or explain' level. That means, investors need to either adopt the SFC's Principles of Responsible Ownership or provide an explanation why they do not adopt (for example, they have opted to adopt other

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[48] According to the SFC's Consultation Conclusions on the Principles of Responsible Ownership (March 2016), the Principles are not intended to include individual and retail investors. Although these investors play a vital role in terms of corporate governance in listed companies, the SFC thinks that it would be more appropriate to enhance these investors' rights through investor education, rather than in the Principles.

[49] See footnote 17

international standards instead or that their business model precludes adherence to the Principles).

60. Indeed, applying the 'comply or explain' approach in the context of stewardship code is not a novel idea – the UK Financial Reporting Council, for example, sees the UK Stewardship Code as complementary to the UK Corporate Governance Code and hence should also be applied on a 'comply or explain' basis.[50] Regional peers such as Japan and South Korea also have made their respective stewardship code subjected to the 'comply or explain' basis. Experience in these markets suggests that 'comply or explain' imposes no major hurdles on investors, especially when constructive training/education about the long-term value of responsible ownership is provided. The FSDC believes that once more ESG information is available in the market, the demand for change of company strategy (to take account of ESG more seriously) will come into play.

(v) SFC and other regulators should provide more guidance on ESG thematic investment products

61. The availability of ESG thematic investment products in the market is also of importance for facilitating greater allocations of capital to ESG investment factors that may more rapidly contribute to sustainable business culture.

62. In the Hong Kong market, the range of ESG-related products is currently limited. For example, at present, there are only 21 SFC-authorised funds with an investment focus on climate, environmental or sustainable development. One of the reasons is that market players do not have a clear idea about what qualifies an ESG thematic investment product. To the extent where an investment product is within the regulatory ambit of the SFC's, the Commission's provision of clearer guidance would be helpful.

63. Amid the evolving development of the ESG investment market, formulating a prescriptive definition for an ESG thematic investment product is technically less

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50 According to the UK Financial Services Authority's Conduct of Business Rule 2.2.3, a firm, other than a venture capital firm, which is managing investments for a professional client must disclose clearly on its website the 'nature of its commitment' to the UK Financial Reporting Council's The UK Stewardship Code, UK Financial Reporting Council, or 'where it does not commit to the Code, its alterative investment strategy'.

feasible. Nevertheless, some "description" around what such a product is and, where appropriate, some examples in this regard could help the Hong Kong market build a body of knowledge and hence enable the SFC as well as the market players to get ready for the potential market inquiries. We also would like to highlight that the SFC's guidance should not be only limited to green/environment-related investment products, but should also address the social and governance pieces.

64. Similar initiative is indeed in progress in Europe: the European Commission has recently released new legislative proposals to set harmonised criteria for determining whether an economic activity qualifies as environmentally-sustainable, social and/or governance. As suggested in the proposal, an environmentally sustainable activity must: (i) contribute substantively to at least one of the six European Union environmental objectives, e.g., climate change mitigation; (ii) not significantly harm any of the other five environmental objectives; (iii) be carried out in compliance with a number of minimum social and governance safeguards; and (iv) comply with specific technical screening criteria.[51] Other initiatives, if within the region, include the Securities Commission Malaysia's guideline on sustainable and responsible investment (SRI) funds.[52]

65. In other investment sectors, for example in the insurance and pension fund spectrum, the variety of ESG thematic products is also limited. It would be equally helpful to the growth of the Hong Kong ESG investment market if the Insurance Authority and the MPFA could provide similar sort of clearer guidance.

(vi) SEHK should strengthen the emphasis on ESG for both listing applicants and listed companies

66. As stated in paragraphs 36 to 39, the ESG performance and reporting quality of some Hong Kong listed companies has room for improvement. As revealed in a number of surveys, the board's commitment to ESG, possibly due to a lack of discussions on the board's role in the ESG reports, may be one of the key obstacles for these companies to improve. Notwithstanding that the board's responsibility for a listed company's ESG strategy and reporting is set out in the SEHK's ESG Guide, how this

[51] Sustainable Finance, Banking and Finance Newsletter, European Commission (28 June 2018)

[52] Guidelines on Sustainable and Responsible Investment Funds, Securities Commission Malaysia (19 December 2017)

responsibility can fit into the overall governance role of the board is yet to be fully articulated. To this end, the FSDC recommends the SEHK to require a listed company's ESG report to demonstrate the company's governance structure on ESG, with emphasis on the role of the board in the oversight of assessing and managing material environmental and social risks and issues. In its future guides, the SEHK may consider more clearly elaborating the link between the Corporate Governance Code and the ESG Guide which may be in the form of an FAQ, so as to enable the three areas (E, S and G) to be considered and addressed in a more coherent and holistic manner.

67. The requirement for publishing ESG reports under the ESG Guide only applies to listed companies, but not listing applicants. The SEHK has provided listing applicants with guidance which states that listing documents must disclose material risks faced by them (including ESG-related risks) amongst other things.[53] Given the empirical evidence that ESG integration is a useful tool for enhancing risk-adjusted returns through identification, mitigation or management of key risks (see paragraphs 21 to 27), a listing applicant, and eventually its investors, would benefit more if it starts considering ESG factors at an earlier stage. In this context, the SEHK should consider recommending specific ESG disclosure for listing applicants.

[53] SEHK's Guidance Letter HKEX-GL86-16, Appendix 1, Section B ("Risk Factors" section)

VI. CONCLUSION

68. Sustainable investment has been one of the fastest growing areas in recent years and has shifted from a niche area of investment into the mainstream. However, within this growing global investment pool (US$ 22.9 trillion), Hong Kong only accounted for about 0.06% (US$ 13.5 billion). Hong Kong is at risk of being left behind if it does not foster the development of an ESG ecosystem to capitalise on this opportunity through the joint efforts from the public and private sectors.

69. As proven by studies and track records, ESG integration enables financial investors and investee companies to enjoy a number of key benefits: (i) enhanced risk-adjusted returns through identification, mitigation or management of key risks; (ii) lower funding costs; and (iii) access to new sources of capital and AuM.

70. To enhance the attractiveness of the Hong Kong ESG investment market and the competitiveness of the city as a premier international financial centre, policymakers should strive to strengthen their work on ESG:

(i) The Government to take the leadership role in encouraging public funds' support for ESG integration;

(ii) The HKMA to scale up ESG requirements on their external investment managers;

(iii) The MPFA to incorporate ESG factors into its trustee approval and monitoring process and to encourage trustees to take into account international ESG standards;

(iv) The SFC to strengthen the emphasis on ESG through upgrading the Principles of Responsible Ownership to 'comply and explain';

(v) The SFC and the other regulators to provide more guidance on ESG thematic investment products; and

(vi) The SEHK to strengthen the emphasis on ESG for both listing applicants and listed companies.

71. The above recommendations would likely bring about changes in the investment community's behaviour (e.g., on institutional investors' investment preference) and hence have a knock-on effect on the reporting quality of companies. Echoing to what earlier paragraphs have emphasised, within the ESG investment ecosystem, companies play a key and distinctive role and their proactive participation is equally critical to the success of Hong Kong, in addition to what the other stakeholders would contribute. Together, the joint effort of the public and private sectors would be able to help develop a robust ESG investment ecosystem in Hong Kong and thus maintain the city's competitiveness as a leading international financial centre.

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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