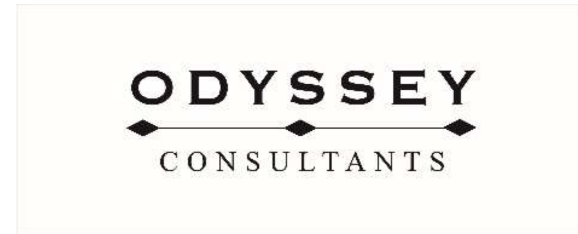


The Basics of ESG and ESG Reporting

October 2022

This is the first in a new series of articles on ESG. This article was prepared in collaboration with Mr. Manoj Dani of Odyssey Consultants Limited who participated in a podcast interview (Business Updates Podcast) with us.

ESG – THE BASICS

There is an increasing trend for businesses in Hong Kong, as well as worldwide, which are incorporating ESG principles and embedding sustainability as their corporate strategies.

In Hong Kong, this is driven by the ESG reporting requirements for all listed companies laid down by the Hong Kong Stock Exchange (**HKEX**), joining with other exchanges such as New York Stock Exchange and London Stock Exchange, so as to raise the sustainability standard to the global level.

1. What does ESG stand for?

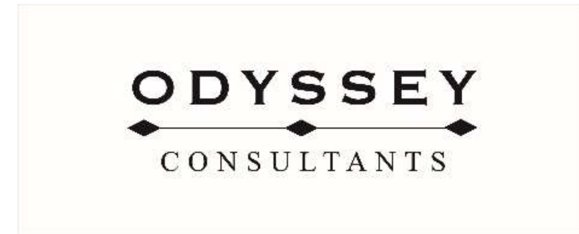
ESG stands for environmental protection, social responsibility, and governance.

ESG now serves as a fundamental assessment standard used by investors and asset managers to evaluate both material risk and determine growth opportunities of investee companies.

- Environmental criteria encompass energy, carbon emissions, climate change, use of natural and water resources, waste discharge and every aspect of how companies affect the environment and how the environment, in turn, affects companies.

- Social criteria address the relationships with employees, employers, clients, and supply chain constituents, including labour relations, health and safety, diversity and inclusion. These relate to both Social (internal) and Societal (external) stakeholders.

- Governance criteria represent internal mechanisms and decision-making procedures by the board of directors and senior management. Governance criteria include board ethics, conflicts of interest, structure,



and diversity of board members. A key issue is the level of independence and accountability of board members.

2. Why are ESG factors so appealing to businesses? Other than compliance obligations, what are the other incentives for companies to integrate ESG?

Investors assess companies based on their holistic performance, long term sustainability and societal impact, thus ESG values must be considered. Asset owners and investors need to become stewards of their own capital.

When embracing ESG as part of a fundamental investment strategy, investors are exploring how these ESG drivers are able to translate into finding value in companies, which might eventually lead to improved corporate performance.

Many formal studies show a positive correlation between higher ESG standards and better financial performance. If companies can demonstrate strong ESG risk awareness, it can contribute positively to corporate investment performance and minimize unnecessary investment risks in the long term.

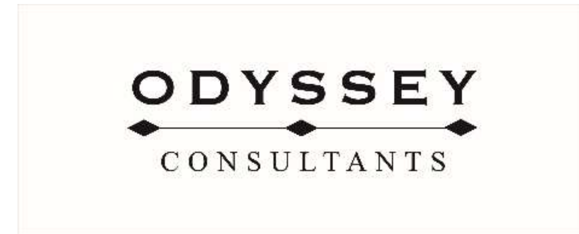
As ESG practices might lead to sound corporate performance and have an impact on reputational risk, it is why, on the legal side, European regulators are pushing for robust implementation of ESG factors within the financial sector and for most corporates.

For reputational risk, several institutional investors, pension funds and endowments are increasingly demanding ESG assessments and reports of their fund managers. Obviously, no investment committee member wants to be caught out with reputational risk on investment decisions they make, which might come back to haunt them in the future.

3. We have heard of the need to integrate sustainability. Why is this important?

Integrating sustainability is a way to show stakeholders that your business stands for something, that it has a purpose beyond just making a profit, and in demonstrating the values and the impact they have on people, the community and the environment.

One inspiring example is where the founder of Patagonia recently transferred 98% of the company shares to an irrevocable trust with the intention of “growing purpose”, not just “growing profit”. All of Patagonia’s future profits are being allocated to combat climate change. Investors see this as an extraordinary gesture and the financial market is certainly paying attention.



