Sustainable investment in Asia

Shifting Asia
Dear reader,

Few would have forecast a few years ago that China would emerge as the world’s second largest green bond issuer in 2018, just two percentage points behind the US; or that Abenomics would transform Japan into the world’s fastest-growing sustainable investing (SI) market with a similar assets under management (AUM) penetration to what the US had in 2014; or that in 2019 Asia would have more stock exchanges with mandatory environmental, social and governance (ESG) reporting than any region in the world.

Attitudes toward sustainable investment in Asia have changed radically in just a few years. And while it has become evident that governments must lead in Asia to produce meaningful change to sustainability challenges, there has also been indirect pressure from the wider public on governments and corporations, particularly on issues relating to climate change and air pollution, which affect people every day in Asia’s cities.

A key driver of Asian governments’ recent policy shift toward SI has been the realization that sustainability linked investment can help tackle broader policy concerns; from shrinking labor forces and slowing economic growth, to migration and infrastructure, climate change and low-carbon world transition risks. To this end, sustainable finance and investment are being harnessed to support key government policies, be it to strengthen corporate governance to stimulate corporate profitability or to fund the infrastructure expense burden with green finance initiatives.

Asian state asset owners ranging from Japan’s government pension investment fund to the Hong Kong Monetary Authority (HKMA), Singapore’s GIC and the Thai Government Pension fund, among others, have led the SI drive by leading through example: integrating sustainability into their own investment process and obliging their investment managers to follow suit. Many have also backed regulators to enhance corporate stewardship and governance code frameworks and enforced ESG disclosure reporting. The HKMA, which regulates the Hong Kong financial system and manages an HKD 4 trillion Exchange Fund, is a case in point; it has been uniquely positioned to put into practice what it has promulgated via new green finance and ESG regulation. Others, like Singapore’s Temasek, have adopted ESG into investment decisions strongly motivated by climate change risk.

Asian asset owners have embraced SI because of the rising acceptance that SI does not compromise financial returns or performance. For long-term investors, including pension funds and insurance companies, SI can lower downside risk from “stranded assets” created by climate change and transition risk. For credit investors, good corporate governance, the central pillar of ESG, can help lower credit risk. In emerging markets, ESG equity strategies have shown outperformance relative to broader benchmarks, which may be due to smaller perceived tail risks of companies with good corporate governance. For our clients, UBS advocates sustainable investment as a core strategy, because its approach makes sense from the perspective of long-term capital preservation.

Sustainable investment is developing rapidly in Asia and with it the breadth and scope of local SI products is improving. The boom in green bonds in particular reflects pent-up demand for investment opportunities in environmental themes, which have strong regional resonance. UBS advocates that clients adopt a portfolio approach to sustainable investment across all asset classes, both liquid and long term. Investors planning legacy assets may consider “impact investing” via private equity or direct investment, which establishes a more direct link between the investment and the measurable social and/or environmental impact.
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Sustainable investment in Asia is poised for rapid growth as government policies increasingly address the growth risk from shrinking labor forces, climate change, the transition to a low-carbon world, inadequate infrastructure, infrastructure funding and the health burden from air pollution. In the last three years, Asian asset owners signed up to the UN’s Principles for Responsible Investment (PRI) have surged, with the overall AUM rising to USD 5tn, almost a quarter of the world’s top 100 asset owners’ AUM.

Japan exemplifies how markets can rapidly catch up with the rest of the developed world. When Japan’s USD 1.4tn national pension fund championed ESG investing in 2014, as a means to improve corporate profitability, Japan SI assets reached 18% of total assets (equivalent to the US in 2014) within just three years. Others are following suit: Hong Kong’s HKMA, which manages a USD 513bn Exchange Fund, is soon to be a UN PRI signatory; Thailand, Malaysia and Korea’s national pension funds, with a combined AUM of USD 866bn, have become UN PRI signatories and are espousing critical top-down regulatory change. In Singapore, climate change risk mitigation has been a strong driver of asset owners Temasek and GIC’s stewardship and ESG investment processes.

Asia is the world’s most vulnerable region to rising sea levels, as most of its economic output is concentrated in coastal megacities. Inadequate attention to climate change risk could cost its economy at least USD 2.8tn, excluding transition risk costs. This is raising the TCFD (Task Force on Climate-related Financial Disclosures) climate-related risk of Asian corporates and their Asian asset holders and spurring tightened environmental regulatory disclosure across the region. Eight Asian stock exchanges have mandatory ESG reporting standards, more than any other region in the world. Hong Kong and Singapore are enhancing and wire-tightening the quality of ESG data and disclosure, paving the way for a broader suite of ESG products and expanding SI markets.

Asia is estimated to require annual investment of at least USD 1.7tn in infrastructure to sustain current economic growth rates. In an increasingly low-carbon world, we expect to see this investment contribute to expansion of green financing and green bond markets. China’s green bond market has ballooned in just three years to become the world’s second largest, just 2 percentage points behind the US. Asian green bond annual issuance, driven by the region’s extensive infrastructure funding needs, could soon triple to USD 150bn, in our view. Hong Kong and Singapore, which are fast developing as offshore green finance hubs and are quickly scaling their sustainable investing capabilities, are well positioned to capture this growth.

China’s aim to lead the world in low-carbon technologies, such as electric vehicles and renewable energy, is partly motivated by its own severe air pollution problems, which raise the national health burden. This creates a strong incentive to expand its low-carbon initiatives, both technological and financial, across the 60 developing countries within its Belt & Road Initiative; these markets are forecast to contribute 50% of the world’s CO₂ emissions by 2050. This should further catalyze the growth of green and low-carbon financial markets beyond its own borders and across Asia.

Sustainable investment in Asia is clearly developing its own narrative, with deep investor concerns about air quality, health and environmental issues related to climate change. Asian millennials also show positive attitudes to consuming in a responsible way. A rising acceptance that sustainable investments do not compromise financial performance is creating an awareness that one can invest in a manner that also addresses one’s own particular sustainability concerns. UBS advises its clients to engage sustainable investing through individual asset classes or adopting a multi asset portfolio approach. Impact investing also offers a clear link between investment and measurable social and/or environmental impact through private equity or direct investment.
Introduction

Asia embraces sustainable investing

“Our challenge is to help more people to make healthy money, ‘sustainable money,’ money that is not only good for themselves but also good for the society.”

Jack Ma
Former Chairman, Alibaba
In Asia, sustainable investing (SI), the incorporation of environmental, social and corporate governance (ESG) considerations into investment decisions, is entering a new and exciting era of growth. According to the Global Sustainable Investment Alliance (GSIA), between 2012 and 2016, SI assets in Asia grew from USD 40bn to USD 526bn, driven mostly by Japan. From 2016, following the merger of UN Principles for Responsible Investment (PRI) and the Association for Sustainable & Responsible Investment in Asia, GSIA ceased to publish a breakdown of Asia ex-Japan SI assets. SI assets as a share of total assets in Japan rose from 3.4% in 2016 to 18.3% in 2018, the same level of penetration that the US reached in 2014. Although statistics tell us that Asia’s ESG story has so far been limited largely to Japan, we argue in this paper that the Asia ex-Japan region, like Japan before it, is poised to catch up fast, propelled by a similar institutional approach to sustainable investing led by governments, which increasingly view sustainable investing as compatible with their own long-term policy direction.

The push for sustainable investing in Asia has historically been driven by European asset owners and signatories to the UN PRI (launched in 2006), particularly sovereign wealth and pension funds. In more recent years, this has shifted with Asian asset owners starting to emerge with regional models for sustainable investment, as reflected by the sharp growth in local signatories to the UN PRI.

