

AIMA primer for Asset Managers in Asia



Contents

01 Overview	3
02 The growth of ESG	4
03 Key concepts and regulatory principles	5
04 ESG and private credit	9
05 Summary of legal and regulatory developments in Asia	12
A. Singapore	12
B. Hong Kong	15
C. Mainland China	17
06 Summary of legal and regulatory developments in the EU and UK	19
07 Practical issues for Asia Asset Managers	21
08 Glossary	22
Additional resources	22

Contacts

Lee Kher Sheng

Managing Director, Co-Head of APAC, AIMA
kslee@aima.org

Grace Chong

Of-Counsel, Simmons & Simmons JWS
grace.chong@simmons-simmons.com

Yongmei Cai

Partner, Simmons & Simmons
yongmei.cai@simmons-simmons.com

Jolyon Ellwood-Russell

Partner, Simmons & Simmons
jolyon.ellwood-russell@simmons-simmons.com

Matthew Jones

Senior Professional Support Lawyer, Simmons & Simmons
matthew.jones@simmons-simmons.com

Overview: ESG for Asia Asset Managers

01

The past decade has witnessed a significant increase in concern about, and attention to, environmental issues - predominantly climate change. There has been a growing realisation that if an alternative, more sustainable path is to be found, this can only be through integrated action on an international scale.

This action has involved a number of different initiatives.

Perhaps most critically, the [Paris Agreement on climate change](#) of December 2015 brought all nations together for the first time in taking co-ordinated steps aimed at strengthening the global response to the threat posed by climate change.

The Agreement's central aims (of limiting the rise in global temperature in the 21st century and enhancing the ability of countries to deal with the impacts of climate change) are to be reached through appropriate financial flows, a new technology framework and an enhanced capacity building framework.

Beyond initiatives tackling climate change, social and governance topics have also risen in prominence. In Asia, social issues such as palm oil, deforestation, health regulations and modern slavery have become key issues to asset managers. For example, prominent companies such as Unilever and Nestle have announced intentions to start manufacturing products with sustainable palm oil.

Additionally, corporate governance is also of increasing concern, as studies show that it strongly relates to the company's financial performance and risk profile. Governance covers a broad range of corporate activities including board and management structures as well as a company's policies, standards, information disclosure, auditing and compliance. In recent times, some ongoing concerns in corporate governance include executive compensation, gender diversity and equality as well as tax avoidance.

Looking at these trends holistically, investors have begun to incorporate critical environmental, social, and governance (ESG) factors into their investment analysis and decision-making process, in a process known as "ESG investing".

To boost ESG investing on a global scale, in 2006, the United Nations introduced the Principles for Responsible Investment (PRI), which is a network of investors that promotes sustainable investing principles. More recently, in December 2016, the United Nations adopted its [2030 Agenda for Sustainable Development](#).

This Agenda sets out 17 Sustainable Development Goals (SDGs), which recognise that ending poverty and other deprivations must go hand-in-hand with strategies to improve health and education, reduce inequality, and

spur economic growth – all while tackling climate change. These SDGs have since been conceptualised as corporate targets and different commentators have varying ideas on how the SDGs can be incorporated into ESG investment. For example, the PRI proposes a five-part framework on how investors can shape their investment outcomes in line with the SDGs whereas other asset managers have treated the SDGs themselves as more targeted and directional investing goals.

Given that ESG issues are increasingly prioritised by companies, global and local policymakers, and institutional investors, Responsible Investment (RI) has become one of the most significant and fast-growing trends in the hedge fund industry.

According to Morningstar, mutual funds and exchange-traded funds with a focus on sustainability raked in US\$20.6 billion of total new assets in 2019.¹ In particular, the net money flows into these funds, also known as impact or ESG funds, were almost four times as much as US\$5.5 billion in 2018. Most recently in the course of the coronavirus fallout, it was also observed that on average, sustainable equity funds had managed to weather the initial stage of the downturn better than conventional funds.²

Asset managers are thus confronted with challenges on what their overall aspiration in this space should be, how they can integrate ESG concerns into their investment strategies and disclosures to investors, and what resources they should tackle to exploring these issues. There are also increasing concerns about greenwashing, and how ethical data is calculated.

This AIMA primer focuses on these key areas:

- Key ESG concepts and taxonomy
- EU Disclosure Regulation and the extra-territorial implications for Asia asset managers
- Emerging ESG developments in Singapore, Hong Kong, and China
- Developing an ESG strategy and roadmap – checklist for asset managers

We hope that this primer will be useful for asset managers in Asia, so as to help asset managers understand emerging developments in the ESG space, and provide some clarity around the language of Responsible Investment, to facilitate meaningful conversations between asset managers, investors, and other stakeholders.

¹ <https://www.cnbc.com/2020/01/14/esg-funds-see-record-inflows-in-2019.html>

² <https://www.morningstar.com/articles/972475/sustainable-equity-funds-are-outperforming-in-bear-market>

The shift towards responsible investing over the past few years can be demonstrated anecdotally through the following statistics:

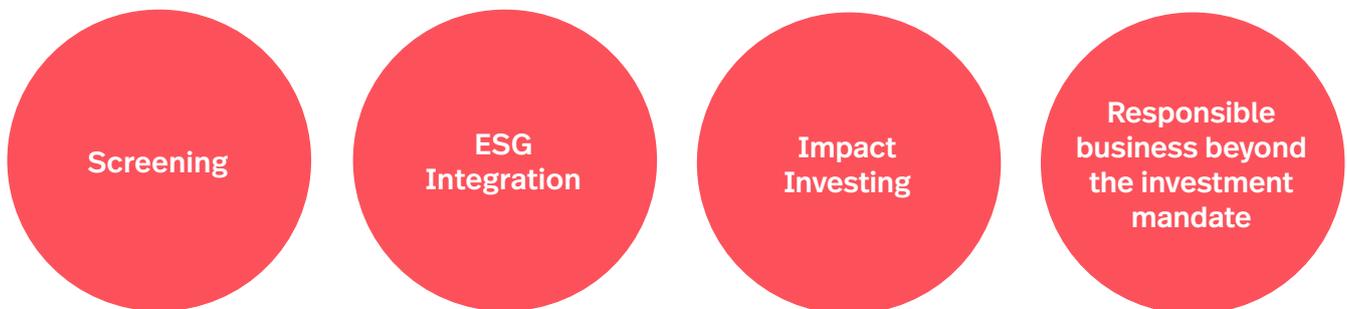
- European sustainable funds now hold €668 billion of assets, an increase of 58% from 2018.
(Source: [Morningstar, Record-Shattering Year for Sustainable Investments, 4 February 2020](#))
- 360 sustainable funds were launched in Europe in the past year, bringing the total number to 2,405.
(Source: [Morningstar, Record-Shattering Year for Sustainable Investments, 4 February 2020](#))
- 2018 saw a 23.3% increase in ESG mandates for the 500 largest asset managers globally
(Source: [Simmons & Simmons, Top 10 things asset managers need to know about the EU ESG initiative, February 2020](#))
- Global socially responsible investments grew by 34 percent to \$30.7 trillion from 2017 to 2019.
(Source: [Bloomberg, Global Sustainable Investments Rise 34 Percent to 30.7 Trillion, 1 April 2019](#))
- 84% of Millennials have stated that they focus on ESG impact as a central goal.
(Source: [Simmons & Simmons, Top 10 things asset managers need to know about the EU ESG initiative, February 2020](#))
- According to BlackRock, the period 2013 to 2019 saw a 67% increase in assets in sustainable mutual funds and exchange - traded funds in Europe and the United States.
(Source: [Simmons & Simmons, Top 10 things asset managers need to know about the EU ESG initiative, February 2020](#))



Key concepts and regulatory principles

03

(A) Key concepts



Screening

Screening is a process in which certain assets are excluded from an investment portfolio. It is one of the simpler forms of RI and has been practiced by managers for some time – generally in response to demands from large institutional investors linked to religious, public, or charitable organisations. Further, screening does not involve as high an active investment risk as compared to other ESG strategies as the concern is with excluding certain business activities than with enhancing returns. By way of example, a manager may invest in accordance with a screening policy which prohibits it from investing in tobacco companies, or arms manufacturers. Screening is currently practiced in the STOXX Europe 600 ESG-X and STOXX USA 500 ESG-X Indices. Often, managers offer screened versions of existing strategies.

