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Green Finance

Deloitte Risk Advisory – November 2020

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What is Green Finance?

Green financing is to increase **level of financial flows from the public, private and not-for-profit sectors to sustainable development priorities**. A key part of this is to better manage environmental and social risks, take up opportunities that bring both a decent rate of return and environmental benefit and deliver greater accountability.

UN Environment Programme

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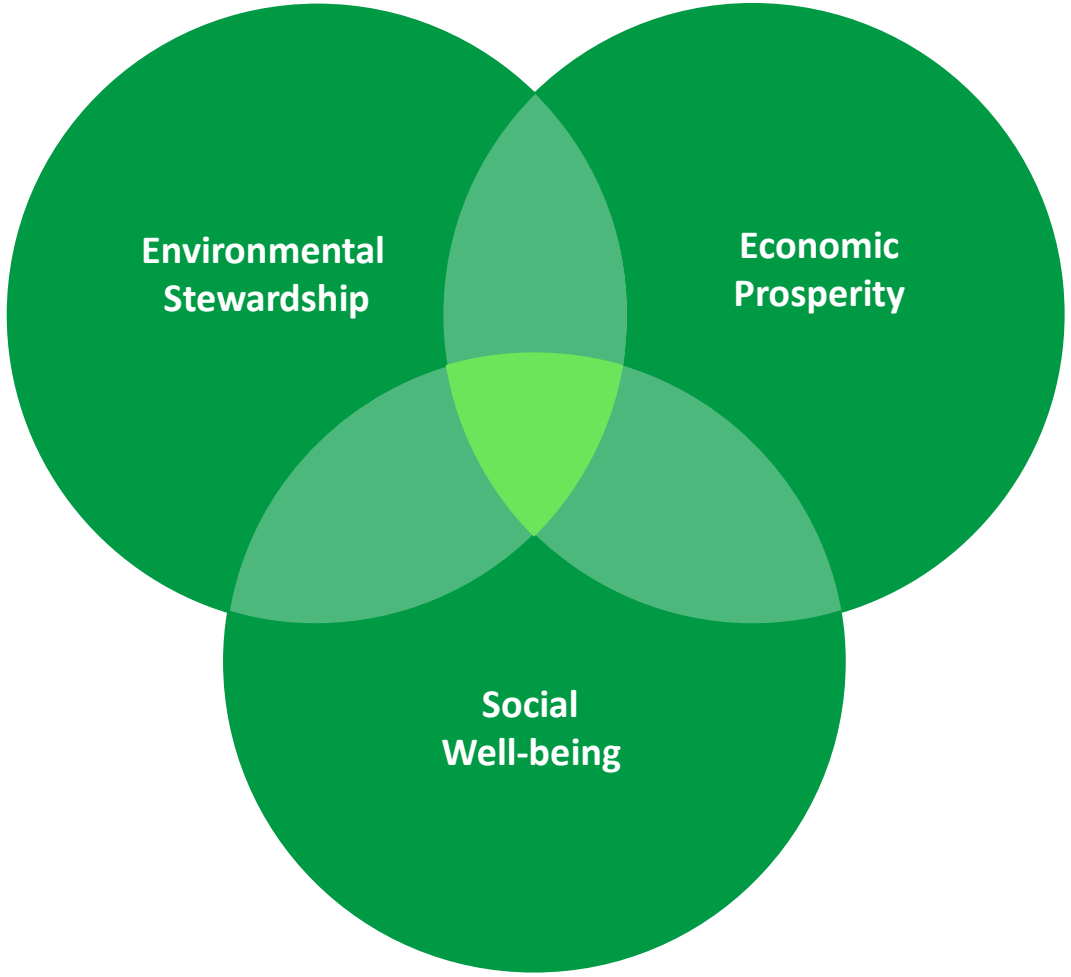
From sustainability….