A key driver for Asia has been Japan, which since 2017 led the drive into sustainable investment through the Government Pension Investment Fund (GPIF). The Japanese government-led model is in many aspects suited to Asia due to its centralist government approach, and is a working model that asset owners and investment managers in other Asian countries could replicate. Hong Kong is already considering following elements of the Japan model, with the Hong Kong Monetary Authority’s reserve fund engaging in SI and about to complete the PRI signatory application process. Other Asian governments, like Singapore’s, are also seizing the initiative, particularly in the area of regulation, banking and green financing.

SI best practices developed by global institutions and based on developed markets have often set the precedent and provided frameworks for Asia to follow. Examples include the PRI, a framework for investors; the Global Reporting Initiative (GRI) and the Sustainable Accounting Standards Board (SASB), both of which help corporations improve their transparency to investors on ESG issues; and the growth in the availability of ESG research and ratings from both established and new specialist data providers such as MSCI, Sustainalytics and ISS, helping investors to integrate ESG considerations into investment processes. While these bodies have been around for many years – the GRI for example was founded in 1997 – the growth in ESG invested assets in Asia has only taken off more recently as investors (and governments) respond to a set of increasingly daunting domestic challenges. These include slower economic growth; rapidly ageing societies, particularly in Japan; the need for infrastructure investment to sustain economic growth, particularly in Asia’s emerging markets; Asia’s high vulnerability to climate change; and the environmental, particularly clean air, impact of breakneck urban growth and migration in many Asian countries.
Chapter 1

Sharp rise in Asian UN PRI signatories

“We owe it to future generations to put our planet on a sustainable footing”
Lim Boon Heng
Chairman, Temasek
Although the GSIA, the industry leader in monitoring SI assets globally, has stopped gathering data on SI assets for Asia ex-Japan, the continued growth in SI in the region is evidenced by the sharp rise in the number of PRI signatories and their assets under management (AUM). This augurs well for the future growth of SI assets in the region. Recent signings by asset owners like AIA in Hong Kong, the Employee Provident Fund and Khazanah Nasional Berhad in Malaysia, the Thailand Pension Fund, and Chinese asset managers Harvest Fund Management, China Asset Management, E Fund Management and Bosera Funds have propelled PRI signatory AUM in the
Chapter 1 – Sharp rise in Asian UN PRI signatories

region to USD 2.9trn as of July 2019. Meanwhile, the strong momentum in Japanese signatories has continued since the GPIF (the world’s largest pension fund) became one in 2015. Total PRI subscribed AUM in Japan reached USD 8.8trn as of July 2019, with notable growth in 2019 driven by new asset owner signatories Sumitomo Mitsui Trust Bank and Sumitomo Life Insurance, which together added USD 784bn in new PRI subscribed AUM. Total AUM signed up by Asian asset owners is now equivalent to half of the AUM of the world’s top 20 asset holders.

PRI signatory AUM is not the same as dedicated ESG-managed AUM; one can also have ESG managed assets and not be a PRI signatory like Singapore asset owners GIC and Temasek, and PRI signatories don’t always offer strategies that are dedicated to ESG (though many do). Nonetheless, for many asset owners and investment managers, being a signatory forms an important first step to engaging with SI due to the requirement that a responsible investment policy covers 50% of AUM within two years (see grey box on UN PRI on page 11). Most commit to move toward SI for all of their assets, but may start with a single asset class, usually long-only equity as this is the asset class that has the resources and support available for integrating ESG considerations. Some Asian asset owners, like China’s Harvest and the Thai Pension Fund, are rapidly applying SI approaches across their entire portfolio and asset allocation.

PRI signatory AUM in Asia still has plenty of room to grow. Some of the region’s largest asset owners, with a total AUM of USD 2.7trn, have yet to sign and there are less regional investment manager signatories. In Asia, the challenge to becoming a UN PRI signatory is the PRI requirement to provide reporting on two-thirds of SI assets, including AUM and asset allocation breakdown. Some Asian asset owners may not be quite ready to take this step for strategic reasons despite already having their own internal ESG investing policies. For sovereign wealth funds, the PRI has introduced a waiver for this requirement and plans to introduce separate reporting requirements for banks, which may resolve some of the pushback to signing up in Asia.

As Japan has shown, when leading state asset owners become signatories, it can set off a chain reaction with other state and private asset owners following suit. After signing the PRI, the GPIF started requiring external managers to establish ESG investing frameworks and guidelines (refer to interview with the HKMA’s Kim Chong on page 12).
Chapter 1 – Sharp rise in Asian UN PRI signatories

What are the United Nations Principles for Responsible Investment?

The Principles for Responsible Investment (PRI) is an independent investor initiative supported by the United Nations. The six Principles for Responsible Investment are a voluntary and aspirational set of investment guidelines:

- **Principle 1**: We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2**: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3**: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4**: We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5**: We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6**: We will each report on our activities and progress towards implementing the Principles.

These principles were developed by and for investors to help them incorporate ESG issues into investment decisions, thereby helping build a sustainable global financial system benefiting the environment and society as a whole and enabling long-term value creation.

Becoming a signatory to the PRI is a public demonstration of an organization’s commitment to the mission. Signatories are asset owners, investment managers and investment service providers. Asset owners include pension funds, sovereign wealth funds, foundations, endowments, insurance and reinsurance companies and other financial institutions that manage deposits. Investment managers are organizations that manage third-party assets, and service providers offer solutions or services to assets owners or investment managers.

To maintain PRI signatory status, organizations are required to pay an annual membership fee and, more importantly, to publicly report on their journey toward responsible investment through the PRI Reporting Framework. The first reporting cycle for a signatory is optional but highly encouraged for learning experience. Subsequently, it is compulsory for signatories to file an annual report to detail their progress. An audit procedure will determine if these organizations "walked the talk" by demonstrating the minimum requirements for responsible investing set out by the PRI. Such requirements include obligating half of a fund manager’s assets to be following the responsible investing policy. Signatories that fail the audit process are placed on a watch list for two years. During these two years, the organization must make improvements to meet the minimum requirements or risk being de-listed as a signatory. However, a de-listed signatory can regain signatory status should it complete its reporting framework.

Source: UN PRI www.unpri.org, UBS
What triggered the HKMA’s announcement of three new measures for sustainable banking and green finance in May this year? Is the HKMA already investing in ESG products as pledged in Measure 2?

I think the HKMA’s 7 May 2019 announcement on new measures for sustainable banking and green finance made very clear our stance and approach on the ESG issue to the public. The Hong Kong government announced its goal to become a green finance hub last year, and concerns over climate change and sustainability have grown very fast globally, partly driven by the Paris Agreement and the increased frequency of extreme weather conditions and their destructive effects around the world.

In terms of investment, the HKMA is already engaged in green bond and other green investments, including renewable energy and green buildings. We are giving more weight to ESG in our mandates, for example, by requiring external managers of Hong Kong equities and active China equity portfolios to comply with the Principles of Responsible Ownership issued by the Securities and Futures Commission in 2016 on a “comply or explain” basis. Other ESG implementation measures include incorporation of ESG factors in our credit risk analysis of our bond portfolio and examination of ESG policies and practices of our general partners as part of our due diligence of private market investments, among others. With the measures in place, we effectively adopt a guiding principle that if we were to choose between two investments with comparable risk-adjusted return characteristics, we should prioritize the one with higher ESG content.

The HKMA has an HKD 4trn Exchange Fund to manage. Are there any specific allocations to ESG investments?

We have adopted ESG integration in our approach to investment and have been weaving ESG factors into our investment process for both public and private market investments. On the issue of whether to pursue an asset allocation target for ESG investing, we are of the view that a bottom-up approach to sourcing appropriate ESG investments may be more appropriate – which means that we look into aspects of ESG content in our investments. The rationale is that ESG assessment is highly situational and project specific. Therefore, rather than adopting a one-size-fits-all threshold or benchmark to assess the ESG risks of a project, we tend to identify ESG factors that are relevant to a project and then assess their impact on the project for a better risk-adjusted investment decision. By looking deeper into specific projects or mandates, we would also try and avoid “greenwashing” investment proposals.
Do you believe Japan’s top-down ESG model is suitable for Hong Kong? What drives the ESG mindset in HK? Is it climate change, infrastructure, the environment or something else?