“Screened ESG derivatives are an essential tool for the development of a sustainable financial ecosystem. They allows passive and active investors to efficiently manage their portfolio while being fully ESG compliant. Eurex’s screened derivatives success story is proof of the resilience and level of ESG investors’ commitment.”

- Mezhgan Qabool, Head of Market Development APAC, Eurex

While screening is relatively straightforward, it comes with several potential challenges. The first is that investors may have different views as to what assets are acceptable in a screened product, making it difficult to offer a single screened fund of mixed assets. Some investors, for instance, may not want their capital invested in companies that produce alcoholic beverages, while others may only be concerned with ensuring that their capital is not invested in arms manufacturers. This problem is generally overcome through the use of separately managed accounts.

Another challenge is that screening may inadvertently increase the profits to be gained from investing in excluded securities, a market effect which has been noted by several prominent figures in the financial services sector.³ To illustrate this, take a (fictitious) company, Nicotine Inc. As more investors adopt screening policies which forbid investment in tobacco companies, the demand for Nicotine Inc.’s stock will decrease. To remain attractive to investment, Nicotine Inc. may need to add a premium to its stock, making holding it more profitable and thus rewarding those who still invest in the company. The corollary of this, however, is that the cost of Nicotine Inc.’s capital would increase.

Many managers have informal conventions around the securities in which they invest, such as an unwritten rule not to invest in landmine manufacturers. However, a manager is only practicing screening when those conventions are codified in a formal policy. As such, many firms may be able to practice screening simply by formalising the principles by which they already abide.

³ See, for instance, the comments of Cliff Asness, CEO, AQR, on this topic: <https://www.aqr.com/cliffs-perspective/virtue-is-its-own-reward-or-one-mans-ceiling-is-another-mans-floor>

Furthermore, a risk of relying solely on screening is that a company may unnecessarily miss out on profit-making opportunities. It is important that screening is conducted in tandem with companies' fundamental research in potential investments, such that profit-making considerations are also taken into account, to achieve the aims of investors.

Last, there is the issue of inaccurate screening of business activities based on various ESG criteria. For one, this may arise because of company size bias, where companies with larger market capitalisation are likely to have more meaningful ratings as compared to those with smaller market capitalisation. Another factor is that there is no standardisation of ESG data across companies, making it difficult to accurately gauge whether the screening results are correct or not.

Environmental, social, and governance (ESG) integration

The use of environmental, social, and governance factors when investing – a process generally referred to as “ESG integration” – is an increasingly common form of RI. Simply put, ESG integration involves accounting for environmental, social, and governance factors when making an investment or risk management decision. One form of ESG integration is through the building of portfolios on ESG themes, by only investing in companies which suit that particular ESG slant (e.g. a portfolio with an environment slant may invest only in electric car makers).

For example, stocks on the EURO STOXX 50 Low Carbon Index are weighted based on their carbon emissions, where stocks with lower carbon intensities are overweighted and stocks with higher emissions are underweighted. Another example is the STOXX Europe ESG Leaders Select 30 Index which consists of European companies which are selected both on the basis of their risk profile as well as ESG-screening. Certain international exchanges, such as Eurex Exchange, have also provided ESG Index Futures which are linked to the above-mentioned indices.

ESG integration is generally practiced for the purpose of limiting undesired risk and can be done at both the asset and the portfolio level. At the asset level, a manager may examine the ESG attributes of a company before investing in it. For instance, it may investigate the company's sensitivity to climate change, or its workplace safety practices. At the portfolio level, a manager might monitor ESG attributes – for instance, the total aggregate carbon emissions of every investment in a portfolio, in order to gauge that portfolio's overall exposure to the risk of a carbon tax.

ESG integration can also be practiced to generate increased performance. This is clearly related to the question of risk mitigation: a company with a poor safety record, for instance, will be more exposed to legal claims or regulatory penalties that could jeopardise its profits. Some have suggested, however, that companies with high ESG scores may simply be more adaptable in general, and

better positioned to capitalise on economic transitions. While the notion that a well-run company tends, on balance, to deliver better financial performance than one which is run poorly is relatively uncontroversial, the performance effects of ESG integration have not yet been fully determined. It should also be noted that, as the use of mainstream ESG factors becomes more popular, any outperformance that they may provide could be eroded.

Crucially, one of the greatest challenges managers face when implementing ESG is gaining the necessary data. Issuers are generally not required to disclose information on their performance on most ESG factors, and such data is even more difficult to source for private assets. Third-party ESG data, meanwhile, can be expensive, limited, and inconsistent. As such it can often be difficult to gather the data necessary to reliably integrate ESG into investment and risk management decisions.

Other significant challenges include difficulties in applying ESG criteria when dealing with short-term or tactical macro trading and when using quantitative algorithmic trading. Given the difficulties of accurately assessing ESG criteria, this problem is made worse when dealing with short-term trades as there is less time to conduct a proper evaluation of the assets involved. Moreover, algorithmic trading is usually run through a “black box” where exact decision-making processes may not be made clear. To address this particular challenge, one possible solution would be to ensure that the potential trades that may be run through the algorithm are checked against the relevant ESG criteria beforehand.

For more information on how a firm can implement ESG integration, please see AIMA's guide **Responsible Investment Policies for Hedge Fund Firms**.⁴

Impact investing

Impact investing is the most rigorous, and least common, form of RI: it calls for deliberately investing capital in order to create measurable social or environmental goods. In many ways, impact investing bridges the gap between traditional investing and philanthropy, by deliberately creating public goods while also generating profits. Impact investing is closely linked to social entrepreneurship, where for-profit companies work to solve social and environmental problems.

For example, only companies with strong environmental stewardship are selected for the STOXX Europe Climate Impact Index Futures. Carbon Disclosure Project (CDP) climate change scoring methodology is used to assess the environmental impact of companies, with a focus on solving climate change problems and managing the associated risks and impacts. Empirically, the STOXX Europe Climate Impact Index has a 53.60% lower carbon footprint than the STOXX Europe 600 Index. Other examples of impact investing include supporting structured finance for projects such as wind farms or encouraging positive shareholder activism in generating social or environmental goods.

⁴ <https://www.aima.org/resource/aima-responsible-investment-policies-for-hedge-fund-firms.htm>

Some managers go beyond screening altogether and focus on impact investing instead. These managers opt to deliberately invest in assets which are targeted at not only generating long-term returns, but also reducing negative externalities and impacts to the environment and society. For example, Japan's Government Pension Investment Fund put out a call for applications of environmental indices for global equities and eventually selected two indices in which to invest in, to provide an opportunity for companies to work on carbon efficiency and disclosure.⁵

At present, impact investing is relatively uncommon in the hedge fund industry; it is seen more typically in the private equity and private credit sectors, where closed-ended funds may invest in infrastructure such as hospitals and schools. Hedge funds prioritise their ability to protect and grow the capital of their investors, and some argue that impact investing is simply too restrictive to be able to meet that goal. In addition, the implementation of impact investing may require an updating of expertise within a firm, as many managers lack the in-house talent needed to measure long-term social and environmental impact. As such, impact investing tends to be offered by smaller firms which have opted to specialise in this type of investing.