Sustainable development: Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

Brundtland Report, 1987

Corporate sustainability means balancing environmental stewardship, social well-being, and economic prosperity while driving toward a goal of long-term success for the health of the company and its stakeholders.

Farver, 2013



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Green and sustainable financing in Hong Kong

Regulatory update: HKMA's sustainable banking and green finance initiatives

On 7 May 2019, The Hong Kong Monetary Authority ("HKMA") published a press release to present its initiatives in promoting the development of sustainable banking and green finance in Hong Kong.

HONG KONG MONETARY AUTHORITY
香港金融管理局

1. Green and sustainable Banking
   - Develop a common framework for "Greenness Baseline" assessment of banks
   - Establish goals/targets for promoting green and sustainable banking
   - Monitor progress made by banks
2. Responsible Investment
   - Adopt Green and ESG investments as appropriate for the Exchange Fund
3. Centre for Green Finance (CGF)
   - Establish the CGF as a platform for sharing technical support and experience in green finance development

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Green and sustainable financing in Hong Kong

Regulatory update: HKMA's sustainable banking and green finance initiatives

In June 2020, The Hong Kong Monetary Authority ("HKMA") published a white paper on green and sustainable banking.

HONG KONG MONETARY AUTHORITY
香港金融管理局

1. **Phase 1 – Development of an assessment framework**
   - Assesses the "greenness" baseline of AIs.
   - Formed a Working Group on Green and Sustainable Banking consisting of representatives from 22 AIs to develop the framework.

2. **Phase 2 - Engaging the industry and other relevant stakeholders in a consultation on the supervisory expectations or requirements**
   - Consult the industry on HKMA supervisory expectations
   - Adopt a proportionate approach such that the requirements are appropriate to AIs of different sizes.

3. **Phase 3 - implement, monitor and evaluate banks' progress**

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Green and sustainable financing in Hong Kong

Regulatory update: Fund Managers disclosure requirements

The Hong Kong Securities and Futures Commission ("SFC") published a consultation paper on management and disclosure on climate risk by fund managers outlying proposed changes to the code of conduct, which is developed with reference to Taskforce on Climate Related Financial Disclosure (TCFD)

SFC 證監會

Governance:

- require the board to have oversight of the incorporation of climate-related considerations into investment and risk management processes
- oversee progress against goals for addressing climate risks

Climate Related Risk Management:

- Apply appropriate tools and matrix to assess and quality risks
- Adopt appropriate measures to quality risks
- Monitor risks on an on-going basis

Investment Management:

- Identify climate-related risk and assess the impact in the investment management process
- Assess materiality and relevance

Climate Related Risk Disclosure:

- Make disclosure on how these risks are factored in the portfolio construction process

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Green Banking

- Climate change would pose risks to the **operations and business** of banks, for example, by causing disruption to banks and their clients.
- Climate change would bring business **opportunities** to banks arising from the reallocation of capital in transitioning to a low-carbon economy.

Green Insurance

- **Process for Insured/Project Selection** – Working solely with brokers and insureds that create a positive environmental and social impact
- **Underwriting Models-** insurers are required to factor in 'Climate Change' and a 'Carbon Price' into their risk models.
- **Product Development** – create and supply dedicated insurance solutions/ products that enable a shift towards a low carbon economy and new environmental friendly technologies

Green Fund Investment

- Investment in **green industry**
- Incorporate **green element** into investment decision

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Sustainable finance framework development

Develop an ESG strategy to gain a competitive advantage in the marketplace and to enhance long-term value creation

Key steps to having a fit-for-purpose SF/ESG strategy

1. Assess current state and identify missing components

Perform a gap analysis on current ESG capability maturity against existing and emerging ESG regulatory requirements and industry best practices

2. Evaluate business impacts and prioritise areas for remediation

Conduct an ESG impact assessment to identify significant impacts to the business so that internal stakeholders can prioritise their efforts to address missing components in the strategy

3. Develop the required components of the ESG strategy

Develop the overall ESG policy and guidance and design reporting and monitoring mechanism including data collection methodology for the metrics and targets

4. Finalise the ESG strategy and communicate

Conduct high level ESG training to senior management team and other staff to align expectations to the new strategy and cascade it through the rest of the organisation

What should organization do?