The GPIF’s engagement with ESG is very much aligned with Abenomics, its “three arrows,” and its focus on governance and diversity. In Europe, there is good public awareness, for example, of the risk of climate change and environmental issues, which have reached the trustees and boards of pension funds through concerned stakeholders. There is a growing environment-focused green finance movement in Hong Kong, which, together with the stewardship code launched in 2016, has become the main driver for the ESG trend here, from our perspective. With our unique role as the banking regulator and promoter of green finance in Hong Kong as well as an asset owner, the HKMA has a three-pronged approach to help promote ESG. Further, by supporting the Task Force on Climate-related Financial Disclosures, we seek to collaborate with like-minded investors to promote ESG standards in the investment process. In the banking sector, there are initiatives to develop a framework for greening the financial system. We have also established a Centre for Green Finance to promote and advise relevant parties on the subject.

We understand that the HKMA is in the process of becoming a UN PRI signatory. Do you expect many of your external managers or other Hong Kong asset owners to follow suit? What is the pushback to becoming a signatory in your view?

Yes, we are in the process of signing up to the UN PRI. In complying with the UN PRI requirements we expect all required public disclosures to be ready by 2021. The burden of disclosure might be one of the factors that asset owners consider before signing up to become a PRI signatory. We have included ESG factors in the selection, appointment and monitoring of our external managers. We want our external managers to take ESG matters seriously and we expect them to help us discharge our ownership responsibilities in the investee companies by adopting active ownership through voting and engagement activities. By becoming a UN PRI member we hope that other asset owners will be encouraged to become members, making green and sustainable investment a core aspect of their investment.
Chapter 2

Sustainable investing in Japan: A model for the rest of Asia?

“Innovation and corporate governance are extremely important to improve the profitability of Japanese companies”

Shinzo Abe
Japan’s prime minister

Mt. Fuji | Gettyimages
In September 2015, Japan’s JPY 160trn GPIF became a PRI signatory. The move set a precedent for the Japanese asset management community – the number of Japanese PRI signatories reached 57 in the following two years, a 68% rise, with combined assets managed under SI principles rising from USD 7bn in 2014 to USD 2.18trn in 2018. In July 2017, the GPIF made its maiden commitment to sustainable investing with a JPY 1trn investment in three listed ESG indices. This brought the penetration of SI managed assets as a share of total Japanese AUM to 18% in 2018, the same as the US in 2014, making it the world’s fastest-growing market for SI.

Japan’s remarkable success in growing SI assets in such a short time frame is impressive, all the more so in light of the fact that the Tokyo Stock Exchange still does not require mandatory ESG reporting (refer to SSEI table on page 22). Japan’s success can be attributed to the Financial Services Agency’s (FSA) launch of the Japanese Stewardship Code in 2014, which created the basis for the right corporate culture for asset owners and managers to engage with ESG issues. The new code encouraged sustainable investing practices, investee-client engagement and a “comply or explain” approach to the code. A year later in 2015, Japan introduced a new Corporate Governance Code, which, according to Natsuho Torii of the Japan Exchange Group, required corporations to take positive measures to address sustainability issues.

Since the GPIF cannot directly own Japanese companies by law, its stewardship activities focus on intermediaries or asset managers. The change in corporate culture from the new codes encouraged asset managers to not only improve their own governance, but that of their portfolio holdings while integrating long-term ESG factors into the investment process.

The Japanese sustainable investing approach has been a top-down one, aligned with Prime Minister Shinzo Abe’s economic policies (“Abenomics”). It’s led by a government asset owner and disseminated to domestic asset managers through a culture of corporate stewardship and governance supported by appropriate regulation. Can this model be replicated in other Asian markets? We believe so, as the strong state-policy-led economic management in most of Asia should enable such a top-down approach, although the drivers and motivation for establishing sustainable investment may be different.

In Japan, ageing demographics, a shrinking labor force and low corporate capital returns have necessitated a new corporate culture encouraging efficiency and a change in labor culture, elements which Abenomics has embraced. Improved corporate stewardship and governance fit well into this model.
Elsewhere in Asia, sustainable investing is likely to be driven more by infrastructure investment and green financing. China’s 13th Five-Year Plan (2016–2020), for example, includes the commitment to grow a green bond market and establish green development funds. Both Hong Kong and Singapore compete in the green financing market as regional financial centers. Indeed, the Hong Kong government seeks to become a “regional green finance hub” and Beijing plans to use it as a green financing center for Belt & Road Initiative (BRI) infrastructure investment. Thus, while asset owners and investment managers from outside Asia will likely continue to drive ESG investing trends in Asia as their own sustainable investment mandates rise, a key catalyst for a breakthrough in sustainable investing in Asia ex-Japan could, like Japan, be government-driven.

Recent developments, for example, in Hong Kong suggest that this is starting to happen. The HKMA, as both Hong Kong’s banking regulator and manager of the Exchange Fund, is well placed to implement what it espouses. As the HKMA’s Kim Chong explains in his interview on page 12, with the key measures for Sustainable Banking and Finance put in place in May 2019, the HKMA commits to putting responsible investment to practice by employing ESG factors in its credit risk analysis of bond investments, requiring external managers to comply with the SFC’s principle of Responsible Ownership, growing its green bond portfolio and investing in ESG-themed equities via ESG benchmark indices. These measures have close echoes of Japan’s GPIF approach, as Pat Woo explains on page 34. With an HKD 4trn (USD 512bn) Exchange Fund, ESG investment by the HKMA could catalyze the broader Hong Kong market toward sustainable finance. The HKMA has acknowledged that investing according to ESG criteria is now already part of its own and its external managers’ investment process. Hong Kong’s Mandatory Provident Fund (the pension fund), which manages close to HKD 1trn, and the Hong Kong Hospital Authority could potentially emulate the HKMA by integrating ESG in their investment decisions.
What has JPX been doing to encourage ESG investment in Japan and how do you increase understanding and appreciation of the impact of ESG?

In 2015, we created Japan’s Corporate Governance Code with the Financial Services Agency, which encourages listed companies to consider taking positive and proactive measures to address sustainability issues. Dialogue regarding ESG progressed, and in June 2018 the code was revised, clarifying that ESG issues should be included in “non-financial information” for reporting purposes. We also produced a Japanese translation of the SSE’s model guidance for ESG reporting that provides principles and points to consider when looking at ESG disclosure. We regularly collaborate with third parties, including arranging seminars and symposiums to share information among market participants and to identify what ESG information is useful for investors, and also take part in global initiatives such as the World Federation of Exchanges’ Sustainability Working Group. JPX develops and provides sustainability products such as ESG-based indices, including the Carbon Efficient Index and the Capex and Human Capital Index with S&P, and has launched a Green and Social Bonds Platform. We also spotlight companies that promote women’s participation in and contribution to the workforce and have a high appreciation for employee health and welfare, by publishing their names under “Nadeshiko Brand” and “Health and Productivity” stock selections.

What drives Japanese corporations to shift toward ESG? Have there been any key events or regulation changes?

In 2015, several key events took place that encouraged Japanese companies to embark on sustainability: the Paris Agreement, the adoption of the United Nations’ Sustainable Development Goals, and in Japan, the implementation of the Corporate Governance Code and the Stewardship Code. The GPIF, the world largest pension fund, announced that it would integrate ESG into its investment analysis and decision-making and became a signatory of the PRI in the same year. This had a significant impact on investors and asset managers, which in turn led corporations to be more proactive about ESG disclosure. All of these events have enabled companies to put emphasis on ESG issues and build ESG strategies over the last few years, including the Corporate Governance Code, which we believe has helped Japanese corporations establish efficient
and effective corporate governance in order to measure their business risks and opportunities and enhance long-term corporate value. Recently, we have seen significant improvements regarding ESG disclosure, and more and more companies have been endorsing the concept of ESG.