Responsible business beyond the investment mandate

Many managers are beginning to consider how they can improve their ESG profiles as businesses, beyond their investment mandates. This is manifesting itself in managers considering factors such as the gender balance and diversity of their own staff (particularly within their portfolio management teams), the wellbeing and mental health of their staff, their governance in internal decision making, and their environmental footprint. Some managers are also considering ESG factors when creating fund structures, such as by seeking to diversify the composition of the directors on their fund boards.

This is, at least partially, driven by demands from investors, who are increasingly evaluating the managers to which they allocate against ESG factors. For more information on these considerations please see AIMA's guide, **Policy and Practice: ESG Considerations at Alternative Investment Management Firms**.⁶



⁵ <https://www.gpif.go.jp/en/topics/GPIF%20Selected%20Global%20Environmental%20Stock%20Indices.pdf>

⁶ <https://www.aima.org/resource/aima-policy-and-practice-esg-considerations-at-alternative-investment-management-firms.html>

(B) Regulatory principles

The regulatory environment surrounding RI has only just started developing, but with significant potential to promote and incentivise sustainable investments. At present, one of the most high-profile initiatives in this area comes from the European Commission, which has adopted an action plan to increase capital flows to “sustainable” investments. This plan has formed the foundation of recent and proposed EU regulations, further details of which are set out below (see the section entitled “EU Developments”). At the same time, there has been a significant regulatory push around RI elsewhere, such as in the People’s Republic of China, where the China Securities Regulatory Commission has announced plans to require issuers to disclose the environmental risks associated with their operations in 2020.

Given the dynamism of this topic it is vital to ensure that robust and comprehensive regulation goes hand in hand with encouraging innovation. In conjunction with our members, AIMA has formulated the following key principles to help inform the debate on effective RI regulation.

Investor-led

Effective RI regulation should take into account that managers have a fiduciary duty to act in the best interests of their investors. As a corollary, RI principles can be framed as guidelines as opposed to compulsory goals as not all investor interests may align with proposed RI principles. This would strike a balance between moving towards more RI, as well as ensuring that managers are not inadvertently in breach of potential RI principles. As managers are best positioned to address both the needs of their investors and RI principles, it would be best to adopt a consultative approach with managers in arriving at an ideal regulatory framework.

Principles-based

As RI is constantly evolving, it is important that any RI regulation be high-level and principles-based, to be able to support asset managers in adapting and developing their own RI principles in a natural and sustainable way. This will ensure a harmonious relationship between regulators and managers, providing the latter with the requisite flexibility to change their strategies and asset allocations in response to the evolution of RI, while meeting the overarching aims of RI. For instance, biomass wood chips were once seen as “sustainable” products, but they are now avoided because of their high carbon emissions. Ultimately, regulation must provide some transitional space for managers to respond to changing data and information.

Proportionate

Given the diversity of investment strategies that exist, RI principles should be applied in varying ways to cater to the uniqueness of such strategies. This would ensure that the principles are applied realistically across different investment objectives and strategies, thus reducing the risk of “greenwashing” and increasing the likelihood of managers practicing RI in a meaningful way. By way of example, RI principles that are applicable to investment strategies with a long-term horizon may not be similarly suitable for strategies based on short-term sovereign bonds – thus necessitating a tailored approach.

Non-duplicative

Given that some RI practices and principles are already being utilised by managers through thorough risk management and asset selection processes when

choosing investment opportunities, regulators should seek to build on these existing practices and integrate regulatory processes with such practices. In this vein, regulators should seek to avoid duplicating existing practices, but instead seek to introduce rules and principles that can be easily incorporated into current modes of investment management such that sustainable considerations become more commonplace naturally.

Consistent

RI is a broad term that can contain multiple meanings, and as such regulators should aim to ensure consistency in the terms they use across different regulations. This is likely to require cooperation between market participants, policymakers, and regulators to create a common vocabulary which has an appropriate level of flexibility. Ultimately, this will pay off in reducing uncertainty and ambiguity among managers and encourage greater acceptance and practice of RI.

Practical

RI should be evaluated through practical means, and regulators should adopt an approach that is realistic, especially in relation to usable data. Oftentimes, the data necessary to implement many forms of RI may be expensive, inconsistent, or unobtainable. If certain forms of data become mandatory to assess, managers may feel compelled to purchase such data, creating artificial markets. Further, mandating the use of a specific form of data might distort the concept of RI by artificially defining its parameters. In this regard, a consultative approach between regulators and managers to work out a feedback mechanism for the measurement of adherence to RI principles would be an ideal starting point.

Broad-based

To increase the effectiveness of RI principles across the financial sector, regulators should aim to apply the applicable regulations to all relevant parties in the financial sector. This will help to ensure that certain limitations applicable to the regulation of asset managers can be overcome – such as data scarcity – as well as strengthen the impact of RI in the industry as a whole. In this regard, other bodies such as issuers should be included.

With the rapid development of ESG financing in recent years, the private credit sector is no exception. Whether a private credit asset manager is deploying capital towards its portfolio or attracting investors towards its strategy, ESG considerations are becoming increasingly important. Further, it is becoming increasingly apparent that private credit funds will be expected to maintain ESG policies for inspection by investors or regulators. How a private fund manager might invest or fund an ESG asset can vary enormously from direct sustainable loans to purchasing Collateralised Loan Obligation (CLO) products from financial institutions that have packaged distributed portfolios of sustainable finance or ESG backed loans. Moreover, the debt structures themselves can take many forms and are on a spectrum from green bonds or ESG linked loans to asset backed sustainable supply loans or notes.

The exact product detail and sheer scale of ESG linked debt goes beyond this primer, but suffice to say, the availability of products for private credit funds to play their part in ESG is becoming increasingly available. In this section, we set out how private credit managers can incorporate ESG elements into their investment strategies, a selection of the most common structures and sustainable finance products, followed by two sets of recent voluntary guidelines published by the Asia Pacific Loan Market Association (APLMA), a pan-Asian association which aims to promote growth and liquidity in the syndicated loan markets in the Asia Pacific region, regarding green loans and sustainability linked loans.

1. Incorporating ESG Factors into Private Credit Strategies

1.1 ESG and Responsible Investment Policies

It is common for private credit funds to adopt specific investment policies, incorporating ESG and responsible investment considerations into their investment activities. A typical policy consists of the following components:

- **Investment objectives:** Specific ESG and responsible investment performance targets are important in guiding funds in selecting appropriate investments. Funds may align their objectives to globally recognised development goals such as the UN Sustainable Development Goals described in section 1 above.
- **Assessment framework:** An assessment framework is similarly important to allow firms to properly review the performance of a borrower and its business against the prescribed performance targets.
 - **Exclusion list:** An exclusion list specifies the types of businesses which a fund will not finance. A widely adopted list is the International Finance Corporation (IFC) Exclusion List,⁷ which excludes 8 types of businesses, such as production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, and production or trade in tobacco and alcoholic beverages (excluding beer and wine).
 - **Assessment criteria guidelines:** A set of assessment criteria guidelines (to be updated periodically) for a fund's selected ESG and responsible investment performance targets is further necessary for firms to accurately assess their progress towards their ESG targets.
- **Reporting:** Reporting requirements to which borrowers are subject should be included, such as specifying that impact screening and reporting will be conducted as requested by the fund or impact investor partners.

⁷ https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/company-resources/ifcexclusionlist#2007

1.2 Sustainable Finance

We set out below several popular ESG investment options available for private credit funds.

Green bonds

Proceeds of green bonds are exclusively applied to new or existing environmental-friendly projects, such as sustainable water management, pollution prevention, low-carbon transport and renewable energy. While most green bonds are issued by banks, it is increasingly common for sovereigns and corporations to issue their own bonds. Corporate issuers often benefit from enhanced company reputation and a diversified investor base through attracting a new subset of investors with an interest in sustainable development.