Organizations should incorporate environmental, social and governance (ESG) criteria into their investment decisions to enable more effective management and valuation of natural capital and ecosystem services.

Readiness assessment
Perform a feasibility study on their existing ESG maturity capabilities against the UNPRB (UN Principles for Responsible Banking).

Use Proprietary Tier Structured Model Tool
Use structured model tool to effectively visualise the maturity of sustainability capabilities (both as-is and to-be) on a single page; it has drill-down and aggregation functions so that each capability assessment can be fully justified if needed.

ESG materiality assessment
Not every ESG factor will be material to a organisation's business; organisations need to identify, assess and validate the most material ESG issues that they should focus on and propose detailed recommendations.

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Integrating ESG factors into banks' risk management framework (RMF)

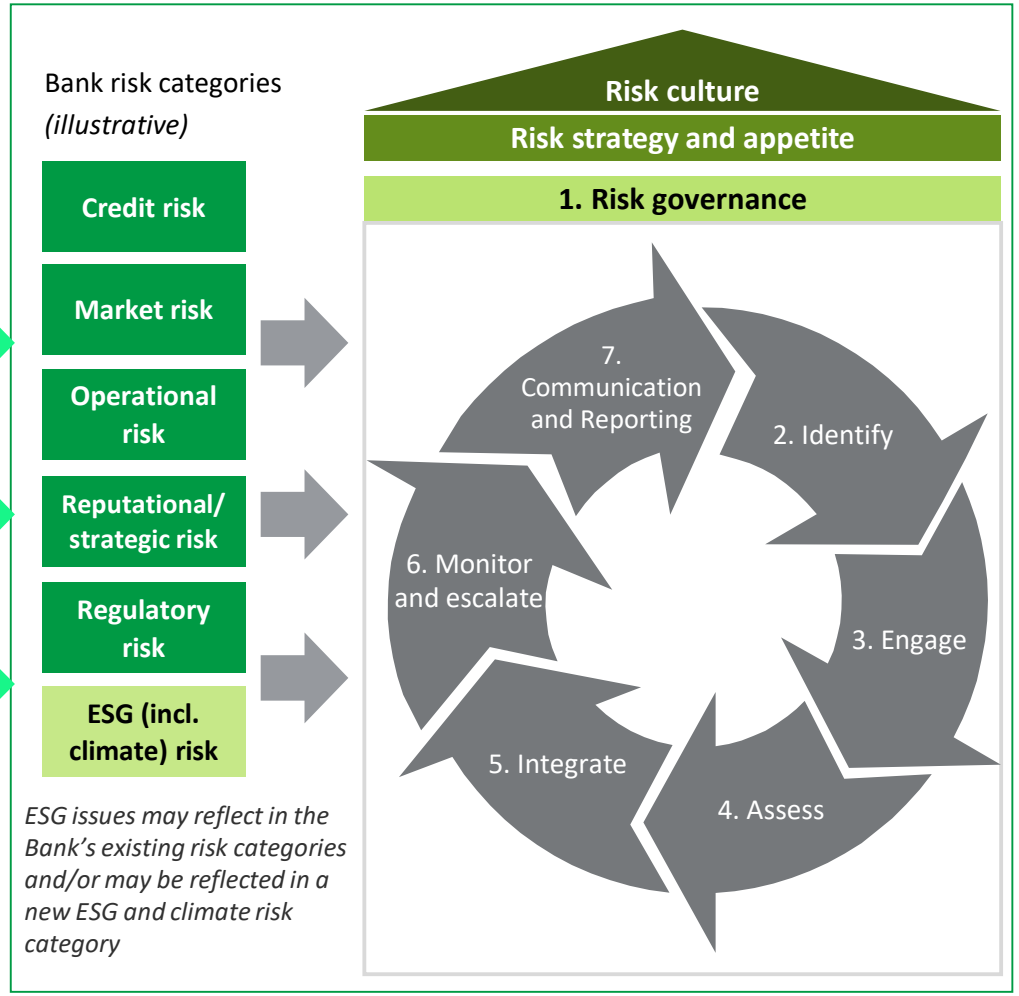
Incorporating ESG issues to banks' existing risk management framework is an important process - doing so will provide a holistic view to identify, assess, and address the impact of these to our clients' organisation