Mandatory ESG disclosure is applied in many markets in Europe and Asia. Is JPX also moving in the same direction? If not, why?

Each market adopts a different approach to ESG disclosure as each market has different regulatory, economic and social backgrounds. JPX believes voluntary disclosure is best for Japan in the current environment as each corporation is at a different stage of ESG development, with different opportunities and constraints. In addition, awareness of the importance of ESG management has already somewhat penetrated into corporations, especially large-cap companies that have established their own ESG disclosures. As Japanese companies are moving in the right direction, we seek to promote guidelines progressively rather than ask for compulsory disclosure. In the meanwhile, we believe the mutual understanding of both corporations and investors through dialogue is indispensable for further ESG development in Japan and we intend to continue encouraging this in the near future.

Japan is perhaps one step ahead of other Asian countries in sustainable investing. Do you think Japan will become a leader of sustainable investing in APAC in the future? Can the Japanese model be used for ESG investing in the rest of Asia?

All the members of the SSE acknowledge their role in fostering and promoting the development of a sustainable financial system. Not only in APAC but also globally, each exchange generates ideas, but instead of a few exchanges taking the lead they look for the best solutions together. As the exchanges are at different stages of market development, there is no such thing as a one-size-fits-all methodology or standard. Moreover, the elements of E, S or G may change over time. But some basic information concerning the environment, for instance, can be standardized globally. For example, the Task-force on Climate-related Financial Disclosures (TCFD) is likely to have a considerable impact in the near future. The TCFD’s recommendations provide a good framework for climate-related disclosure practices, and the number of supporter organizations is growing worldwide.

Any developments at ESG-conscious asset owners are always of interest. We work to constantly communicate with asset owners such as the GPIF as well as the government, and we share Japan’s developments with other exchanges.
Asian regulators drive sustainable investing

“The HKMA, in support of the mission to reduce climate change risks and to achieve sustainable finance, will launch three sets of measures”
Norman Chan
CE, HKMA
**Greater adoption and enforcement of stewardship codes**

Stewardship codes are guidelines for how an investor exercises corporate ownership and governance, including engagement with invested companies. The emphasis they place on good corporate governance leads many to believe that getting the “G” in ESG right is crucial for the creation of a sustainable investing culture. With corporate governance strengthened, it follows that attention to ESG issues by investors occur as a matter of corporate risk management and best practice implementation. Japan was one of the first Asian countries to introduce a Stewardship Code in 2014, which the GPIF actively embraced. Now seven jurisdictions across Asia have also established stewardship codes. In some countries this has been a response to high-profile corporate governance scandals.

In Malaysia, the Code for Institutional Investors was introduced in 2014 but has encountered challenges in that many leading institutional investors are owned by government-linked companies. Here the risk of corporate abuse related to domestic politics has been high, as seen by the 1MDB scandal. In Korea, the Stewardship Code was established in 2016, in part due to calls to strengthen corporate governance standards after several scandals including the Samsung-Cheil Industries merger and Hanjin Group events. Corporate stewardship, including active ownership and direct engagement (see pop-up box below), has received pushback in Korea, where it is often regarded as investor overreach and interference. The adoption of the code by the Korean National Pension Service, the world’s third-largest pension fund, in 2018 was broadly welcomed and closely followed by the exercise of its voting rights in leading Korean companies. In Hong Kong, although the Principles of Responsible Ownership were introduced by the SFC in 2016, only in 2019 has the HKMA led by example in forcing its external equity portfolio managers to comply with the PRO. In Asia, the effectiveness of stewardship codes seems to often depend on their adoption and enforcement by leading state asset owners.

**Asian regulators enhance ESG reporting standards**

While the emphasis on corporate stewardship as a practical top-down approach for establishing an ESG investing culture is growing in Asia, bottom-up development remains important as well – i.e. incorporation of ESG factors into the investment process, through research and portfolio construction. As the HKMA’s head of compliance, Kim Chong highlights in the interview on page 12 the availability of reliable ESG data can be a constraint to SI.

Access to ESG-related data on investee companies is important, as it allows investors to evaluate a company’s management of ESG risks and opportunities and engage meaningfully on ESG issues. Most Asian stock exchanges have signed up to the Sustainable Stock Exchange Initiative (SSEI), marking a commitment to promote SI and encourage better corporate management of ESG issues. Aside from top-down engagement activities by shareholders, regulators that enforce mandatory reporting on ESG criteria can help establish corporate awareness of sustainability issues. The “dialogue,” alluded to by Pat Woo in

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**The power of engagement**

Successful engagement can mitigate risk and enhance long-term shareholder value. It is most effective in concentrated portfolios where the investors can devote significant time to each holding and identify those companies most likely to be receptive to proactive investor involvement. Active shareholder engagement, directly with the company or by filing shareholder proposals, is a way of achieving positive impact by incrementally altering the behavior of targeted corporations for the better. A number of studies have documented that following ESG engagement strategies can lead to outperformance (Hopener et al. (2019) and Dimson et al. (2015))\(^\text{1}\).

\(^\text{1}\) Please refer to “UBS Sustainable investing: education primer: ESG engagement equities” dated 01 August 2018
his interview (page 34), that emerged between listcos and the Hong Kong Securities Exchange Commission after the latter introduced its May ESG reporting guide is a testament to this.

ESG data transparency has improved considerably in developed markets in recent years, particularly in Europe and the US as a result of the demand for information from investors. The availability of ESG data in Asia is still patchy, with many Asian countries still lagging Europe and the US in terms of transparency. However, the growth in PRI signatories and SI assets should provide a catalyst for improved data, greater availability of third-party ESG ratings, and ultimately a wider range of SI products, including investable ESG indices as well as other SI approaches (refer to “How to invest?” on page 42).

According to SSEI’s 2018 Report on Progress, of the world’s 16 stock exchanges that have mandatory ESG reporting requirements, eight are in Asia, the largest number of any region: Hong Kong, India (Bombay SE and NSE), Malaysia, Thailand, Singapore and Vietnam (Hanoi SE and Ho Chi Minh SE). By 2020 we expect more Asian countries to join this list, including China, Indonesia and the Philippines. And while quality and standards for ESG data in Asia is mixed, there is evidence it is improving with more detailed metrics, especially around environmental disclosure. In key markets like Hong Kong and Singapore, greater tightening of existing ESG reporting standards has occurred over the last 12 months.

Significantly, currently no Asian stock exchanges have sustainability bond listings. However, we anticipate this will change. Key asset owners like the HKMA are incorporating sustainable investing principles into bond investments – which should catalyze the development of sustainable bond products across the region.

Fig. 3

ESG reporting status of Asian exchanges

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock exchange</th>
<th>SSE Partner Exchange</th>
<th>Has report on sustainability</th>
<th>Requires ESG reporting from listed companies</th>
<th>Offers written guidance ESG reporting</th>
<th>Offers ESG related training</th>
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Source: UBS, as of September 2019
Chapter 3 – Asian regulators drive sustainable investing

China

Fang Xinghai, the Vice Chairman of the China Securities Regulatory Commission (CSRC), announced in 2018 that environmental information disclosure would be compulsory for all listed companies by the end of 2020. Currently, the only companies required to make environmental disclosures are those included in sustainable indices like the SSE Corporate Governance Index, companies in the Shenzhen 100 index, companies issuing shares both on- and offshore, and financials.

Hong Kong

In 2016, the HKEX (Hong Kong Exchanges and Clearing Market) introduced the “comply or explain” principle for reporting ESG disclosures. In January 2019, ESG disclosure requirements were further upgraded to require a more standardized reporting template. Five key performance indicators were introduced: key air pollutants, greenhouse gas emissions, hazardous waste production, non hazardous waste production and measures to mitigate emissions. In May 2019, the HKEX issued a consultation paper reviewing the new ESG reporting guide and tightening the reporting time line.