Sustainability linked loans

Sustainability linked loans are defined under the Sustainability Linked Loan Principles⁸ (SLLPs) (see paragraph 2.2 below) as any types of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious and predetermined sustainability performance objectives. The loan terms are tied to the sustainability performance of borrowers who, as a result, can potentially benefit from a lower interest rate when a specified performance target is achieved.

ESG linked real estate

Buildings account for a substantial share of energy consumption and greenhouse gas emissions. In response to investor demand, an increasing number of real estate owners and operators have incorporated ESG performance as part of their business strategies, developing ESG policies and designing buildings with green and sustainable features.

Real Estate Investment Trusts (REITs) are an integral part of ESG linked real estate investments. They own, develop and manage a vast portfolio of commercial and residential buildings e.g. offices, shopping centres, hotels and apartment buildings which are large producers of waste and consumers of energy. Recent research found that REITs with a more sustainable portfolio benefited from higher rental income and lower interest expenses, resulting in increased cash flows available for distribution to shareholders.⁹

For more detail please refer to: <https://www.aima.org/article/press-release-private-credit-to-play-key-role-in-asia-s-economic-rebound.html>

Supply Chain Finance (SCF)

The ESG investment trend presents an opportunity for private credit managers, especially in Asia, to embed ESG elements into SCF structures. Sustainable supply chains may be financed by the following mechanisms:

- **Sustainable trade loans:** Sustainable trade loans aim to incentivise suppliers to achieve certain sustainability performance targets (SPTs) specified by the lender in its manufacturing or sourcing of goods, services or activities. Here, the lender provides preferential rates to sustainable suppliers.
- **Buyer-led payable finance programmes:** Buyers can integrate ESG considerations into their supply chain by ranking suppliers according to their sustainability performance, among other means. While suppliers sell their receivables income at a discount to SCF providers, they receive preferential terms such as favourable lending rates or early financing, for demonstrating strong sustainability performance. Buyers will then pay their invoices on the due date directly to the SCF providers.

Sustainable securitisation

Private credit funds can also invest in the capital markets or CLOs via ESG securitisation, which is characterised by the sustainability of the underlying assets and the sustainable use of proceeds of the securities. Sustainable securitisation has become more viable and profitable with the growing types of eligible sustainable assets such as loans for hybrid and electric vehicles, loans for solar energy projects and commercial and residential mortgages for energy efficient properties. Indeed, the Organisation for Economic Co-operation and Development (OECD) estimates that the annual issuance of sustainable asset-backed securities has the potential to reach USD380 billion in the 2031-2035 period.¹⁰

⁸ <https://www.aplma.com/en/gsl/3>

⁹ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2920788

¹⁰ <https://www.oecd.org/cgfi/quantitative-framework-bond-contributions-in-a-low-carbon-transition.pdf>

2. Voluntary Guidelines for Green Loans and Sustainability Linked Loans

While the lack of standardisation across data formats and reporting is believed to have hindered the adoption of ESG elements into broad debt market practices, the APLMA has recently taken the lead to publish two sets of voluntary guidelines as guidance for green loans and sustainability linked loan market participants.

2.1 Green Loan Principles

In December 2018, the APLMA, along with, the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) (together, the Associations) issued the Green Loan Principles (GLPs),¹¹ providing voluntary guidelines for the green loan market to apply on a deal-to-deal basis. Green loans are defined under the GLPs as “any types of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects”. An indicative list of eligible green projects is set out in Appendix 1 of the GLPs, which is essentially the same list published by the International Capital Market Association (ICMA) for green bonds. Examples of eligible green projects include renewable energy, energy efficiency, pollution prevention and control, and climate change adaption.

The GLPs consist of four core components:

- **Use of proceeds:** The loan proceeds must be utilised for eligible green projects.
- **Process of project evaluation and selection:** A borrower should clearly communicate to its lender its environmental sustainability objectives, the process for determining how its projects fit within the Appendix 1 eligible categories and the related eligibility criteria.
- **Management of proceeds:** The net proceeds of the green loan should be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner.
- **Reporting:** A borrower should make and keep readily available up-to-date information on the use of proceeds to be renewed annually until fully drawn, and thereafter in the event of material developments.

2.2 Sustainability Linked Loan Principles

In March 2019, the Associations further launched the SLLPs to provide a separate set of voluntary guidelines for sustainability linked loans.

The four key components of the SLLPs are as follows:

- **Relationship to borrower’s overall corporate social responsibility strategy:** A borrower should clearly communicate to its lender its sustainability objectives and how these align with its proposed SPTs.
- **Target setting – measuring the sustainability of the borrower:** Appropriate SPTs, which should be ambitious and meaningful to the borrower’s business and tied to a sustainability improvement in relation to a predetermined performance target benchmark, should be negotiated and set between the borrower and the lender for each transaction.
- **Reporting:** A borrower should make and keep readily available up-to-date information relating to their SPTs, with such information to be provided to institutions participating in the loan minimally on an annual basis.
- **Review:** The need for external review is to be negotiated and agreed between the borrower and the lender on a transaction-by-transaction basis. If no external review is sought, it is strongly recommended that a borrower should demonstrate or develop the internal expertise to validate the calculation of its performance against the SPTs and to thoroughly document such expertise.

In addition to the above principles, bank authorities in Asia have also been pushing for ESG developments. For details of measures taken by the Association of Banks in Singapore (SBA), the Hong Kong Monetary Authority (HKMA) and the People’s Bank of China (PBOC), please see section 6 below. It is anticipated that the private credit sector will continue to lean into the trend of the banking industry and further increase its attention on ESG financing.

¹¹ <https://www.aplma.com/en/gsl/2>

Summary of legal and regulatory developments in Asia

05

A: Singapore

The ESG legal and regulatory framework has been slowly gaining momentum in recent years. We set out below a number of key developments that asset managers in Singapore might find useful.

1. Key regulatory initiatives

1.1. MAS Sustainable Bond Grant Scheme

The Monetary Authority of Singapore (MAS) launched the Sustainable Bond Grant Scheme¹² (SBG Scheme) in June 2017 to fund the expenses of eligible companies for obtaining an external review for green bonds issued and listed in Singapore.

The key aspects of the grant are as follows:

- The grant is subject to a cap of S\$100,000 or 100% eligible expense per qualifying issuance and is eligible for first time or repeat bonds, as well as for multiple applications, up till 31 May 2023.
- The review should be done by an independent external review or a rating based on any internationally recognised green/social/sustainability bond principles or framework.
- The bond programme size should be at least S\$200m with initial issuance of at least \$20m and a minimum tenure of one year.

1.2 MAS Green Investments Programme¹³

As part of the Singapore government's Green Finance Action Plan, MAS launched the Green Investments Programme (GIP) on 11 November 2019. This is a US\$2bn investment fund that will channel funds to asset managers committed to deepening green finance activities and capabilities in Singapore. Its aim is to invest in public market investment strategies with a strong green focus to support environmentally sustainable projects in Singapore and in the region. In order to qualify for selection, interested asset managers need to demonstrate a strong commitment to deepening their green investment capabilities across various functions and increase the management of green-focused funds in Singapore.

MAS has said that it will also look out for asset managers that actively incorporate environmental considerations into their investment process and direct capital towards underlying investments that have a greener profile. The experience of the team, particularly in relation to environmental-related expertise, will be an important consideration in the selection process.

MAS's initial investment under the GIP will be a US\$100m placement with the Bank for International Settlements' Green Bond Investment Pool.