Many fund managers have demonstrated that sustainability factors contribute to financial performance. For example, a simple metric they measure through employee surveys might show a more motivated and productive workforce helps cement better performance. They understand that a strong culture of diversity and taking care of employees typically helps to grow value in companies. It is one thing for a company's management to claim "our people are our greatest assets", it quite another to genuinely support, engage, and train employees for sustainable employment and operational success.

There are also brand and reputational advantages to being a leader in sustainability with meaningful capital flowing to ESG-oriented companies, while the opposite is true. Companies that are inadequate in accounting for material ESG risks are likely to face increased costs of capital and lower valuations.

4. What is ESG Investing? Why has it become more important among asset managers?

A small group of ethically driven investors initially led ESG investing as a type of sustainable investment. It later progressed into mainstream ESG considerations that investors look at to assess companies.

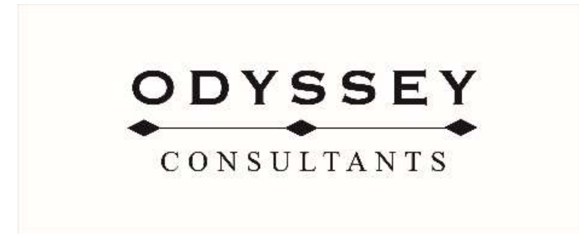
Asset managers consider ESG integration as a key investment strategy expected by investors. At the start, it took the form of mere norm-based or values-based exclusions. Now, we see key investors demanding the ultimate form of ESG investing, being impact investing.

For fund managers in Hong Kong, the Securities and Futures Commission revised the Fund Manager Code of Conduct, making it a requirement to take climate-related risks into consideration and make disclosures in their investment and risk management processes when managing ESG funds and climate-focused funds.

5. Why is there so much concern among companies on climate risk?

Scientists believe there is a strong link between severe droughts and climate change impacting the world's largest economies.

When the Chinese province of Sichuan announced it would extend industrial power cuts and activate its highest emergency response, this negatively impacted factories and manufacturing facilities, causing supply concerns. The



vital Yangtze, the longest river in Asia, reached its lowest level on record for August 2022, affecting hydropower supply and causing widespread shortages.

On the flip side, environmental stresses have the potential to drive innovation and opportunities – the silver lining being that these have the potential to propel countries like China to fast track its sustainable green power market to ensure reliable water, green electricity and green infrastructure development.

In Europe, cargo ships have had to reduce their loads because of the Rhine's low levels. Italy recently declared a state of emergency along its important Po river valley, which produces around 40% of the country's food, including wheat and tomatoes. The Po valley has barely seen any rainfall for around four months.

Separately, Arizona and Nevada will probably cut their water allocations by up to 20% next year because of the increasing mega-droughts in the Southwest.

6. What does climate impact mean?

Companies need to be aware of the critical risk of climate impact, which could mean:

(1) Higher energy prices as hydro and nuclear power are reduced given the lower levels of water;

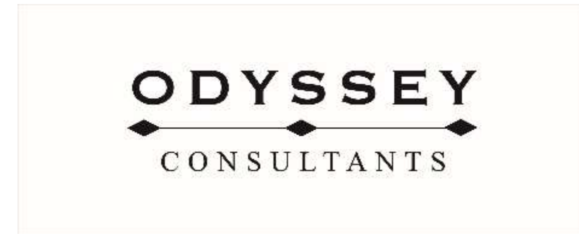
(2) Higher transport costs and supply chain disruption could also raise food prices, adding to inflationary forces and squeezing a global trade system that was already under pressure from the coronavirus pandemic;

(3) Legal risk of externalities—shipping delays impact trade payments, leading to litigation. Climate risk causing natural disasters means insurance costs and litigation on claims will probably increase.

Asset managers are embracing Net Zero but there are many challenges along the journey, such as:

Gaining buy in—Sustainability managers often ask "How do I get the rest of the business on board, particular senior management?".

There is plenty of compelling evidence that investors, employees, and customers want businesses to take action on climate change. They know that inaction is a



key business risk and that there is great commercial opportunity in action – what is good for the planet is good for business in the long run.

The second challenge is **ESG data collection and ESG reporting**. With new reporting regulations, companies can spend most of their time collecting data and reporting, which may come at the expense of unified efforts to drive real change.

