Friends of the Earth (HK)-PolyU

ESG Integration Focus Group Report 2019

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PROJECT NATURE
This report summarizes the key findings of the four focus groups on ESG integration. The purpose of this report is to find out the drivers and challenges of practicing ESG integration in Hong Kong and Mainland China. We also provide some suggestions on the way forward.

ACKNOWLEDGEMENT AND DISCLAIMER
We are thankful to the focus group participants and FoE (HK) in supporting this project through donation. All errors are our own.

Friends of the Earth (HK)-PolyU ESG Integration Focus Group Meetings 2019: Summary Report (Louis Cheng, CESEF Center, PolyU)

Synopsis

A total of 46 participants have filled a simple questionnaire and engaged in an in-depth group interviews on their views related to the drivers and challenges of ESG integration. We targeted major stakeholders including buy-side, sell-side, asset owners, financial service professionals (such as private bankers and high-end financial planners), fund managers, investor relation executives of Hong Kong listed firms, representatives of financial professional bodies, ESG data providers, and ESG consultants.

For more mature ESG stakeholders, the top three choices of ESG drivers are risk management, client demand, and regulation. For this segment, corporate governance practice and management buy-ins lead to the emphasis of risk management based on ESG channels. As long-term risk mitigation is commonly regarded as an obvious benefit of E, S, and G factors, we conclude that risk management is the driver of ESG integration for those market participants who have passed the initial hurdle of understanding the ESG issues. In fact, this more mature segment should have already enjoyed some client demand and see it as a driver as well.

For this mature-stage segment, the corresponding top barrier of ESG integration is a lack of comparable and historical ESG data. Since these more mature ESG stakeholders have already been practicing ESG integration, their main challenge is to find ways to do a good job in ESG analysis. Unfortunately, the existing universe of ESG performance data including the ESG scores and ESG reports at firm level is still at a developing stage, especially for Hong Kong and Mainland. Therefore, we see great opportunity for data venders and research institutions, which are interested in strengthening the ESG data quality, and then investment products and service solutions in this region.

For the early-stage ESG stakeholder, regulation is named as the top driver. However, this driver may imply a sense of compliance as the main reason. Many stakeholders of this segment may be affiliated with small institutions and resources are tight in general. In addition, they suffer from a more passive top management, board and clients who do not see significant value from ESG integration but as an expense item. Consequently, this early-stage segment would name limited understanding of ESG issues and concerns about poor financial returns as top barriers. Of course, for this segment, due to limited resources (or lack of understanding), stakeholders cannot (or do not know how to) conduct in-house ESG analysis for their own use. Therefore, it heavily relies on third party investment products and consultants to engage ESG issues. It is

NOT a level-playing field between ESG data/services providers and the client firms. The additional difficulty of understanding certain ESG information (due to the technical nature of E factors) makes it extremely challenging for this segment to even validate what the ESG consultants have done for them. The knowledge gap between the ESG services providers and the clients lead to the current problem of lacking a check-and-balance for these ESG activities.

We believe that ESG integration is an important channel to achieve sustainability for the society as a whole. Through ESG investments, corporations will take sustainability issues more seriously and investors and stakeholders can vote with their feet. The power of finance should play a vital role in enhancing sustainability through ESG integration. In order for us to improve ESG performance of Hong Kong and Mainland China, we believe that, Hong Kong as a financial center, should achieve the following milestones:1) Improve quality of ESG information; 2) Produce various ESG performance benchmarks and KPIs; and 3) Enhancing the scope and depth of ESG products and services.

1. Purpose and Approach:

ESG stands for Environmental, Social and Governance. The objective of the focus group meetings is to better understand the drivers and challenges of ESG integration through an in-depth sharing among stakeholders. We targeted major stakeholders including buy-side, sell-side, asset owners, financial service professionals (such as private bankers and high-end financial planners), fund managers, investor relation executives of Hong Kong listed firms, representatives of financial professional bodies, ESG data providers, and ESG consultants.