1.3 SGX Guide to Sustainability Reporting for Listed Companies

In 2016, the Singapore Stock Exchange (SGX) rolled out a list of sustainability reporting requirements¹⁴ that listed companies in Singapore must adhere to, under Listing Rule 711A.¹⁵ Rule 711A requires every listed issuer to prepare an annual sustainability report (the publication of information on material ESG factors in a comprehensive and strategic manner), which must describe each issuer's sustainability practices with reference to the primary components set out in Listing Rule 711B on a "comply or explain" basis.

This regulation aims to provide a more comprehensive picture of issuers' positions. While financial reports and statements of financial positions provide a snapshot of companies' present financial situation and an account of the previous year, sustainability reports of ESG factors reflect the risks and opportunities in view, managed for future returns. Taken together, they enable better assessments of issuers' financial prospects and quality of management.

The principles of sustainability reporting are as follows:

- **Board responsibility:** Over the course of the business, the Board as a provider of strategic direction is required to determine the ESG factors identified as material to the business and see to it that they are monitored and managed. Ultimate responsibility for each issuer's sustainability reporting lies with the Board.
- **Report risks and opportunities:** Each issuer should consider both risks and opportunities and report them clearly, bearing in mind to maintain an accurate and balanced view.
- **Performance measurement:** Each issuer should have a good performance measurement system that will

¹² <https://www.mas.gov.sg/schemes-and-initiatives/sustainable-bond-grant-scheme>

¹³ [https://www.mas.gov.sg/news/media-releases/2019/new-us\\$2-billion-investments-programme-to-support-growth-of-green-finance-in-singapore](https://www.mas.gov.sg/news/media-releases/2019/new-us$2-billion-investments-programme-to-support-growth-of-green-finance-in-singapore)

¹⁴ [https://api2.sgx.com/sites/default/files/2018-07/Sustainability%20Reporting%20Guide%20\(220218\).pdf](https://api2.sgx.com/sites/default/files/2018-07/Sustainability%20Reporting%20Guide%20(220218).pdf)

¹⁵ <https://api2.sgx.com/sites/default/files/2018-09/Singapore%20Index%20Fund.pdf>

allow for the benchmarking of performance against the stated objectives and to enable comparison over time and across entities.

- **Comparability:** Each issuer should give priority to using globally recognised frameworks and disclosure practices to guide its reporting.
- **Stakeholder engagement:** Each issuer's responsibility on disclosure is first and foremost to current and potential stakeholders. Each issuer's interaction with its stakeholders is also of interest to investors for its relevance to sustainability across the value chain of the issuer. Stakeholders' perspectives contribute to inform each issuer's identification of material ESG factors.
- **External assurance:** An issuer whose sustainability reporting is already matured after several annual exercises would want to undertake external assurance by independent professional bodies to boost credibility of the information disclosed and analysis undertaken, and strengthen stakeholder confidence.

The primary components of the report include: (i) material ESG factors; (ii) policies, practices and performance; (iii) targets; (iv) sustainability reporting framework; and (iv) board statement.

Asset managers have noted that more guidance is needed on how companies should identify the material ESG factors, especially on a sector-focused basis. Some ESG factors can differ greatly from sector to sector – for example, energy companies may have more environmental considerations than technological ones.

2. Implications for asset managers

2.1 Impact of MAS grants and programmes

By lowering associated costs, the MAS SBG is likely to spur on more companies who are in the midst of considering issuing green bonds to seek external review. This is likely to boost the credibility and consequential quality of green bonds issued in the Singapore market. By extension, this presents greater underlying investment opportunities for asset managers looking to deploy their funds from green-focused collective investment schemes.

Since the availability of willing investors is also a key consideration for asset managers looking to set up green-focused collective investment schemes, the GIP presents an attractive opportunity for significant source of investor funds. Having secured a GIP investment is likely to also boost the confidence of other institutional investors that may be sitting on the fence with respect to green-focused funds, so all in all the GIP is an important development that is likely to grow the pie of green investors.

2.2 Impact of SGX Sustainability Reporting Guidelines

As sustainability reports and alignment to ESG is now “mandatory” for listed companies, asset managers will need to take into consideration ESG factors in their portfolio early on if an exit strategy of an IPO is on the cards. Investments in industries with elevated risks will force asset managers to look into their ESG impacts and risks, and consider alternative investments that can mitigate negative ESG impacts. The identified ESG factors material to the business will be important for asset

managers to consider in their portfolio, and investments must, in addition to monitoring the financial return of investments, find ESG metrics that will enable the measuring of performance in terms of ESG indicators so as to facilitate sustainability reporting later on. The key message is to start planning early.

2.3 Impact of ABS Guidelines on Responsible Financing

The ABS Guidelines complement the MAS Risk Management Guidelines on Internal Controls where banks are required to have three lines of defence for risk management by requiring that banks integrate E&S risks in their internal processes.

Although the ABS Guidelines do not expect banks to perform portfolio-level assessments of their exposure to E&S risks and impacts, MAS has stated that “banks, insurers, and asset managers will need to assess the impact of climate change on balance sheets and their loan and investment portfolios”, signalling its importance to the industry and thus the added requirements for asset managers to consider.

3. Key things to watch in terms of Singapore ESG developments

In June 2020, MAS released three consultation papers on its proposed Guidelines on Environmental Risk Management (Guidelines) for banks, insurers and asset managers. These Guidelines are aimed at strengthening financial institutions' resilience to environmental risk, as well as enhance the role of the financial sector in transitioning towards an environmentally sustainable economy both in Singapore and in the region.

The Guidelines cover three broad areas: effective governance, robust risk management, and meaningful disclosure. Under effective governance, entities are encouraged to establish board and senior management oversight of environmental risk policies and practices. Further, they are encouraged to incorporate environmental considerations into strategies, business plans and product offerings, as well as set clear roles and responsibilities within the governance structure, with adequate resources allocated to managing environmental risk.

As for risk management, the Guidelines propose that entities conduct environmental risk assessments of customers and investments, adopting an enhanced level of due diligence for higher risk transactions. On top of this, they should develop tools and metrics to assess environmental risk exposures, including capabilities in scenario analysis and stress testing. Another related aspect involves improving customers' and investees' environmental risk profile in order to shape positive behaviour on their end as well.

The last area of the Guidelines relates to meaningful disclosure, which includes taking reference from international reporting frameworks, such as the Taskforce on Climate-related Financial Disclosures recommendations, disclosing approaches to managing environmental risk and the impact of material environmental risk, as well as regular reviews of disclosures to improve comprehensiveness, clarity and relevance.

However, industry participants have raised concerns on how the environmental risk management guidelines can be enforced and the risks of “greenwashing” if managers are compelled to adhere to the guidelines in an inauthentic way.

Further, while the guidelines provide for scenario planning and stress testing, scenario planning might not be feasible for a number of financial institutions due to cost and resource limitations. Additionally, the reliability of scenario planning is still questionable as some worry that the number of varying factors and considerations can lead to misleading or inaccurate predicted outcomes.

Asset managers are also concerned about the quality of their data. Without proper standardisation, data on ESG factors might not successfully account for different biases, such as geographic and size biases. The lack of disclosure obligations and regulation in some jurisdictions also contribute to imperfect data.

Additionally, in Minister Ong Ye Kung’s speech in Parliament on 4 February 2020, Minister Ong stated that

MAS takes climate change-related risks seriously and is a founding member of the Network for Greening the Financial System, which develops best practices for a more sustainable financial industry.

Minister Ong explained that financial institutions are potentially exposed to such risks, because they provide financing and insurance services to businesses that can be impacted by a wide range of climate change-related events, including natural catastrophes. There are also risks arising from changes to public policies, technologies, or consumer preferences that can impact businesses significantly.

Climate change is therefore increasingly relevant to financial institutions, both because the risks will be on their balance-sheets and because they will play a role in enabling their customers and the economy at large to make a transition - here in Singapore as well as abroad. As such, Minister Ong said that MAS is working towards incorporating a broader range of climate change-related risks in thematic scenarios as part of its future industry-wide stress test.