ESG issues to consider

Environmental
- Climate change
- Materials sourcing and use
- Waste management
- Energy efficiency
- Water management
- Biodiversity
- Environmental policy

Social
- Employment practices
- Labour conditions
- Occupational safety risks
- Political funding
- Financial products and services information to customers
- Financial consumer protection

Governance / other
- Corporate governance
- Political accountability
- Solvency
- Voting policies
- Environmental and social impacts of investments, products and services



Key integration steps

1. **Risk governance** – Provide management oversight on ESG related risks; maintain on-going monitoring and ensure alignment to the organisation risk appetite.
2. **Identify** - Conduct a gap analysis to understand the full spectrum (both established and emerging ESG risks) of our clients' organisation risks.
3. **Engage** – Leverage on subject matter experts within the organisation to interpret the ESG related risks.
4. **Assess** - prioritise material ESG issues based on the impact and likelihood for inclusion into the existing risk management framework.
5. **Integrate** – mapping ESG issues can be one to one or one to many risk categories.
6. **Monitor and escalate** – monitor the implementation and performance of ESG related risks and make revisions if progress falls short of expectations.
7. **Communication and reporting** – establish information and communication channels to cascade relevant ESG-related risk information to internal and external parties.

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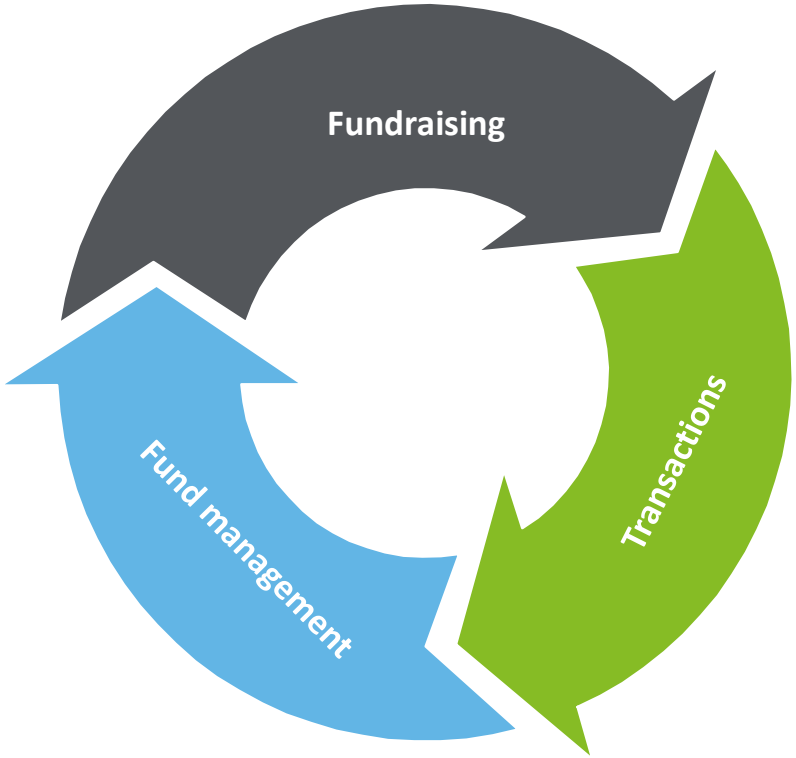
Responsible investment

Our approach is designed to integrate ESG in the entire lifecycle of investment, from fundraising to investing, monitoring the investment, managing the fund and divesting



Fundraising *(Investment Strategy)*

- Design ESG investment criteria
- Screening and management tools to identify risks and opportunities

Transactions *(Investments/Divestments)*

- ESG due diligence covering environmental management, health and safety, labour practices, etc.