We conducted four focus groups to reach out to these stakeholders as below:

Focus Group	Date	Supporting Organization/Host (Number of Participants)
1	March 15, 2019	Hong Kong Society of Financial Analysts/CFA Institute (n=13)
2	May 3, 2019	Institute of Financial Planners of Hong Kong (n=12)
3	July 26, 2019	Hong Kong Investor Relations Association (n=11)
4	October 11, 2019	PolyU's Center for Economic Sustainability and Entrepreneurial Finance (n=10)

Ten to thirteen participants attended each of our focus groups. A total of 46 participants have filled a simple questionnaire and engaged in an in-depth group interviews on their views related to the drivers and challenges of ESG integration. We want to emphasize that even the choices provided in our survey may be similar to those in other large-scale surveys conducted previously by professional organizations, their answers to these two questions (i.e. drivers and challenges) have been justified thorough explanations in the meeting. Therefore, the findings of our focus groups can supplement and substantiate the results provided by the previous survey using objective questions mainly.

2. Overall Observations of the ESG Integration: the Case of Hong Kong-based Investment Professionals

2.1Various concerns related to ESG integrations

Comparing the E, S, and G factors, G is being considered the most by buy-side professionals. For E, some clients would give some considerations. However, S is mostly not in the picture at all. ESG cannot be integrated in a uniform fashion across all 3 issues (i.e., E, S, G). Sector-specific consideration must be given to each firm and emphasis would be different among E, S, and G factors. ESG integration for developed markets is different from that of Hong Kong and Mainland. In Europe, the public's interest on ESG drives the regulators to implement ESG guidelines for asset management, which force the asset managers to work with asset owners together to formulate ESG integration in investments. For equity, ESG enhances upside potential. For fixed income, ESG provides downside protection. In majority of asset owners is affected by peer pressure to consider ESG and only a small percentage of them engages ESG due to genuine concern.

2.2 Key Findings

Table 1 lists the frequency counts for key drivers and barriers of performing ESG integration. Based on the CFAI survey questionnaire, we construct seven drivers and nine barriers for the participants to choose from. Then each participant was required to explain in more detail why certain drivers and barriers are selected.

Drivers

"Risk management" is named as the main motivation to integrate ESG issues by 26 out of 46 (56.52%) participants. "Client demand" is the second most popular reason cited by participants (20 out of 46 or 43.48%). "Regulation" is cited by 19 out of 46 (41.3%) participants as the main driver, making them as the third most popular reason for integrating ESG issues into investment decisions.

a) Risk Management

We further explore why risk management is perceived as the main motivation. For large firms, risk management is a key issue as ESG risks are critical for large firms, leading to a higher priority from the top management. In addition, more mature ESG stakeholders including asset owners, asset managers and listed firms tend to have more restrictive and prudent approach towards risk management at corporate level. Therefore, managing ESG risks is natural under such a corporate culture. In terms of asset management, clients of mature-stage ESG stakeholders regard ESG risks as an important aspect of investment approach, leading to the conclusion that risk management is the main motivator for ESG integration.

b) Client Demand

Client demand is perceived as the second driver. Reasons behind appear to be diversified. As for the mature-stage ESG stakeholders, they already have existing clients who prefer ESG integration as important mandate in the investment policy statement. So, client demand is regarded as one of the top drivers. For listed firms, high-end consumer products and European/North American clients of industry goods have already integrated high ESG standard in their products/services. For this segment, ESG expectation is an integral part of overall product quality for a while. Due to supply chain expectation for ESG performance, there appears to have a comprehensive approach in place for practicing ESG.

In terms of inducing further client demand, there exists some industry practices of preparing in-house ESG scores for clients' portfolios so that the clients can understand the ESG performance of their investments in conjunction with the financial returns. In addition, education seminars are provided for the clients to know more about ESG issues in order to create awareness. Such effort seems to create some clients' demand. Another approach is more top-down by executive-led decisions to integrate ESG in investment decision for clients. Such an approach can be efficient but also may create possible frictions among buy-side managers when their investment decision processes generate products and choices that do not synchronize with the ESG mandate.

c) Regulation

Regulation is cited as another important factor to drive ESG integration. We observe that a larger percentage of participants citing regulation as a main driver comes from smaller firms (most of them are early-stage ESG stakeholders). Owing to limited resources and the nature of their clientele, regulation becomes the main driving force of practicing ESG. However, the overall opinion is not quite positive about this factor as participants regard regulation as an obligation for compliance instead of a motivation to integrate ESG factors in investments and their business practices.