Singapore

The Singapore Exchange (SGX) introduced an ESG reporting timeline (2016–2019) on 31 December 2017. Sustainability reporting is on a “comply or explain” basis, with the first sustainability report made mandatory in 2018 and subsequently before July of each calendar year. Since last year more content reporting has been required, including a materiality assessment and the requirement to set targets with a “comply or explain” guideline. Sustainalytics reports that almost half of the exchange’s 200 listed companies have achieved strong ESG reporting status.

Thailand

ESG reporting began in 2012 and continuously improved from 2014–2018, with consultants reviewing standards. Thailand has been ranked in the top ten globally for disclosure rates. Significantly, in January 2019, the Thai Government Pension Fund became a signatory of the PRI and actively promotes an ESG network connecting the regulator, stock exchange and social security fund. Thailand offers an example of where top-down and bottom-up approaches have dovetailed nicely.
India

In India, it has been mandatory since 2012 for the top 500 listed companies to publish Business Responsibility reports as part of their annual reporting requirements. Eight-seven percent of reporting provisions in India deal with environmental issues. Although there have been no new requirements to ESG reporting in India, there has been a gradual improvement in the quality of reports – yet challenges remain.

Vietnam

Despite its status as a “frontier market,” Vietnam established guidelines for disclosing corporate responsibilities in 2016. Most ESG reporting is based on a “comply or explain” basis, whereby companies either disclose sustainability reports or justify their decision not to do so.
Interview with Fang Eu-Lin,
Partner at PwC Singapore

Eu-lin leads the Sustainability and Climate Change Advisory department at PwC Singapore, where she is a partner. Her key projects include stewardship standards, sustainable development goals, climate scenario studies, and carbon tax regulations in Singapore and in the region.

What will be the major development in ESG reporting in Singapore in 2019 and what share of SGX listcos are expected to deliver ESG reports?

SGX has required all listed companies to produce sustainability reports since 2017. Based on my observation, most companies are complying with SGX sustainability reporting requirements and the trend is likely to continue. My sense is that listed companies in Singapore are becoming increasingly comfortable and confident in disclosing ESG-related information. However, I would say that the trend is weighted more to the larger listed companies.

In terms of other notable sustainability related developments in Singapore, implementation of the carbon tax on “large emitters” is one of the key developments stipulated for 2019. This is likely to drive more environmental reporting across upstream industries.

While this carbon tax will directly impact large emitters, the effects might ripple down the value chain. This would be the first time that companies feel the transitional risks of climate change (e.g. steeper energy costs), which may encourage them to better understand the extent of their environmental footprint and how to reduce it.

Another development may be greater reporting standards on packaging waste in relation to the upcoming Extended Producer Responsibility (EPR) regulations in Singapore.

How would you assess the current state of ESG investing in Singapore, especially relative to the rest of Asia ex-Japan?

The adoption of ESG investing is still seen to be at a fairly nascent stage in the Asia ex-Japan market. A 2016 report by AVPN found that less than 1 percent of funds in Asia ex-Japan have leveraged ESG investing, compared to 53 percent in Europe.

Since then, a number of interventions, such as the SGX requirements, have spurred ESG investing and green finance in Singapore and the region. The bottom line is that investment companies play a powerful and important role in encouraging funds to become more sustainable businesses.

It is interesting to note that in a recent WWF report, among the 35 ASEAN banks assessed, only the three Singapore banks and a Thai financial institution met at least half the criteria for ESG integration.

Would the MAS consider investing according to ESG principles in the manner of the GPIF in Japan? Do you believe the success of SI investing in Asia requires a top-down rather than bottom-up approach?

Generally, the Monetary Authority of Singapore (MAS) has been supportive of promoting the ESG agenda in Singapore. The Association of Banks in Singapore (ABS) launched the “ABS
Guidelines on Responsible Financing” in 2018. Another case in point is the Green Bond Grant, and more support may be provided in the future.

In my view, the success of SI can be both driven from the top and from the groundswell. The big issue is that we have lots to do to address climate change before it is too late. There are other large issues to prioritize as well, as deftly summarized in the 17 UN Sustainable Development Goals. Funds need to be directed to companies that can solve these existential issues.

If we want to move faster, a more top-down approach would be more effective, but this can be seen, if not careful, as draconian. Therefore, a top-down approach would need to be ambitious but offer some flexibility or support from other quarters.

Of course, if the groundswell moves quickly, that’s a good way too.

What is the status of green finance in Singapore and what might its role be in elevating sustainable investing?

Green finance has picked up in Singapore. Over the last year, we have seen a number of investments in this space using various innovative mechanisms such as green bonds, green loans and sustainability loans. Green finance plays a crucial role as it allows investors to view sustainability issues from an opportunity lens, rather than from a risk perspective. Whether it is investments in clean technologies or circular solutions, green finance opens doors to sustainable investments, which will in turn help solve some of our present existential issues.
Chapter 4

Climate change creating sustainability awareness in Asia

“I’ve starred in a lot of science fiction movies, and let me tell you, climate change is not science fiction…”
Arnold Schwarzenegger
Actor

Aerial view of a two lane road washed away from storm floodwater | Gettyimages
Much of the recent regulatory developments in ESG reporting in Asia have been driven by an emphasis on the “E” (environment). This is particularly evident in the ESG key performance indicators introduced by the HKEX and China’s enforcement of environmental disclosure reporting by 2020.

As highlighted by Natsuho Torii from the Japan Exchange in her interview on page 18, an important catalyst at play here has been the Task Force on Climate-related Financial Disclosures (TCFD). Founded in 2015, the TCFD published its first recommendations in 2017 and is supported in Asia by the governments of Hong Kong, Singapore and Japan, all of which are island economies.

According to the TCFD, forecasted delays in tackling the climate change challenge could globally cost companies USD 1.2trn over the next 15 years. We believe this message has particularly high resonance in Asia, where 1.77bn people reside in just 10 major river basins which generate GDP of over USD 4.3trn. The TCFD currently receives support from global financial institutions, which collectively claim AUM of USD 118trn. As a result, an Asian corporate with a high exposure to climate-related risks is now more likely to translate into the climate-related risk profile of a global asset owner or manager. And while climate change risk relating to the classic definition of rising sea levels is important for Asia’s island economies and coastal megacities, the near-term transition risk – i.e. the global shift to a low-carbon world – may constitute a greater threat to unprepared corporates. Thus, a bank providing loans to coal-fired power plants or non-electric car manufacturers could see both their own TCFD risk profile as well as that of their shareholders impacted too. Similarly, policy shifts away from single-use plastics set in Europe or elsewhere could impact Asian supply chains, potentially creating “stranded assets” and elevating the TCFD risk of related companies and investors. These TCFD risk concerns, as demonstrated by the quote from HKMA Head Norman Chan on page 20, also partly explains the strengthening of corporate stewardship codes across the region.

In the modern age, greater connectivity and real-time data have given the public greater access to information related to climate change. As a result, expectations and pressure on governments have risen. Citizens’ clean air concerns in several Asian countries that have rapidly urbanized are a clear example of this trend, particularly in China. Asian sovereign wealth and pension funds, many of which have recently become signatories to the PRI, pay greater attention to the TCFD because of their long-term investment horizons. In Singapore, the government has undertaken an SGD 100bn (USD 72.7bn) initiative to mitigate the dangers of rising sea levels. This has created considerable awareness of the issue for sovereign wealth fund GIC and investment firm Temasek, which will be partly responsible for the initiative’s funding.

In 2016, the Asia Investor Group on Climate Change (AIGCC) was founded in Singapore. The AIGCC comprises 32 asset owners and managers and engages companies in Asia to raise local awareness of climate change issues. In 2017, AIGCC together with four partners launched Climate Action 100+, a five-year initiative focused on getting the world’s leading 100 corporate greenhouse gas emitters to improve governance and strengthen climate-related financial disclosure. Twenty percent of the listed companies are Asian.

