# ESG takes centre stage


**Pat-Nie Woo**
**Partner,**
**Business Reporting and Sustainability, Hong Kong**
**KPMG China**
pat.woo@kpmg.com
+852 3927 5674


With the environmental, social and governance (ESG) space developing rapidly, it is now essential for senior executives to adopt a proactive approach to ESG as it moves from the sidelines into the corporate mainstream. As the landscape changes, it is imperative for corporate leaders to get up to speed with how ESG may impact their organisations. Investors will start holding boards and executives to account.

The onus is falling particularly on asset managers in charge of large sums of public money, such as pension funds. If you're looking after public money and that public money is doing harm to the environment or society, that is potentially a huge reputational disaster. At the very least, adopting a comprehensive ESG strategy is sound risk management.

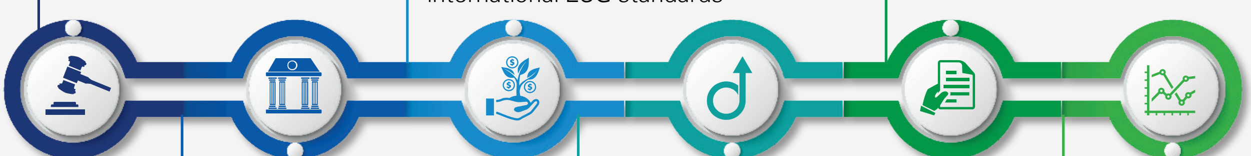
This sense of urgency is now hitting home. I have been in this field for over 12 years now, and for 10 of those, sustainability was seen as a nice-to-have, an add-on that wasn't mission-critical. Those days are over; it is now one of the most important trends in finance.

Regulators in Hong Kong are keenly aware of the scale of the challenge and there has been a flurry of activity in this area. As a member of the Financial Services Development Council here in Hong Kong, last year I was tasked with chairing the Working Group on ESG strategy. We made six recommendations focused on developing a sustainable finance ecosystem in Hong Kong and creating the business case for companies to do better in ESG. I am optimistic our city can be a global leader in this space: Hong Kong is lagging, but is not behind by a large margin, and Hong Kong funds are serious about getting to grips with ESG. At the very least asset managers are acutely aware of the pressing need to adopt ESG investment frameworks to attract money from global asset owners, including pension funds and sovereign wealth funds.

[i] http://www.fsdc.org.hk/sites/default/files/ESG%20paper%20%28Eng%29_Final_0.pdf page 4

***The six ESG recommendations adopted by the FSDC in November 2018[i]:***

1. The Government to take the leadership role in encouraging public funds' support for ESG integration
2. The Hong Kong Monetary Authority (HKMA) to scale up ESG requirements on their external investment managers
3. 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
4. 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'
5. The SFC and the other regulators to provide more guidance on ESG thematic investment products
6. The Stock Exchange of Hong Kong (SEHK) to strengthen the emphasis on ESG for both listing applicants and listed companies



In Asia, Japan is regarded as a role model in this field: its sustainable finance market saw dramatic growth from just USD 8 billion in 2014 to over USD 2 trillion in 2018.[ii] What changed was the decision in 2017 by Japan's Government Pension Investment Fund (GPIF) – the world's largest pension fund with assets of USD 1.4 trillion – to move into the ESG investment space.

As suggested in the FSDC paper, Hong Kong could also use its public funds to catalyse the ESG market. The biggest asset owner here is the Hong Kong government: the Exchange Fund has HKD 4 trillion under management and any comprehensive move by HKMA, which manages the fund, to adopt ESG investing principles would have a powerful knock-on effect. When assets owners take action, asset managers have to respond, triggering movement from the corporates to embed ESG principles into their strategic framework.

But while the culture around ESG is changing, some fundamental aspects of the subject are still not well understood. Many people still look at ESG from the perspective of impact investing or sustainability-themed investing, even though this accounts for a very small part of the market. The biggest single segment, accounting for USD 20 trillion of the total global sustainable finance market, is *negative/exclusionary screening*, which includes Sharia finance. However, the segment which is seeing the strongest growth is ESG integration. This can be broadly defined as the systematic inclusion of ESG issues into investment analysis and decisions, although it does not mean every investment decision is affected by ESG decisions or traditional financial criteria are ignored.

Overall, all classes of sustainable finance are seeing strong global growth, with the value of assets under management rising from USD 23 trillion in 2016 to USD 31 trillion in 2018, according to the GSIA Global Sustainable Investment Review 2018.[iii] As capital starts flowing in this direction, there is an acute need for better data, improved data integrity and stricter rules. And ESG must be embedded into companies' strategy, be it on the corporate side or the asset management side.

At its heart, sustainable finance should be about attracting investment, improving performance and mitigating long term risk. It is not about shrinking the investment universe. Certainly for carbon intensive industries, the cost of capital will increase, and we are already seeing some companies finding it more difficult to roll over certain loans if they have exposure to these sectors. The move in mainland China and globally towards a low-carbon economy – with associated changes in markets and regulations – will also introduce significant transitional risks and what is known as stranded assets. For example, coal-fired power plants will be decommissioned early, creating an asset write-down not just for the operator but all the companies that have provided financing to that operator, including investors, banks and insurance firms. And this does not just concern the electricity-generating sector, but other sectors such as the automotive industry, the aviation industry and the maritime industry.

Indeed, the cost of capital could become an issue for any company which does not integrate ESG principles. Banks are coming up with supply chain financing strategies that link a supplier's cost of finance to its sustainability performance. This could mean some suppliers who score poorly may find financing a lot more expensive.

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[ii] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf page 8

[iii] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf page 8

Sustainability is becoming intrinsic to businesses across a host of sectors from food to fashion. Companies should regard it as central to their future: for example your sustainability as a supplier will start impacting your clients' ESG performance and their ability to attract investors and financing.

There are concrete benefits to adopting ESG standards. Meta-research from Oxford University and Arabesque Partners[iv], which analysed more than 200 reports, showed a strong correlation between sound sustainability practices and lower costs of capital, better operational performance and strong stock price performance. This research was conducted in 2015, and with incentives now being more aligned between ESG performance and business performance, I would expect this correlation to be even stronger today.

The narrative around ESG has significantly changed. It is now a key metric that directs the flow of capital: boards and C-suites must keep a close eye on developments.

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[iv] https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf

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