Fund management *(Integration, post-deal value creation and on-going management)*

- Design and implementation of ESG reporting tools and information systems, at both the fund and portfolio company levels
- ESG reporting and assurance

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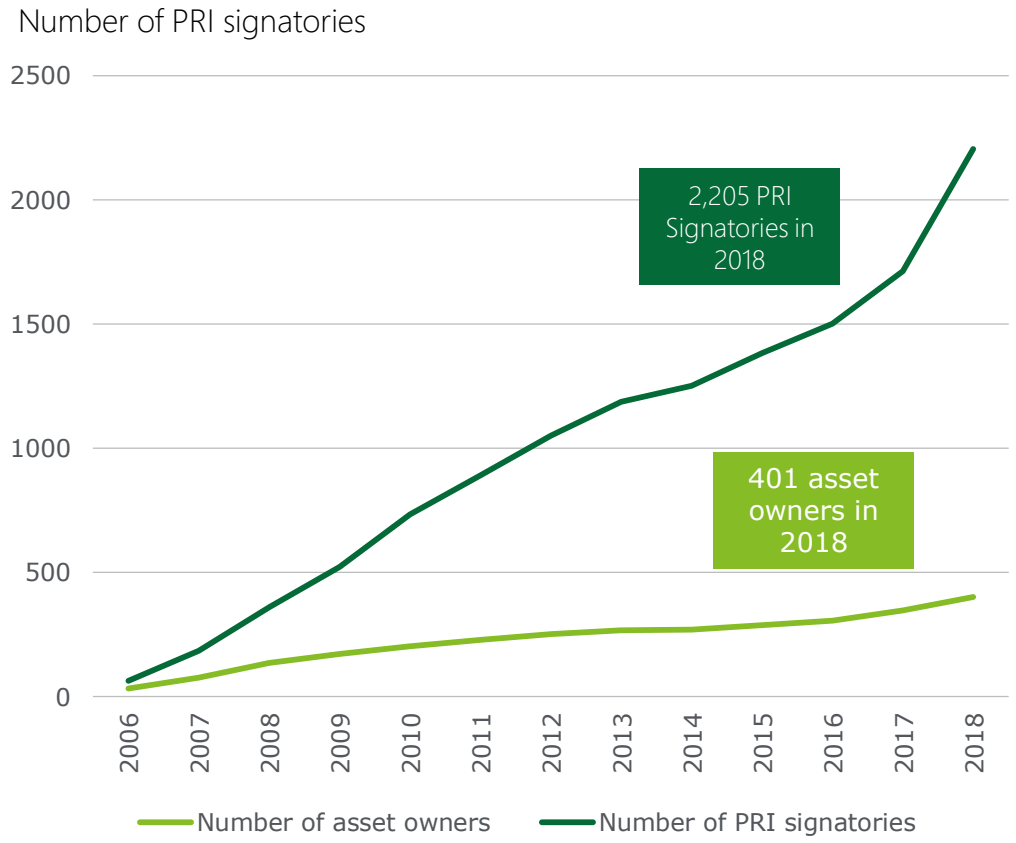
Substantial growth in ESG assets

Investors increasingly connecting financial performance with ESG performance

- According to Global Sustainable Investment Alliance, ESG investing assets increased from $22.9 trillion in 2016 to **$30.7 trillion in 2018**
- UN PRI, the world's leading advocate of responsible investment, has more than **2,200 signatories in 2018**