Rising engagement by such institutions translates into a greater awareness by Asian companies to address climate issues and engage the TCFD. This is the backdrop against which Asian regulators have been strengthening their ESG disclosure requirements and corporate stewardship codes in recent years. The Strategic Framework for Green Finance released by Hong Kong’s security regulator (SFC) in September 2018 mentions prioritizing the enhancement of “listed companies’ reporting of environmental information emphasizing climate-related disclosure, taking into account the Mainland’s policy direction to target mandatory environmental disclosure by 2020, and aiming to align with the TCFD recommendations.”

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2 2019 Status Report, TCFD
3 CWR “No Water, No Growth,” September 2018
4 Source: “Today,” September 2019
Chapter 5
Infrastructure spending and green financing as major SI drivers

"Clear waters and green mountains are as valuable as mountains of gold and silver”
Xi Jinping
Paramount Leader, China
Infrastructure spending as key source for green finance growth
The recent sharp growth of green finance initiatives in Asia has been driven by large-scale infrastructure spending both in Asia and through China’s Belt & Road Initiative in global emerging markets. Because infrastructure projects are long term by nature, there is a need to address the impact of climate change and transition risk, both in project construction and operation. This offers Asia a unique opportunity to grow scalable green finance markets as part and parcel of its late-mover infrastructure rollout bid in a low-carbon world. We forecast that the annual green finance opportunity in Asia, based on addressing the climate and transition risks of annual infrastructure spending needs, could reach USD 200bn annually by 2030. Were it exclusively financed by green bonds, it would represent a four-fold increase of Asia’s current annual green bond issuance.

According to the Asian Development Bank (ADB), Asia will require an annual investment of USD 1.7trn a year in infrastructure from 2016 to 2030 just to sustain current economic growth levels. Of this sum, an estimated 16%, or USD 272bn per year, is needed for climate adaption and mitigation measures. The UN Framework Convention on Climate Change points out that Asia, due to its large population, frequent natural disasters, rapid urbanization and vast migration to coastal cities, is highly vulnerable to climate change. The ADB cites that natural disasters cost the Asia-Pacific region USD 76bn a year from 2007 to 2016, double the annual cost of the previous decade. Without major investments in protective infrastructure or relocation, up to 100m people would be directly affected. The UN recommends building an increasing resilience into infrastructure upfront at the design stage rather than later.

To meet the Paris Agreement’s goal of limiting the rise of global temperatures, the treaty cites that the world will need to attain zero CO2 emissions by 2050 from current annual levels of one gigaton. Infrastructure often comprises up to half of a nation’s carbon footprint, making transition risk management critical for Asian infrastructure planning. With emerging market infrastructure spending set to comprise two thirds of the global total by 2025, and China championing many low-carbon emission initiatives such as clean energy and electric vehicles, there is considerable pressure to address low-carbon considerations in all aspects of Asian and emerging market infrastructure planning. This creates sizable opportunities for the growth of green finance markets.

In a low-carbon world, capital investment in infrastructure evaluates the whole life value of the asset rather than the minimum build-out cost. This entails low-carbon considerations not only in project design and use of construction materials but also in the functionality and operating life of the asset. Examples of low-carbon design across the whole life value of an infrastructure project include water treatment plants able to generate energy by harnessing the effluent flow under treatment, thereby minimizing the asset’s carbon footprint, and railway tunnels with greater diameters to improve energy efficiency of trains passing through and capturing thermal energy for use in overhead buildings. In both cases, initial investment costs are recovered through energy savings over the long term.

China’s green bond market “Big Bang”
Green financing refers to a financial instrument, such as bank loans, bond issues and equities, under contract to a firm that can be exchanged for positive environmental impact. Green financing in China has been government-driven and has involved mobilizing bank lending into green sectors, restricting bank lending in overcapacity industries such as steel and coal mining, and encouraging green bond issuance and green bond funds.

China’s 13th Five-Year Plan (2016–2020) outlines a series of reforms for greening China’s economic development, forecasting an estimated USD 274–468bn in green financing requirements. In 2016, the People’s Bank of China issued Guidelines for Establishing the Green
Financial System, which call for a unification of green lending and bond standards, environmental data disclosure, mandatory pollution liability insurance, new carbon finance products and international cooperation under the G20 framework.

Since entering the green bond market in 2016, green bond issuance in China has soared with USD 86bn of bonds outstanding in 2018. Indeed, within a space of three years, China has become the second largest green bond market globally with 18% market share, just 2 percentage points behind the US (“Emerging market bonds: Invest sustainably with EM green bonds,” UBS CIO, 14 June 2019).

Internationally aligned Chinese green bonds, including HK panda bonds (USD 208m), totaled USD 31bn in 2018. This, in our view, creates a good investment opportunity for international investors seeking exposure to China.

Green bond issuance in Asia Pacific reached USD 50bn in 2018, largely because of China, and has strong growth potential on the back of regional infrastructure spending, in our view. Asian financial hubs Hong Kong and Singapore have been quick to seize the initiative with the establishment of key green finance legislation to establish themselves as green finance centers.

**Green bonds as catalyst for Hong Kong and Singapore green finance frameworks**

In September 2018, Hong Kong’s SFC published a Strategic Framework for Green Finance addressing the trading of green bonds, indices and derivatives. In May 2019, the HKMA followed up with key measures on sustainable banking and green finance. As the HKMA’s Kim Chong mentions, the HKMA has pledged to employ ESG factors into its own bond investment as well as to grow green bond portfolios and establish a Center for Green Finance. Hong Kong has raised a total of USD 5bn from 13 green bonds issues with plans for a USD 12.7bn (HKD 100bn) green bond program to encourage more Chinese offshore issuances. It has become Asia’s fourth latest green bond issuer after Japan, mainland China and South Korea.

In Singapore, the regulator has also been speeding up the development of the nation’s green bond market. The Monetary Authority of Singapore (MAS) has estimated that the ASEAN (Association of Southeast Asian Nations) countries will require USD 200bn in annual green investment through to 2030 and estimates private finance will fund half of this figure. In June 2017, the MAS launched the Green Bond Grant Scheme, an SGD 100,000 rebate program to cover upfront costs to obtain external certification required by issuers to show that bond funding projects are “green.” The MAS reports SGD 2bn in green bond issues since 2017. A year earlier, the Singapore Stock Exchange introduced its “comply or explain” sustainability reporting requirement. (Refer to the Singapore section in “Asian regulators drive sustainable investing” chapter on page 23.)

![China still the dominant force in EM green bond issuance](source: China Green Bond Market 2018, UBS)
“Greening the belt and road”: A green finance platform for emerging markets

“We need to work with the international finance community to encourage private investment in BRI”

Dr. Ma Jun
Chair, China Green Finance Committee

The Belt & Road Initiative (BRI), a Chinese infrastructure program for developing countries that has spent close to USD 60bn since launch in 2013, underwent a major revision in April 2019 at the Second Belt and Road Forum in Beijing. The revision responds to growing international concern over debt servicing and related corporate scandals that have emerged in some BRI countries. Although BRI spending by the Chinese government has to date only reached USD 59bn, accounting for just 13% of annual overseas direct investment, we believe it has potential to grow considerably in light of the ADB’s emerging market infrastructure spending projections (USD 5.5trn by 2025). China has voiced the view that it would like to see greater involvement of multilateral banks and international private capital to expand an existing BRI funding capacity of CNY 200bn mainly from state development banks and funds. This is seen as a move to both raise the credibility and sustainability of its infrastructure spending, i.e. “greening” it, as well as to diversify the investment risk of its projects.