Other drivers

Another diver receiving more attention is "generating alpha". There is a minority view that research indicates a possibility of alpha generation by ESG screens. We understand that most of the current research concludes that ESG portfolios lead to lower return relative to the non-ESG counterpart. However, if the benchmark is an appropriate ESG index, the conclusion could be very different. There is some consensus on requiring social returns as a necessary component to measure the overall performance of ESG portfolios.

Another main driver is "senior management buy-in". For large listed firms, this reason appears to be important to drive ESG effort. Sometimes, the business model requires the ESG reputation and other times consumers demand ESG standard for products. Large companies need to watch over the whole supply chain on ESG compliance in order to avoid public relation troubles or possible litigation. For some firms, ESG is being integrated from the very beginning of the business process such as using green finance to support infrastructure activities.

Barriers

21 out of 46 (45.65%) rank "Limited understanding of the ESG issues and/or ESG integration" as number 1 barrier. 19 out of 46 (41.3%) name "Lack of comparable and historical ESG data" as the second barrier. 18 out of 46 (39.13%) report that the third main barrier is "Concerns about negative returns, tracking error and underperforming a benchmark".

a) Limited understanding of the ESG issues and/or ESG integration

Owing to a lack of quality disclosure, it is extremely difficult for asset managers to implement meaningful ESG screens. This is particularly true for early-stage ESG stakeholders who have limited exposure and industry experience. As it is very labor intensive to conduct ESG research manually, most asset managers can only conduct subjective evaluation focusing on selective elements that are critical. Many participants regard lack of understanding and poor financial performance are the main reasons that individual clients do not care about ESG integration. Of course, disclosure and poor information quality on ESG materials are other reasons that lead to the limited understanding. Therefore, many asset owners and managers are relatively confused about how to evaluate the ESG aspects of investments, leading to a slow adoption of ESG integration. Inertia of organizational culture in resisting changes makes it even more difficult to change the investment process of asset managers to integrate ESG.

Media awareness in Asia does exist but it is still at the beginning stage. Asset managers and owners see difficulty in measuring how ESG performance can be translated into firm value. Risk mitigation and long-term sustainability are viewed as key benefit for ESG integration. More research and evidence are needed to substantiate this claim. Consequently, a scientific approach to ESG integration is still far away. For asset owners who have no clue on the meaning and implications of ESG screen, education and training can be important. For mature-stage ESG stakeholders, this is less an issue due to the sophistication of their clientele and investment process. In addition, large asset managers can help to improve ESG awareness and then performance of listed firms proactively through shareholder activism through proxies and letters to company boards on ESG issues.

b) Lack of comparable and historical ESG data

For mature-stage ESG stakeholders who have existing clients demanding ESG integration, lack of comparable and historical ESG data to generate reasonable benchmarks for analysis become an important issue, making this concern as the second barrier in our survey. For pension and public institutions, challenges for ESG integration include lack of comparable ESG data and products to choose from. Participants choosing this barrier are more mature and sophisticated in terms of their ESG understanding and experience. This segment in general does not choose low client demand as a barrier, suggesting that they have some demand for ESG integration.

Instead, they regard that benchmarking and stronger evidence for ESG benefits are needed to push forward for more ESG integration.

c) Concerns about negative returns, tracking error and underperforming a benchmark

It is commonly agreed among most ESG stakeholders that performance of the so-called ESG or environmental-focus investment products currently existed is relatively poor in terms of financial return. Indeed, casual observation suggests that earlier ESG investment vehicles in Hong Kong seem to demonstrate poor investment return. Such a performance deters further participation from investors. On the other hand, due to the lack of interest in adopting ETFs as an investment tool in Hong Kong (e.g., the top 5 ETFs capture 95% of the trading among all ETFs), launching an ESG ETF may not be a good solution to stimulate more investment participations for ESG integration. Finally, concerns about negative returns in terms of business profit and market valuation are always an issue in pursuing any cost-related activities including ESG initiatives.

3. Conclusion

Owing to Asian culture and emphasis on financial return only, intermediaries and asset managers feel that it is difficult to push ESG integration. Some participants feel that the regulators should step up their efforts in simplifying the ESG information reported by the listed firms to make it more transparent and user-friendly for investors. The barriers reflect the mirror image of the drivers. For firms that cannot pursue ESG in a more positive manner, they suffer from the lack of support related to the drivers mentioned. Client demand and senior management buy-in are in fact the needed drivers to pursue ESG. Without them, companies cannot be successful in ESG performance.