B: Hong Kong

To enhance the competitiveness of the city's ESG investment market, Hong Kong regulators have been gradually introducing more disclosure and reporting requirements in recent years. We summarise below key regulatory developments in Hong Kong and their implications on asset managers.

1. Key regulatory initiatives

1.1 Companies Ordinance – Directors' Reporting

Since the Companies Ordinance (Cap. 622 of the Laws of Hong Kong) (CO) came into effect in March 2014, Hong Kong companies (unless exempted) are required to include in the business review section of their annual directors' reports a discussion of their environmental policies and performance.¹⁶

1.2 Listing Rules – ESG Reporting Guide

The disclosure obligations under the CO have been incorporated into the Listing Rules,¹⁷ such that they apply to all listed companies regardless of their place of incorporation.

The Listing Rules further provide an ESG Reporting Guide, which comprises two levels of disclosure obligations: (i) general disclosures on which issuers must report with a "comply or explain" approach and (ii) recommended disclosures. The ESG Reporting Guide is organised into two subject areas for issuers to disclose on: (i) environmental (emissions, use of resources, environment and natural resources) and (ii) social (employment, health and safety, development and training, labour standards, supply chain management, product responsibility, anti-corruption and community investment).

The principles of ESG reporting are as follows:¹⁸

- **Materiality:** The threshold at which ESG issues become sufficiently important to investors and other stakeholders such that they should be reported.
- **Quantitative:** Key performance indicators (KPIs) need to be measurable and enable the effectiveness of ESG policies and management systems to be evaluated and validated. An explanatory narrative should accompany quantitative information.
- **Balance:** Unbiased and presented in such a way that it will not inappropriately influence the judgment of the reader.
- **Consistency:** The issuer should use consistent methodologies to allow for meaningful comparisons of ESG data over time.

The Stock Exchange of Hong Kong (SEHK) published FAQ Series 18¹⁹ (last updated on 28 February 2020) to provide issuers with further guidance on ESG reporting.

1.3 Securities and Futures Commission (SFC) – ESG Reporting

On 11 April 2019, the SFC issued a circular²⁰ (SFC Circular) targeting SFC-authorized funds which incorporate globally recognised green or ESG criteria or principles as their key investment focus (Green or ESG Funds).

Accordingly, the offering documents (including product key fact statements) of Green or ESG Funds should, disclosure, at a minimum, the following:

- The key investment focus and targeted objective.
- The investment strategies adopted, such as the relevant green or ESG criteria or principles considered, the expected exposure to the securities or other investments that reflect the stated green or ESG investment focus, and the investment selection process and criteria adopted.
- Any exclusion policies (e.g. activities, sectors, countries) adopted.
- Risks associated with the funds' investment schemes, such as subjective judgment in investment selection and concentration in investments with an environmental or ESG focus.

Managers of Green or ESG Funds are also under an ongoing monitoring duty to regularly evaluate the underlying investments to ensure that the funds continue to meet the stated ESG investment objectives.

Separately, a webpage²¹ (SFC Webpage) was launched by the SFC in late 2019 (last updated on 24 February 2020) to list all SFC-authorized Green or ESG Funds complying with requirements of the SFC Circular.

¹⁶ Section 388 of the CO and section 2(b) of Schedule 5 of the CO.

¹⁷ Appendix 16 of the Main Board Listing Rules, paragraph 28(2)(d); Rule 18.07A(2)(d) of the GEM Listing Rules.

¹⁸ Section 11 of Appendix 27 of the Main Board's Listing Rules and section 11 of Appendix 20 of the GEM's Listing Rules.

¹⁹ https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/h/k/HKEX_FAQ_18.pdf

²⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=19EC18>

²¹ [https://www.sfc.hk/web/EN/regulatory-functions/products/list-of-environmental,-social-and-governance-\(esg\)-funds.html](https://www.sfc.hk/web/EN/regulatory-functions/products/list-of-environmental,-social-and-governance-(esg)-funds.html)

1.4 Hong Kong Monetary Authority – Sustainable Banking and Green Finance Measures

On 7 May 2019, the HKMA announced three sets of measures in support of Hong Kong’s green finance development, which include:²²

- **Three-phased green and sustainable banking:**
 - **Phase I:** Developing a common framework to assess the “Greenness Baseline” of individual banks.
 - **Phase II:** Engaging the industry and other relevant stakeholders in a consultation to set tangible deliverables for promoting green and sustainable developments of the banking industry.
 - **Phase III:** Implementing, monitoring and evaluating banks’ progress regarding Phase II’s deliverables.
- **Responsible investment:** Prioritising green investment in its role as the manager of the Exchange Fund where the long-term return is expected to be comparable to other investments on a risk-adjusted basis.
- **Centre for Green Finance (CGF):** Setting up the CGF to foster a green financial sector in Hong Kong.

1.5 Green Bond Grant Scheme

In June 2018, the Government launched the Green Bond Grant Scheme to subsidise eligible green bond issuers in bond certification under the Green Finance Certification Scheme, which was implemented by the Hong Kong Quality and Assurance Agency to provide third-party conformity assessments and certification for green bond issuers. The maximum subsidy per bond issuance is HK\$800,000.

2. Implications for asset managers

2.1 Review of ESG Disclosure by SEHK

The SEHK reviewed ESG reports submitted by randomly selected issuers in 2018 and released its findings and analysis in December 2019.²³ Whilst all sample issuers produced an ESG report on time, a significant variance in the quality and detail of the reporting was identified. Key comments/ recommendations by the SEHK are as follows:

- **Materiality assessment:** A materiality assessment is a fundamental element in a proper analysis of ESG-related risks. Issuers are encouraged to conduct and include details of such assessments in their ESG reports.
- **Board involvement:** Boards should be meaningfully involved in assessing and addressing ESG-related risks.
- **“Comply or explain” both acceptable:** The SEHK noted that only 3% of “comply or explain” provisions were “explained”. The SEHK emphasised that “explain” is in no way a less preferred secondary option, especially when a “comply or explain” provision is immaterial to an issuer.

2.2 Impact of the SFC Circular

For existing SFC-authorized funds or new funds which fall within the scope of the SFC Circular, managers should file to the SFC a confirmation of compliance with the disclosure and ongoing monitoring requirements. Such confirmation can either be (i) a self-confirmation of compliance or (ii) a confirmation supported with independent third-party certification or fund label to demonstrate compliance.

It is noteworthy that the list of Green or ESG Funds on the SFC Webpage is compiled based on confirmations provided by fund managers. The SFC has not independently verified the effectiveness of the investment strategies, investment selection processes, investment portfolios etc. of such funds. The list, therefore, does not constitute an official guarantee of the funds’ green or ESG attributes, or related performance.

3. Key things to watch in terms of Hong Kong ESG developments

3.1 Changes to the ESG Reporting Guide

In December 2019, the SEHK published the Consultation Conclusions – Review of the ESG Reporting Guide and Related Listing Rules,²⁴ stating changes which will be effective for financial years commencing on or after 1 July 2020. Key changes include:

- Introducing mandatory disclosure requirements to include: (i) a board statement setting out the board’s consideration of ESG matters, (ii) application of reporting principles “materiality”, “quantitative” and “consistency”, and (iii) explanation of reporting boundaries of ESG reports.
- Upgrading the disclosure obligation of all “Social” KPIs to “comply or explain”.
- Amending the “Environmental” KPIs to require disclosure of relevant targets.
- Requiring disclosure of significant climate-related issues which have impacted and may impact the issuer.
- Shortening the deadline for publication of ESG reports to within five months after the financial year-end.