China’s recent incursion into infrastructure projects in Western Europe, particularly Italy, has exposed it to stringent environmental and sustainable finance requirements for infrastructure imposed by the EU. China’s own domestic carbon reduction policies strongly commit it to “greening the BRI,” no less because the sixty-plus countries of the BRI (excluding China) account for around one quarter of global CO2 emissions. This share could double by the middle of the century if BRI countries’ GDP growth rates rise to double the rate of OECD countries, as has been forecast. With China currently operating the world’s largest carbon-trading exchange since launch in 2017, it is strongly positioned to help BRI countries set up carbon exchanges and allow them to trade on China’s national exchange.

10 “China’s reboot of the Belt and Road Initiative,” Economist Intelligence Unit, July 2019
11 “A Low Carbon Belt and Road,” Ma Jun, Simon Zadek, The Asset, March 2019
What was the motivation behind the FSDC Paper no.36 to Hong Kong regulators in 2018? Does Hong Kong still lag the rest of the region in terms of ESG disclosure and reporting standards in your view? Why is it important for Hong Kong to catch up?

The working group I chaired held the view that Hong Kong needed to develop the ecosystem and market for sustainable finance. We needed a “why” for companies to want to do well in ESG. As such, the main focus of the paper was to ask the largest asset owners in Hong Kong, the Hong Kong government and related funds, to consider ESG in their investment decisions. We felt that moves by invested capital, such as the HKD 4 trillion Exchange Fund managed by the Hong Kong Monetary Authority, would catalyze the market and begin the process of developing the sustainable finance market. Similarly for the Mandatory Provident Fund (Hong Kong’s pension fund), which has close HKD 1 trillion, we thought the trustees could also integrate ESG in their investment decisions.

While drafting the paper, we felt we had comprehensive proof that integrating ESG criteria has a positive impact on organizations’ financial performance and cost of capital. So in the long term, investors can use it as a risk mitigation and yield-enhancement tool. This is particularly true today, as issues such as climate change will lead to major changes in regulations that will impact business models across the board.

We are hoping the moves by the Hong Kong government and regulators will have a similar impact as what happened in Japan, where the market grew from USD 8 billion to USD 2 trillion from 2014 to 2018 after the government pension fund announced they would consider ESG in their investment decisions.

We are already seeing shifts in the investment management industry’s perception of ESG after a flurry of announcements made by the HKMA, SFC and HKEx in the past six to nine months. So it is definitely shifting in Hong Kong.

There has been some pushback by HK listed companies against the new mandatory ESG disclosure consultation paper released in May 2019. Some companies claim that disclosure is often not relevant to them. Is this a setback in your view?

I think there may be some misunderstanding with regard to the required disclosures linked to key performance indicators. In 2016, the Hong Kong Exchange (HKEX) introduced the “comply and explain” principle for ESG disclosures, which still remains relevant under HKEX’s new ESG reporting.
guideline. Thus, if a required disclosure like “hazardous waste production” is not “material” to a listed real estate investment trust, for example, then it’s a matter for the company to point this out or “explain” why not. However, you have a problem if a fashion retailer explains that disclosure of supply chain management is immaterial. Part of the goal of the new ESG reporting guidelines is to make company boards consider, assess and create awareness of what might be relevant to their organization in ESG terms. In this sense, the dialogue that has emerged with listcos on the back of the HKEX’s May consultation paper is a positive development.

Listed companies in Asia often are not clear on what benefits ESG disclosure reporting brings to their company and share price. The benefits often only become evident after investors have full ESG disclosure from the company. How to break out of this chicken and egg cycle?

I think the volume of creditable research on the positive link between sustainable practices and corporate performance demonstrates why corporates should address ESG issues relating to disclosure reports. For example, a survey by BNPP AM and University of Oxford of 200 studies showed that 90% showed a positive link between a company’s cost of capital and sound sustainability standards, 88% showed that solid ESG practices improved a company’s operating performance and another 80% showed a positive influence of good sustainability practices on the performance of shares. C-suite executives need to consider their ESG approach as a fundamental governance issue. There is a direct link for companies that manage their ESG and having good governance.

“Greening the Belt and Road Initiative” seems to be a campaign that is gathering some momentum. Can this help elevate ESG investing in Hong Kong?

The Belt & Road Initiative (BRI) certainly has potential to raise greater awareness of ESG compliance in Hong Kong because China understands that for BRI to work internationally, it needs to recognize and uphold global standards. The “Greening the BRI initiative,” which is a joint UK-China project, has partly emerged in response to China’s engagement in European infrastructure and a result of the need to adhere to Europe’s commitment to mitigate the long-term environmental effects of infrastructure roll out. For China to attract private and international capital to engage in BRI projects, it must adhere to strict green financing principles. And in order for Hong Kong to be perceived as a trusted platform for financing BRI, it must demonstrate full commitment to sustainability principles.
Chapter 6

Investment implications

“The United States and Asia are similar when it comes to having conversations about ESG. They only want to look at how it affects their ability to make money or lose it”

Joy Frascinella
Head of PR, PRI
Sustainable investing and performance

As the above quote by Joy Frascinella suggests, a contributing factor to the shifting mindset toward sustainable investing in Asia is the rising body of recent works and studies showing that it does not compromise financial performance. Moreover, it has been argued that SI can enhance financial returns\(^\text{12}\).

Fig. 5 suggests that the majority of studies on sustainable investing that incorporate both “exclusion” (the exclusion of companies or industries from portfolios not aligned with an investor’s value) and “integration” (the integration of ESG principles in the investing process to improve portfolio risk and return) showed no systematic bias, suggesting that SI performs no better or worse than conventional approaches. When faced with two investment options with similar risk-return characteristics, we believe it thus makes sense to prioritize the one with the superior ESG profile, as the HKMA’s Kim Chong points out in his interview on page 12.

\(^{12}\) Refer to UBS CIO report: Sustainable value creation in emerging markets, dated 12 July 2016
Incorporating sustainable investment strategies in emerging markets, however, has been shown to deliver comparable and potentially better financial performance than traditional investments. Over the last 10 years, the MSCI EM ESG Leader Index (a benchmark for sustainable investing) has outperformed the MSCI EM benchmark with an annual excess return of 3.2% (refer to Fig. 6). According to RiskLab, this can be attributed to a much higher dispersion in emerging markets between leading and lagging ESG performance when compared to developed markets\(^\text{13}\). Additionally, evidence supports that the prevalent risk of poor corporate governance among EM companies results in those companies with consistently strong corporate governance being disproportionately rewarded by the market due to lower tail risks.

With Asian emerging markets accounting for nearly three quarters of the capitalization of the MSCI EM Index and 85% of the MSCI Asia ex-Japan Index, one might expect similar ESG performance results for Asia. Indeed, the MSCI Asia ex-Japan ESG Leaders Index has enjoyed an annualized excess return of 2.0% over the benchmark since 2007 (see Fig. 7).

ESG is becoming an increasingly important part of the investment approach of asset owners with long-term investment horizons, such as pension funds and insurance companies, and of family offices focused on wealth preservation (refer to UBS CIO publication “Liquidity. Longevity. Legacy.” September 2018). Indeed, the Official Monetary and Financial Institutions Forum (OMFIF) has

\(^{13}\) Source: Hoerter, 2015 ESG in equities
stressed the importance of ESG considerations for long-term capital preservation across the entire asset management industry.

From a corporate perspective, incorporating ESG considerations into management decision-making can improve operational performance and capital returns, a major motivation for its introduction in Japan. KPMG’s Pat Woo suggests (refer to interview on page 34) that management adoption of ESG in itself is perceived externally as a sign of strong corporate governance. A study by the University of Oxford and Arabesque Asset Management showed that 90% of studies demonstrate that sound ESG standards can lower a company’s cost of capital, 88% of studies positively correlate solid ESG practices with better operational performance, and 80% of studies indicate that stock price performance is positively influenced by good sustainability practices (refer to Fig. 8).

Fig. 8
Corporate sustainability and profitability are interrelated

According to 88% of the studies “solid ESG practices result in better operational performance”.