The current ESG data is a result of regulation and a large pool of ESG consultants pursuing the ESG reporting which may vary in quality in a substantial manner. For example, a conglomerate that cover various industry sectors may find it difficult to comply with a strong regulation that have industry-specific ESG standard. In addition, a blanket regulation with detail and strict requirement may cause more trouble by increasing the quantity (instead of quality) of the ESG reports. Therefore, it may not be wise to solely reply on stronger regulation to enhance quality information disclosure of ESG. Finally, the quality of ESG consultant may be an issue that drives the high percentage of noise in the ESG reports. We need a better system to enhance data quality instead of quantity in ESG reporting. The issue of materiality is related to the unique condition and characteristics of the firm. Purely enforcing a stronger regulation without understanding the specific materiality issue related to the firm can be problematic. One possible idea is to persuade the company board to adopt a certain ESG issues as a mandate so that company can pursue material issue that matters the most.

Direct engagement with company's board can be an effective way to enhance discussion about long-term, material issues over which the board has oversight. As more board directors become more accustomed to engage with investors in this way, board engagement remains a meaningful part of investment stewardship and ESG research process. To better understand the concerns and seek possible solutions, we divide our concluding observations by the stage (i.e., mature and early) of ESG stakeholders[1]:

1) **The ESG landscape for more mature ESG stakeholders**

   The top three choices of ESG drivers (namely, risk management, client demand, and regulation), reflect the importance and role of the driving forces behind these factors. For more mature asset management managers, asset owners, and listed firms, corporate governance practice and management buy-ins lead to the emphasis of risk management based on ESG channels. As long-term risk mitigation is commonly regarded as an obvious benefit of E, S, and G factors, we conclude that risk management is the driver of ESG integration for those market participants who have passed the initial hurdle of understanding the ESG issues. In fact, this more mature segment should have already enjoyed some client demand and see it as a driver as well.

   For this segment, the corresponding top barrier of ESG integration is a lack of comparable and historical ESG data. Since this more mature segment has already been practicing ESG integration, their main challenge is to find ways to do a good job in ESG analysis. Unfortunately, the existing universe of ESG performance data including the ESG scores and ESG reports at firm level is still at a developing stage, especially for Hong Kong and Mainland. Therefore, we see great opportunity for data venders and research institutions, which are interested in strengthening the ESG data quality, and then investment products and service solutions in this region.

2) **The ESG landscape for early-stage ESG stakeholders**

   For early-stage ESG market participants, regulation is named as a top driver. However, this driver may imply a sense of compliance as a driving force. Many stakeholders of this segment may be affiliated with small institutions and resources are tight in general. In addition, they suffer from a more passive top management, board and clients who do not see significant value from ESG integration but as an expense item. Consequently, this early-stage segment would name limited understanding of ESG issues and concerns about poor

[1] While we do not have a scientific definition of early-stage and mature-stage ESG stakeholders, we can observe that in general early-stage ESG stakeholders (including asset owners, buy-side, and listed firms) are smaller in asset size, subject to stronger limitation in resources, lower level of understanding and enthusiasm from top management towards ESG integration. On the other hand, mature-stage ESG stakeholders belong to larger firms, exhibit more resources to embrace ESG activities, and demonstrate stronger commitment from top management towards ESG integration.

financial returns as top barriers. Of course, for this segment, due to limited resources (or lack of understanding), stakeholders cannot (or do not know how to) conduct in-house ESG analysis for their own use. Therefore, it heavily relies on third party investment products and consultants to engage ESG issues. It is NOT a level-playing field between ESG data/services providers and the client firms. The additional difficulty of understanding certain ESG information (due to the technical nature of E factors) makes it extremely challenging for this segment to even validate what the ESG consultants have done for them. The knowledge gap between the ESG services providers and the clients lead to the current problem of lacking a check-and-balance for these ESG activities.

4. The Way Forward

We believe that ESG integration is an important channel to achieve sustainability for the society as a whole. Through ESG investments, corporations will take sustainability issues more seriously and investors and stakeholders can vote with their feet. The power of finance should play a vital role in enhancing sustainability through ESG integration. Like any product market development, it takes time to make information more assessable and economically affordable to all stakeholders. ESG information is of no exception. In order for us to improve ESG performance of Hong Kong and Mainland China, we have to achieve the following milestones:

1) Improve quality of ESG information

Sustainability Accounting Standards Board (SASB) estimates that 70% of the ESG data are noise. We need to recognize the respective roles of risk management, client demand and regulation as drivers to different stage of ESG stakeholders. At the same time, we need to understand the corresponding barriers to these two segments. Using this matching information, the regulators and stakeholders should stay within their boundary and utilize their strengths and advantages to improve the quality of ESG disclosures.