3.2 Government Backing of ESG Finance

On 22 May 2019, the Government announced the successful offering of its inaugural green bond under the Green Bond Programme, with an issuance size of US\$1 billion and a tenor of 5 years.²⁵ The proceeds for the bond will be used to finance or refinance public works projects which provide environmental benefits and support the sustainable development in Hong Kong. It is anticipated that the Government will continue to take the lead in promoting ESG finance.

²² <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2019/05/20190507-4/>

²³ https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/ESG-Guide/esgreport_2018.pdf?la=en

²⁴ [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/May-2019-Review-of-ESG-Guide/Conclusions-\(December-2019\)/cp201905cc.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/May-2019-Review-of-ESG-Guide/Conclusions-(December-2019)/cp201905cc.pdf?la=en)

²⁵ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2019/05/20190522-3/>

C: Mainland China

Development of ESG in China

ESG integration into investment and financing strategy has had a late start in China. However, since 2006, China has been, from top down, pushing for green finance and investments by increasing disclosure requirements for environmental, social responsibility and corporate governance and encouraging ESG investment strategies.

1. Key regulatory initiatives

ESG in China started with the effort to raise environmental awareness by regulators and policy makers.

In 2008, the Shanghai Stock Exchange issued the Environmental Information Disclosure Guidelines which require mandatory disclosure by listed companies of any environmental event which may have a greater impact on the trading price of relevant shares and derivatives and of the impact of these environmental incidents on companies' operations and shareholders within two days from the date of the event.²⁶ Companies are also required to disclose either in a single separate disclosure or included in their annual reports certain environmental information, such as total annual energy consumption, the details of pollutants discharged etc.²⁷

In 2016, the People's Bank of China (PBOC), together with other ministers and governmental departments, issued the Guiding Opinions on Building a Green Financial System (the GOBGFS). The GOBGFS aims to establish systematic arrangements through green financial instruments and relevant policies to support the transition from a traditional economy to a green economy. The GOBGFS also looks to open China's green investment markets. Chinese companies and institutions are encouraged to issue offshore green bonds, and, equally, international investors will be supported in issuing green bonds and making green investments in China.²⁸

With the increasing importance of ESG globally and further opening up of China, Chinese securities regulator China Securities Regulatory Commission (CSRC), revised the Code of Corporate Governance of Listed Companies in 2018. This resulted in mandatory obligations for all listed companies to disclose environmental information, information relevant to the performance of poverty alleviation and other social responsibilities, as well as information relevant to corporate governance.²⁹

Both the Shanghai and Shenzhen Stock Exchange have launched ESG information disclosure guidelines in 2018 for consultation. These guidelines are expected to be effective soon.

In the same year, the Asset Management Association of China (AMAC) issued the Green Investment Guidelines with the intention to guide the industry to construct green investment systems, build up universal frameworks and behavioural norms for green investments. Measures set out in this Guidelines are not mandatory. ESG investment method was encouraged to be adopted by fund managers when conditions permit.³⁰ Fund managers who provide fiduciary management services to domestic and foreign pensions funds, insurance funds, social welfare funds and other professional institutional investors are asked to play a role as a model to actively establish long-term mechanisms in line with green investment or ESG investment norms.³¹

2. ESG integration in Chinese markets

Within the policy and legal frameworks, listed companies are making mandatory as well as voluntary disclosure of ESG data. However, there is generally a lack of standardisation of the data within the frameworks.

In the meantime, with further opening of the Chinese financial markets to international investors, also with the inclusion of certain A shares in MSCI Indexes, Chinese companies and asset managers have now greater awareness of how ESG performance can impact investments.

AMAC has been conducting surveys with its members on responsible investments and incorporation of ESG factors since 2017. The latest survey for 2019 reveals that while more and more asset managers have participated in the surveys and indicated their interest and focus on ESG, there remain around 12-13% expressing that they do not understand ESG responsible investments. The survey also shows that currently in the Chinese market, there are issues of a lack of systematic ESG data integration and personnel who have good understanding of ESG principles and relevant experiences, which have affected the quality and effective use of ESG data.

²⁶ Article 2 of the Shanghai Stock Exchange Environmental Disclosure Guidelines.

²⁷ Article 3 of the Shanghai Stock Exchange Environmental Disclosure Guidelines.

²⁸ Article 30 of the GOBGFS.

²⁹ Articles 96 and 96 of the Code of Corporate Governance of Listed Companies (2018)

³⁰ Article 4 of the AMAC Green Investment Guidelines.

³¹ Article 5 of the AMAC Green Investment Guidelines.

3. Implications for asset managers

According to the PRI paper “ESG and Alpha in China” (2020), a PRI study, using data from MSCI ESG Research for companies in the MSCI China Index, as well as local asset manager examples in the China A-shares market, found that ESG data incorporation in investment analysis is a source of Alpha.

The latest AMAC survey report also found that 68% of respondents cite Alpha generation and 24% cite risk mitigation as the value added by ESG incorporation. Therefore, asset managers are now actively integrating ESG factors in their investment decision making process. In practice, ESG integration by asset managers may be done in different phases starting with initial filters to due diligence, and investment decision making to post investment management. For initial filters and due diligence, the key is to classify ESG problems and identify ESG risks. During the decision-making phase, ESG factors are incorporated into the action plan so that ESG expectations and goals are set out clearly. The final post investment management will help to evaluate the implementation of the ESG plan and prepare the ESG report to investors.

4. Key things to watch in terms of China’s ESG developments

We think that ESG integration will emerge as the most important growing factor post COVID-19. China will continue use a top-down driving force to push for ESG integration through regulatory and policy frameworks. As discussed above, we anticipate that ESG disclosure will be mandatory under stock exchanges disclosure guidelines soon. Once disclosure becomes mandatory, accumulation of comparable historic data on ESG metrics will become possible, which will then significantly improve investors’ adoption of ESG factors.

In the meantime, more details may be provided by regulators or industry associations as standards and requirements for ESG integration (in particular those related to social responsibility and corporate governance) so that the ESG criteria in China can match international standards and that foreign asset managers will find it easier to evaluate and invest in China.

Asset managers in China will become an important force to spearhead further ESG integration effort in the hope to enhance investment capacity and boost Alpha post COVID19.



Summary of legal and regulatory developments in the EU and UK

06

The EU has set in motion an ambitious legislative programme to make ESG concerns a central plank of regulation in the financial services industry. Although this initiative is particularly relevant to managers which have an express ESG or sustainability focus, key aspects of the new rules will apply to all managers – even those without an express ESG or sustainability focus.

The first set of rules of relevance to most asset managers is scheduled to come into force in March 2021.

1. Key regulatory initiatives

Level 1 measures

Three new Regulations are of especial importance to asset managers, namely:

The Framework Regulation (also known as the Taxonomy Regulation)

Aim

This creates a common taxonomy for determining how far an economic activity can be described as being “environmentally sustainable”, which allows managers and investors to establish how environmentally sustainable a given investment is.

Scope

The Framework Regulation will, in large part, be relevant only to managers that make available a financial product which either is aimed at environmentally sustainable investment, or promotes environmental characteristics, although all managers will need to make a negative disclosure to confirm that all out-of-scope financial products are in fact out of scope.

Status

The text of the Framework Regulation has been agreed and is now waiting to be published in the Official Journal of the EU (OJ). Level 2 measures will then follow, though the exact timing of these will depend on how much the EU’s attention continues to be occupied with fighting the COVID-19 pandemic.

The Disclosures Regulation

Aim

This sets out a series of sustainability-related disclosures, which must be made

- in the documentation for a fund or managed account, and
- on a manager’s website.

Scope

Many aspects of the Disclosures Regulation will apply to all managers, including those which have no express ESG focus or sustainability focus (although some aspects will be relevant only to those financial products which have a specific ESG focus).

Status

The Disclosures Regulation was published in the OJ in December 2019, and most of its provisions will come into effect from 10 March 2021.