According to 80% of the studies “stock price performance is positively influenced by good sustainability practices”.

Source: “Corporate Sustainability and profitability are interrelated”, Smith School of Enterprise and the Environment, University of Oxford, Arabesque Asset Management, UBS
Sustainable investing developing its own narrative in Asia

Sustainable investing is developing its own narrative within the Asian investment community and the broader public. The environmental element of ESG has the greatest resonance because of climate change risk and clean air issues, which Asia’s city dwellers confront on a daily basis. This is the result of breakneck urbanization and mass migration to cities. Asia’s high internet penetration and the transparency of air quality data online and in social media have created huge citizen awareness and criticism of government management of air quality issues. In some countries, these have raised deeper political concerns. In China the sensitivities are considerable given that air pollution has been linked to disproportionately high cases of lung cancer. China reported 730,000 incidences of lung cancer in 2015, almost 36% of total global incidences. Governments, like China’s, are attempting to address the problem by clamping down on coal-fired pollution and vehicle emissions and have achieved some tangible measures of success in recent years. As a result, low carbon and green financial products have been well received in the Chinese market and other parts of Asia. This also explains the exponential growth of the onshore green bond market in China. Interestingly, as

14 Source: “Shenzhen: China’s sustainable city,” UBS Global Topics, 20 May 2019

Fig. 9

Millennial asset ownership is growing rapidly
USD 24 trillion of global assets will be owned by millennials in 2020

Source: US Trust Insights on Wealth and Worth Survey, US Trust, BofAML, UBS, as of 2016
highlighted by Eu Fang-Lin in her interview, green finance allows investors to view sustainability from an opportunity lens rather than a risk perspective, an interesting feature of where investment appetite in this field lies.

A positive attitude toward sustainability in investing is often attributed to the rise of the millennial generation (those born between 1982 and 2004). They are portrayed as digital natives with greater awareness of social and environmental issues. A study on China’s millennials and ESG by Sustainalytics15 demonstrated that Chinese millennials have high expectations of products and services and prize their online privacy. They are likely to be critical of companies producing poor quality, adulterated or fake products, or those whose services “compromise online privacy for convenience.” In our view, as their income grows, millennials will undoubtedly become a greater source of pressure on companies and regulators to improve governance practices in China. Globally, around USD 23trn of global assets will be in millennial hands by 2020, according to a wealth survey by the US Trust and BOML (refer to Fig. 9).

15 Source: 14 August, 2019, “China’s Millennials and ESG,” Frank Pan, Sustainalytics
How to invest?

Different motivations to engage in sustainable investing point to different investment strategies. Sustainable investors are typically unwilling to sacrifice returns in order to achieve their sustainability goals. The table below summarizes the different sustainable investing strategies as defined by UBS:

Given the classification in the table, in our view, investments can generate impact through three main channels:

1. **Financing**: By directly financing intrinsically impactful companies or projects. Private equity or direct investments are good examples.

2. **Stewardship**: By engaging with management to persuade companies to adopt more sustainable practices. Provided that the effect of these efforts can be measured and traced back to investors’ actions, this can be considered impact investing.

3. **Signaling**: By investing in companies that investors believe are having a positive impact on people and the planet and divesting from companies that aren’t, investors can signal to the market the importance of corporate ESG performance.

These strategies can be implemented through individual asset classes or through a portfolio approach. ESG integration and exclusions are generally applied to liquid assets such as equities and bonds. Popular sustainable equity strategies include best-in-class (also known as ESG leaders like the MSCI Asia Pacific ESG Leaders Index), thematic equities (e.g. water, clean tech, gender focus, agriculture) and ESG momentum. On the fixed income side, corporate ESG leader bonds and green bonds are most widely used. Most of these sustainable investment asset classes are offered in Asia, although regional sustainable investments through a multi-asset portfolio approach have only recently started to emerge in Asia.

Impact investment has traditionally been undertaken through illiquid market assets such as private equity and direct investments, as there is a clearer link between the investment and the measurable social and/or environmental impact. Impact investing in liquid markets is possible, not so much through the investment itself, but via the mechanism of shareholder engagement (dialogue) and activism (filing shareholder proposal), which have a decades-long track record of delivering positive change within investee companies.

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**Impact investing**

- **Description**: Investing with the intention to generate measureable E & S impact alongside a financial return
- **Motivation**: Achieve environmental or social impact, in addition to financial returns

**Integration**

- **Description**: Integrating ESG factors into traditional investment processes to improve portfolio risk/return
- **Motivation**: Improve the risk/return characteristics of the portfolio

**Exclusion**

- **Description**: Excluding companies or industries from portfolios where they are not aligned with an investor’s values
- **Motivation**: Align investments with personal values

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Source: UBS, “Sustainable Investing in Asia,” Envision Magazine, 2018
Appendix

Fig. 11
Asia ex-Japan signatories to United Nations Principles for Responsible Investment
In USD bn

- Asia ex-Japan AUM (LHS)
- Asia ex-Japan signatories (RHS)

2019 refers to eight months to August 2019
Source: United Nations, UBS, as of August 2019

Fig. 12
Japan signatories to United Nations Principles for Responsible Investment
In USD bn

- Japan AUM (LHS)
- Japan signatories (RHS)

2019 refers to eight months to August 2019
Source: United Nations, UBS, as of August 2019
# Glossary

| **ASrIA** | The Association for Sustainable & Responsible Investment in Asia was a non-profit, membership association dedicated to promoting sustainable finance and investment in the Asia-Pacific region from 2001 to 2015 and has now completed its integration into the PRI with the establishment of PRI Association (Hong Kong) Limited |
| **CG – corporate governance** | Corporate governance is the system of rules, practices and processes by which a firm is directed and controlled, balancing the interests of a company’s many stakeholders. |
| **CSR – corporate social responsibility** | Corporate social responsibility is a self-regulating business model that helps a company be socially accountable – to itself, its stakeholders and the public. |
| **ESG – Environmental, Social, Governance** | ESG refers to three key factors for evaluation to assess the sustainability of an investment. Topics include: Environmental – Climate change, pollution and waste, environmental opportunities; Social – Workplace safety, discrimination and diversity, supply chain, community controversies, human rights; Governance – Corruption, tax gaps, anti-competitive behaviour, business ethics, board structure. |
| **Exclusion** | This investment approach involves excluding individual companies or entire industries from portfolios if their areas of activity conflict with an investor’s personal values. |
| **HKGFA – Hong Kong Green Finance Association** | The HKGFA comprises members from financial institutions and green businesses in Hong Kong to provide policy suggestions to the HKSAR government and other regulators in developing green finance in the city. |
| **Impact investing** | Impact investing is one of three distinct sustainable investment approaches, made with the intent to generate measurable environmental and/or social impact as well as attractive financial returns. |
| **Integration** | Integration is one of three distinct sustainable investment approaches that combines ESG factors with traditional financial considerations to make investment decisions. |
| **PRI – Principles for responsible investment** | The PRI is the world’s leading proponent of responsible investment. |
| **SI – Sustainable investing** | Sustainable investing is an investment philosophy with the intention to perform comparably to traditional investments, while at the same time having a positive impact on the environment and society. |
| **SDG – Sustainable Development Goals** | The Sustainable Development Goals, adopted by all UN member states in 2015, frame the most pressing sustainability challenges facing the globe. There are 17 SDGs with 169 specific underlying targets, aimed at addressing poverty, inequality, climate, shared prosperity and peace and justice for all. |
| **SSEI – Sustainable Stock Exchanges Initiative** | The SSEI is a peer-to-peer learning platform for exploring how exchanges, in collaboration with investors, regulators, and companies, can enhance corporate transparency – and ultimately performance – on ESG (environmental, social and corporate governance) issues and encourage sustainable investment. |
| **TCFD Task Force on Climate-related Financial Disclosures** | The FSB TCFD develops voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders. |
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