2) Produce various ESG performance benchmarks and KPIs

Currently, it is difficult for clients to evaluate ESG service providers and asset managers in a fair manner due to a lack of comprehensive ESG performance benchmarks and KPIs based on the ESG preference of the clients and stakeholders (mandate). We need more comprehensive benchmark to evaluate different ESG strategies to meet the different needs of clients as ESG preferences vary among them.

3) Enhancing the scope and depth of ESG products and services

Upon the availability of better information disclosures and benchmarks, the last ingredient will be the launch of more comprehensive ESG product choices that can meet the clients' needs with various ESG preference. ESG preference is a net outcome of various factors including personal (corporate) characteristics, internal constraints of resources, external constraints related to regulation and social expectation, and risk-return expectation. To better match with the ESG profile of the clients, more ESG products choices and solutions aiming to match these preferences are needed.

5. Implications to FoE (HK) and NGOs

While there are many ways that FoE (HK) or NGOs in general can help in promoting better ESG integration for asset management and firms in Hong Kong, we propose some suggestions for consideration:

1) Based on the focus group findings, we understand that the segment of stakeholders needed help the most is the smaller listed firms related to E and S engagement. It is NOT a level-playing field between ESG data/services providers and the client firms. The additional difficulty of understanding certain ESG information (due to the technical nature of E factors) makes it extremely challenging for this segment to even validate what the ESG consultants have done for them. The knowledge gap between the ESG services providers and the clients lead to the current problem of lacking a check-and-balance for these ESG activities. This is a segment with more ESG challenges that FoE (HK) can lend its support.
2) The more specific role that FoE (HK) can play is to lobby and educate the board and senior management to improve top management buy-in by organizing roundtables for understanding ESG and its benefits.
3) For better efficiency and reaching a desirable outcome, we suggest that the roundtables should be organized by similarities of ESG needs and profiles through groupings by industry and other firm characteristics such as firm size, ESG maturity and challenges found in this report.
4) Upon ESG improvement, this group of listed firms can be included in the radar screen of buyside and investment professionals as investment choices for ESG integration.

Table 1: Summary Statistics for Drivers and Barriers of ESG Integration

Q1. Which are the main drivers to integrate ESG issues into investment decisions? Please select up to two options from the list below.

Drivers	FG1	FG2	FG3	FG4	Total	%
No. of Participants	**13**	**12**	**11**	**10**	**46**	
a) Risk management	9	4	6	7	26	56.52%
b) Generate alpha	4	5	0	2	11	23.91%
c) Regulation	4	5	6	4	19	41.30%
d) Fiduciary responsibility	3	1	4	3	11	23.91%
e) Client demand	7	10	1	2	20	43.48%
f) Incentives	0	1	0	2	3	6.52%
g) Senior management buy-in	0	2	5	2	9	19.57%
h) Others	1	0	0	2	3	6.52%

Q2. Which of the following are the main barriers to integrate ESG issues into investment decisions? Please select up to three options from the list below.

Barriers	FG1	FG2	FG3	FG4	Total	%
No. of Participants	**13**	**12**	**11**	**10**	**46**	
a) Low client demand	1	4	6	1	12	26.09%
b) Lack of company culture to support ESG integration	2	4	6	3	15	32.61%
c) Too much non-material information being disclosed	2	1	1	1	5	10.87%
d) Lack of comparable and historical ESG data	8	4	1	6	19	41.30%
e) Limited amount of ESG research from sell-side and brokers	0	3	0	0	3	6.52%
f) Limited understanding of the ESG issues and integration	7	6	5	3	21	45.65%
g) Concerns about negative returns, tracking error and underperforming a benchmark	4	5	5	4	18	39.13%
h) No evidence of the investment benefits of ESG investing	2	6	1	5	14	30.43%
i) ESG issues are rarely material	0	0	0	0	0	0.00%
j) Others	1	2	3	1	7	15.22%
k) Not sure	1	0	0	1	2	4.35%

End