7. What drives some asset managers to be net zero in their portfolio holdings?

One example is Odyssey's asset manager client based in Singapore and London who aims for all their funds to reach net zero by 2050.

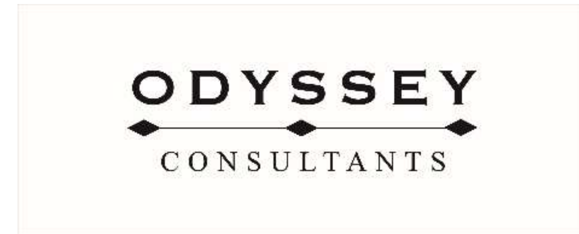
They began this process by tracking and pricing the carbon footprints of their portfolio holdings for nearly a decade. Whilst their internal analysis showed their holdings were lower in carbon footprint relative to peers, they recognized that disclosure fell comparatively short. This inspired the team to continue strengthening their investment decision-making process to be more mindful of the urgency of climate and societal impact. They firmly believe that regular engagement with portfolio companies' management is a more proactive and meaningful approach to ensure their business strategy contributes to a more sustainable planet, society and governance model.

Engagement, they assert, also drives better transparency and disclosure and would eventually lead to the point of zero emissions from business operations. This outcome and purpose-driven ethos drives this asset manager's entire investment and engagement process.

8. What are the existing ESG reporting frameworks? How do these frameworks facilitate ESG compliance?

On ESG reporting, global bodies are planning increasingly higher standards to help companies incorporate ESG factors into their investment process. These institutions include Task Force on Climate-related Financial Disclosures (TCFD), United Nations Principles for Responsible Investment (PRI), and Global Reporting Initiative (GRI). One other to look out for will be the IFRS Foundation's International Sustainability Standards Board (ISSB), which will build upon the SASB Standards.

9. What are the requirements for ESG reporting in Hong Kong?



HKEX has tightened reporting requirement for listed companies, ESG reporting has become mandatory for listed companies as of 1 July 2020.

HKEX has set out ESG reporting guidelines regarding appropriate disclosure of companies' environmental, social and governance impacts, with the goal of championing a sustainable global economy.

The *HKEX ESG Reporting Guide* set out in Appendix 27 the Comply or Explain provisions on the Exchange Listing Rules means that a company's board is responsible for effective governance and oversight of ESG matters, and they need to assess and manage material environmental and social risks.

10. Should ESG be more than a reporting framework?

Companies are advised to approach ESG more than just for reporting, rather for genuinely integrating ESG into business operations and communicate the firms' ESG initiatives to other stakeholders authentically, demonstrating their actual execution of ESG practices and avoiding "greenwashing".

In commercial and M&A transactions, potential acquirers integrate ESG elements into their decision-making and due diligence process, including anti-bribery, environmental compliance and data privacy.

For example, private equity investors or private debt funds consider ESG considerations when calculating valuation factors and determining a company's ability to service its debt.

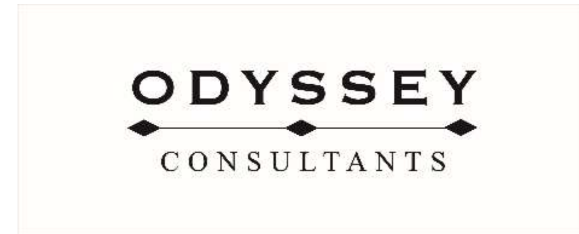
The higher the ESG risk, the higher the reputational risk, the higher the discount factor and the higher cost of financing for a company.

11. What are the challenges and hurdles to ESG compliance?

It is widely accepted that ESG and sustainability practices bring sustainable investment returns, but care and attention to avoid the risk of greenwashing is required, which conveys misleading information about the environmental impact of a company's operations.

The relative inadequacy of internal audit and compliance teams in addressing ESG issues or in monitoring ESG-driven mandates poses yet another challenge.

Corporate boards must take the lead on instilling ESG in a company's culture, and to ensure the compliance team has adequate training and resources to



ensure practice of ESG policies. Consolidating strong corporate ethics can no longer be missing when companies deal with sustainability issues and ESG risk mitigation.

12. What are the best practices adopted by investment managers?

Some investment managers integrate their ESG assessments into their investment process by partnering with non-government organizations (NGOs) in order to adopt more quantifiable and realistic goals in the investment process.

Other investment managers disclose their metrics when determining the social or environmental impact they have through engagement.