Principles for Responsible Investment (PRI)

- Developed by Kofi Annan in 2005; launched April 2006
- Supported by the UN and engages with global policymakers
- ~2,200 signatories in 2018 → approx. $81.7 Trillion in AUM



Source: PRI, 2017 and 2018, Principles for Responsible Investment - PRI

GSIA, 2019, http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

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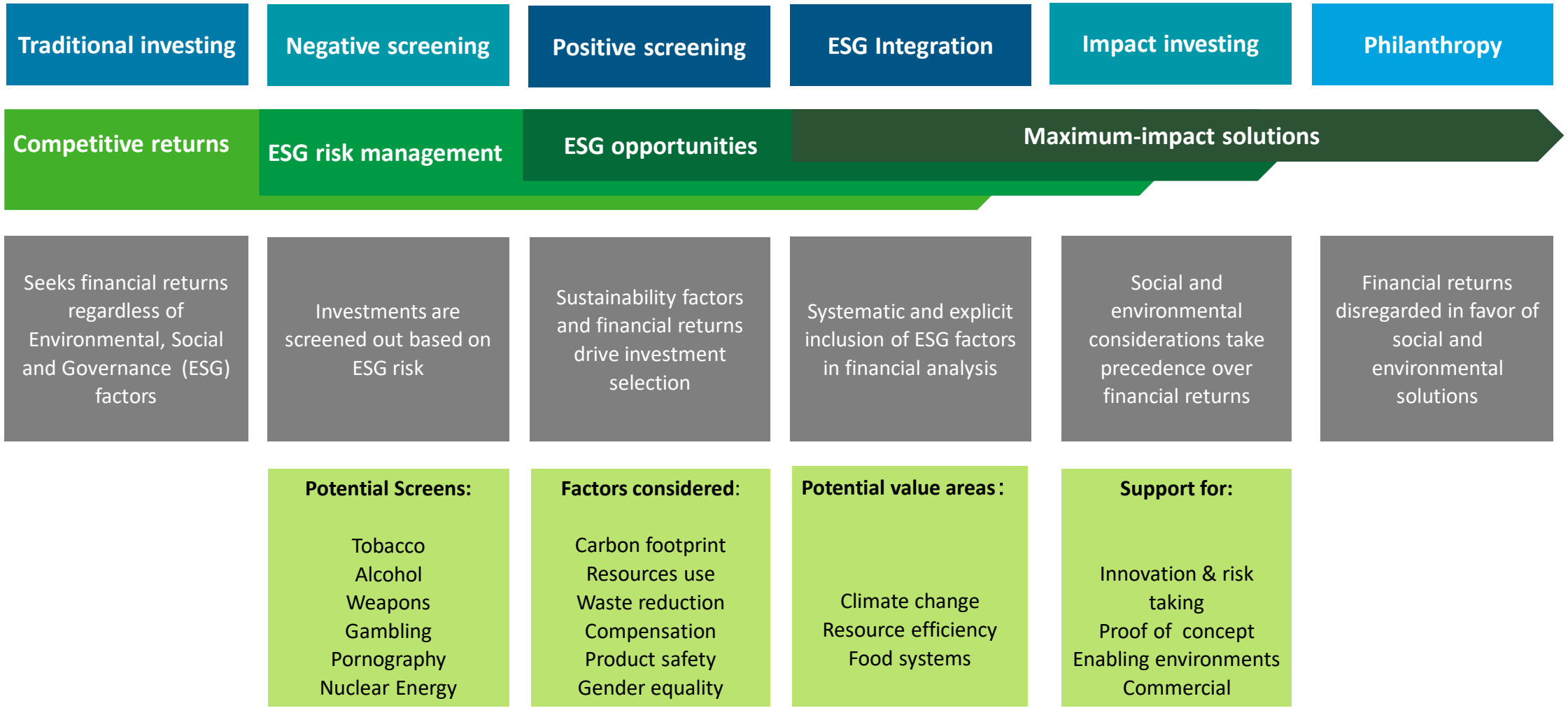
Responsible Investment Spectrum and the respective ESG considering factors