Level 2 measures are under development, with a **consultation** on the content and format of the main disclosure obligations currently running until 1 September 2020. Draft measures are due to be submitted to the Commission by December 2020, and these must be finalised by March 2021.

Low Carbon Benchmarks Regulation

Aim

The Low Carbon Benchmark Regulation amends the Benchmarks Regulation by introducing appropriate and objective low-carbon indices that can be used as a reference index and sets out the key requirements applicable to the methodology for the new benchmarks.

Status

The Low Carbon Benchmark Regulation was published in the OJ on 9 December 2019, and its contents came into force the next day.

Level 2 measures (which were expected to be ready in Q2 2020) have been delayed as a result of the COVID-19 pandemic and are currently expected in Q3 2020.

Level 2 amendments

In addition to the above Regulations, the Commission is proposing amendments to Level 2 measures under the AIFMD, the UCITS Directive and MiFID 2.

AIFMD and the UCITS Directive

The Commission is currently considering advice submitted to it by the European Securities and Markets Authority (ESMA) with a view to making changes to level 2 measures under AIFMD and the UCITS Directive to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes.

MiFID 2

In January 2019, the Commission published a draft delegated regulation under MiFID 2, which would amend an existing delegated regulation to clarify that investment firms providing financial advice and portfolio management would have to

- take clients' ESG considerations and preferences into account in the investment and advisory process as part of the firm's "suitability" assessment, and
- furnish clients with information on the ESG factors of financial products before being able to provide investment advice or portfolio management services and prepare a report to the client explaining how the firm's recommendation meets the client's investment objectives, risk profile, capacity for loss bearing and ESG preferences.

2. The impact of Brexit

The UK left the EU on 31 January 2020 under a Withdrawal Agreement that allows for a transitional period until 31 December 2020. Even allowing for an extension, it seems highly unlikely that any of the new rules mentioned above will come into force until after the transition period has ended (although, if any are in force during that time, they would automatically apply to the UK).

Mindful of the importance of the sustainability initiative as part of the EU's response to the Paris Climate Agreement and its own commitment to supporting the growth of the UK's financial services industry, HM Government listed the Framework Regulation, Disclosures Regulation and the associated Low Carbon Benchmarks Regulation as EU legislation which will be "onshored" – i.e., these regulations would be part of the EU financial services legislation implemented for a period of two years after the UK leaves the EU, in the event of a "no-deal Brexit" (for example, if the transition period ends on 31 December 2020 with no agreement on the trading relationship between the UK and the EU).

However, the Financial Services (Implementation of Legislation) Bill, which would have implemented the onshoring, automatically fell on the prorogation of Parliament ahead of the December 2019 UK general election. The Queen's Speech to the new Parliament noted the UK Government's intention to introduce a Financial Services Bill, which may (or may not) include a provision for onshoring of the EU's ESG legislation – this will only become clearer in due course, when the new Bill is put before the House of Commons.

Practical issues for Asia Asset Managers

07

We set out below a list of key important issues that asset managers can use as a framework to prepare for ESG integration:

01 Global Strategy

- What should your firm's overall global aspiration in this space be? Should your firm have any additional jurisdiction-specific aspirations?
- How would you define your firm's brand and narrative?
- How should sustainability risks be incorporated into the firm's decision-making processes and risk assessments?

02 Clients and Jurisdictions

- Where do you see most demand for responsible investments and what present the biggest opportunities?
- Who are your key competitors and what are the risks of not doing more in this space?

03 Products & Services

- What types of sustainable strategies should you prioritise?
- Does taking into account ESG factors reduce the investment universe and how does this affect your ability to deliver returns?

04 Principles and Culture

- Which areas of investment may create the greatest reputational risk, in light of the focus on responsible investment?
- Are your suitability assessments adequate?
- Do you have adaptive governance structures to ensure that conduct issues in ESG investments are adequately addressed?
- How can you encourage your employees to engage in sustainability issues?
- Who can you appoint to champion ESG initiatives in your firm?
- Is your remuneration policy consistent with integration of sustainability risks?

05 Technological Tools and Data

- What kind of data do you need to make strategy and investment decisions, and how what methodologies are you using to obtain and review such data?
- Is there adequate and quality research to support investment decisions?
- How will you deal with challenges of variation of ethical scores between data providers?

06 Implementation challenges

- Are there laws and regulations in the jurisdictions where you operate which require new policies to be implemented and amendments to fund documentation?
- Will additional investor and regulatory notifications or consents be required?
- How will you set up the project working group, and what is the budget for your ESG project?
- How will you engage senior management and other stakeholders internally?

07 Risks

- Which rules and regulations, ethical industry standards and other best practice and frameworks should you review and benchmark your company against to ensure that you are accurately reflecting your ESG investment performance and ratings?
- Are there proper audit procedures?

08 Engagement with regulators and partners

- How do you plan to engage with regulators and other players (e.g. index providers, data providers, fixed income issuers) in this space?

Best-in-class

Assets or investments that are the best performers amongst their peers in terms of environmental, social, and/or governance factors.

Engagement

The practice of seeking to influence the behaviour of a company in which a fund is invested in order to improve their environmental, social, and governance practices. For instance, engaging with a company's board in order to improve that company's labour practices.

Environmental, social, governance (ESG) factors

Identifying traits of a security that may not have been taken in to account by that security's price, but which may affect its desirability from both a non-financial and a financial point of view. For example, accounting for a company's carbon footprint when deciding whether to invest in that company.

Ethical investment

Using one's ethical principles as the main filter for securities selection. Ethical investing depends on an investor's views: some may choose to eliminate certain industries entirely or to over-allocate to industries that meet that individual's ethical guidelines.

Green investment

Investment activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, or other environmentally conscious business practices.

Impact investing

Investments made in order to deliberately create social goods. For instance, investing in a for-profit company which makes affordable water purifiers for the developing world.

Responsible investment (RI)

An umbrella term describing the formal integration of ethical, social, or sustainability considerations into investment decisions.

Socially responsible investment (SRI)

A screening process which excludes certain securities from a portfolio based on perceptions of their moral worth, their environmental impact, or other non-financial considerations. For example, the exclusion of cluster munition manufacturers from an investment portfolio.

Sustainable investment

An investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management.

Sustainability risks

Risks to the value of an asset occasioned by environmental, social, or governance issues. For instance, the price of an equity declining due to fines levelled against the issuer for environmental damages.

United Nations Principles for Responsible Investment (UN PRI)

An agency that promotes responsible investment through a set of six investment principles that offer actions for integrating responsible investment into investment decisions.

Additional resources

AIMA has published a number of guidance notes, research papers and other documents to support members in the area of ESG. These include:

- **AIMA Policy and Practice: ESG Considerations at Alternative Investment Management Firms** (15 January 2020)
- **AIMA Responsible Investment Policies for Hedge Fund Firms** (15 January 2020)
- **AIMA Responsible Investment Primer** (01 May 2019)
- **AIMA's Due Diligence Questionnaire for Responsible Investment**
- **AIMA: From Niche to Mainstream**
(a research paper created in partnership with Cayman Alternative Investment Summit, examining the state of responsible investment in the hedge fund industry.)
- **AIMA: Perspectives: Industry Leaders on the Future of the Hedge Fund Industry**
(a research paper exploring the future of the hedge fund industry, which discusses how responsible investment might affect the industry.)
- **AIMA: Letter to IOSCO on Issuer Disclosure of ESG Factors**
(a letter written by AIMA to IOSCO in support of its call for issuers to disclose materially relevant ESG factors.)

Disclaimer

The contents of this primer are not intended as legal advice. Due to this dynamism of this field the meaning of some key concepts may change over time.

The Alternative Investment Management Association Limited (AIMA) 2020.