To truly embed ESG, it requires cultural buy-in and a deep commitment to incorporating ESG values from all levels of the company. This takes time. Companies that score highly on ESG factors are long-term sustainable companies and typically perform well.

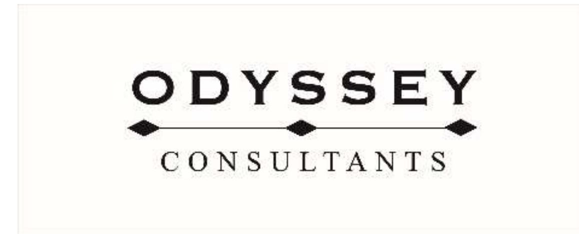
13. What is the most unique development related to ESG you've seen at an investment manager recently?

Some of our asset management clients are taking proactive and decisive steps.

One unique development is the Sustainable Investing Open Access Initiative by our former client, a Dutch asset manager (with also local Hong Kong presence). Their initiative entails opening up their Sustainable Investing Intellectual Property. As a first step, clients and academics will gain free access via a portal to the Sustainable Development Goal (SDG) scores of companies this asset manager has generated using their proprietary SDG framework.

The asset manager actively seeks for feedback on the data, and is in an ongoing dialogue with its stakeholders, clients and sustainable investing experts. As a result, the company expects that this initiative will further enhance the robustness of the data and their methodology.

Traditionally, asset managers protect intellectual property and use it to add value to their proprietary investment processes. Yet the massive challenges our planet is facing require a different approach, and this manager believes there is a need to join forces to address these challenges properly. They take the position that opening up their intellectual property and SDG data helps foster greater transparency and quality of data.



14. What is the way forward for ESG investing?

There is a need for more reliable data and more ways to measure forward-looking data.

Every investor wants reliable ESG data yet there is currently a glaring gap in quality and reporting of such data. We hope to see greater market impetus to standardize and strengthen ESG data.

ESG reporting remains fragmented and will increasingly become regulated in terms of disclosure, as stakeholders scrutinize companies are for claims made. The quantity and quality of disclosure will improve as global standards like those from the ISSB are introduced and frameworks like TCFD become mandatory. There is a strong argument that regulators need a harmonized market standard for disclosure.

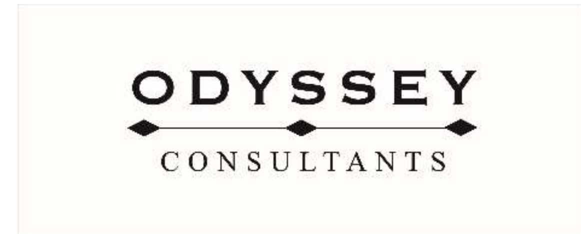
Global regulators have already started tackling greenwashing and this will evolve from addressing blatant forms of misconduct to substantiating an investment manager's nuanced approaches, such as impact and outcome-based investing.

Corporates and investors will continue to focus on key issues like business ethics, climate change, supply chain processes and modern slavery with a growing emphasis on energy, resource and food security given the macroeconomic challenges the world is facing.

15. What advice would you give companies to better integrate ESG values?

First, companies should start early and build on their sustainability initiatives. It helps to have dedicated resource in sustainability (such as a Chief Sustainability Officer) and ensure they are properly integrated in the business, with direct reporting lines to the board.

There will often be imperfect data in this space, but it is still worth providing what one can to improve the quality of disclosure and transparency.



Second, companies should approach ESG more than just for reporting but to integrate ESG into business operations and they must communicate their ESG values and initiatives to other stakeholders authentically. It is all about actual execution of ESG practices and not the veneer of "greenwashing".

Third, companies should implement a clear ESG communication strategy and keep communicating with authenticity.

Please reach out to Odyssey Consultants Limited directly (#LinkedIn), or us at M.B. KEMP LLP (https://www.kempllp.com) if you have further questions.

Manoj Dani, CPA CAIA CESGA®, Odyssey Consultants Limited

Since 1999, Manoj Dani has served as a corporate adviser and respected coach to global asset managers, hedge funds, financial institutions, international law firms, FinTech, and Fortune 500 corporations on how they communicate and present better; how they win business pitches; how they strengthen risk and compliance frameworks, and how they develop winning strategies. In the last 14 years, one of his focus areas has been on how companies across the globe communicate their ESG policies and embed ESG in their investment and engagement processes.