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Responsible investment cycle – an example

	SCREENING	DUE DILIGENCE	INVESTMENT DECISION	INVESTMENT AGREEMENT	OWNERSHIP AND MONITORING	EXIT
OBJECTIVES	• Confirm compliance with the fund's policy and exclusion list. • Identify key ESG issues early. • Plan DD process and allocate resources. • Build common understanding with the company.	• Assess the ESG risks and opportunities to allow the fund's IC to make an informed decision considering: (1) ESG factors; and (2) the company's and fund manager's capacity to address risks and capitalise on opportunities.	• Enable the fund's IC to make an informed investment decision that takes ESG factors into account.	• Secure and formalise commitments from the company to meet applicable ESG requirements including ESG Action Plans. • Protect the fund from reputational, financial and/or legal damage.	• Guide/assist the company to ensure its ongoing compliance with applicable standards, implementation of the ESG Action Plan and improvement of ESG performance. • Stay informed and respond to new developments and/or risks.	• Link evidence-improved ESG performance to company's value. • Engage with buyers on ESG and prepare reference materials. • Ensure company's ESG management system is self-sustaining.
ACTIVITIES	• Ensure compliance with fund's policy and exclusion list. • Identify key ESG risks and opportunities. • Build a common understanding with the company. • Categorise E&S. • Plan DD.	• Define scope of DD. • Perform desk review. • Assess company's CCTR. • Conduct site visits. • Engage ESG experts (if appropriate). • Agree ESG Action Plans. • Ensure influence and oversight. • Prepare DD report. • Provide input for the IC.	• Make an investment decision taking into account ESG factors.	• Negotiate ESG terms with the company. • Incorporate ESG terms in the shareholders agreement (or equivalent document).	• Build on the relationship established during DD. • Regularly monitor: oversee and support the company on ESG matters. • Manage unplanned events. • Prepare for exit.	• Plan the exit. • Prepare relevant ESG documentation for potential bidders.
OUTPUTS	• Identification of 'no-go' and key ESG issues. • Initial E&S categorisation. • ESG section in the screening memorandum for the IC.	• Final E&S categorisation. • Due diligence report. • ESG Action Plan(s). • Summary of finding for the IC. • DD reports, ESAP and supporting material saved.	• IC decisions minuted. • Conclude satisfactory completion of conditions precedent. • Update the IC in case of material changes post-IC.	• Shareholder's agreement or equivalent that includes appropriate ESG clauses and clearly outlines how ESG matters will be handled during the life of the investment.	• Appropriate influence and oversight. • Record monitoring engagements. • Annual ESG reporting and reporting to investors. • Non-routine event communications.	• Financial model taking into account ESG aspects. • Information memorandum including information on the company's ESG performance and improvements over past years.

Source: CDC

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Trend:

1. Sustainable Development Goals

2. Task Force for Climate-related Financial Disclosure

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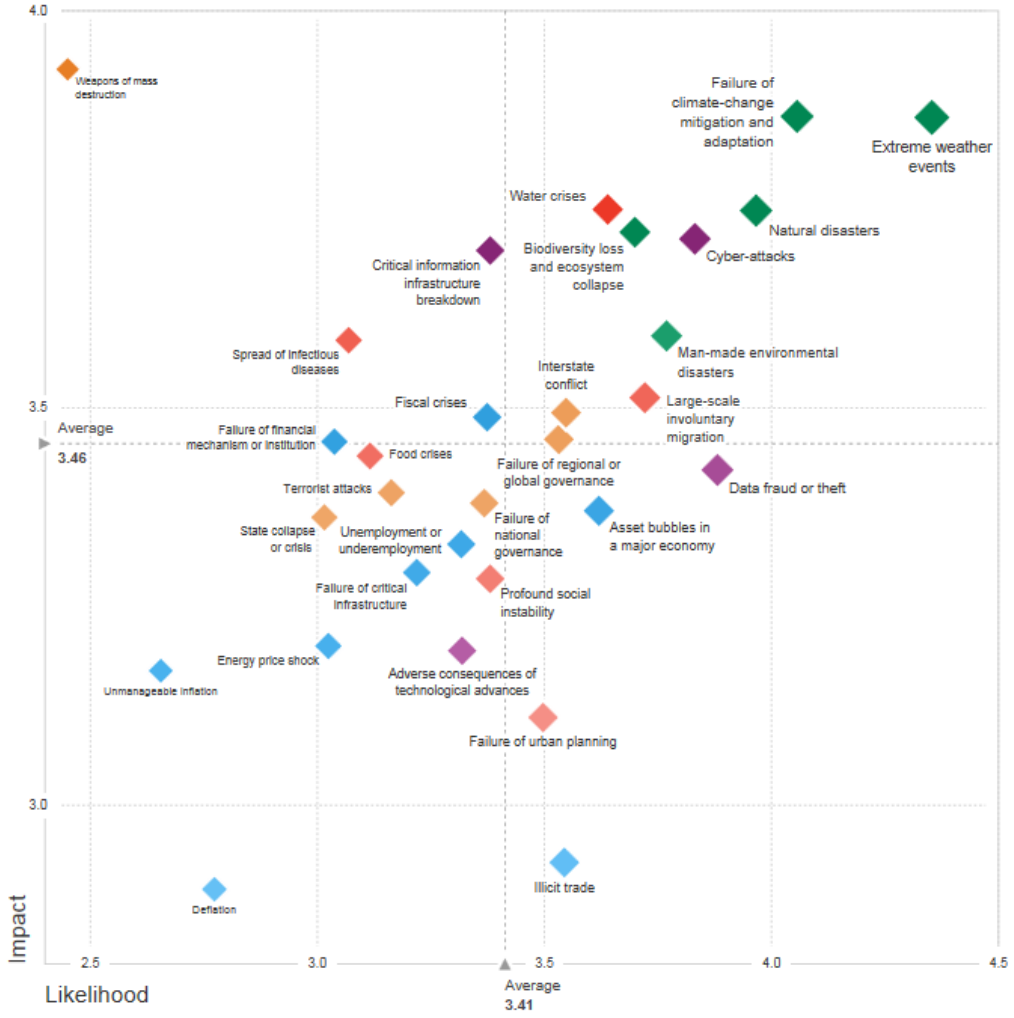
Climate change is the leading risk of the global economy

One illustration: the World Economic Forum 2019 Global Risks Report

The Global Risks Landscape 2019

What is the impact and likelihood of global risks?



Top 10 risks in terms of **Likelihood**	Top 10 risks in terms of **Impact**
1. Extreme weather events	1. Weapons of mass destruction
2. Failure of climate-change mitigation and adaptation	2. Failure of climate-change mitigation and adaptation
3. Natural disasters	3. Extreme weather events
4. Data fraud or theft	4. Water crises
5. Cyberattacks	5. Natural disasters
6. Man-made environmental disasters	6. Biodiversity loss and ecosystem collapse
7. Large-scale involuntary migration	7. Cyberattacks
8. Biodiversity loss and ecosystem collapse	8. Critical information infrastructure breakdown
9. Water crises	9. Man-made environmental disasters
10. Asset bubbles in a major economy	10. Spread of infectious disease

Source: World Economic Forum Global Risks Perception Survey 2018–2019

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Sustainable Development Goals (SDGs)

Blueprint to achieve a better future

- 17 development **goals** set by the United Nations in 2015 for the year 2030 to address global challenges
- Governments often employ SDGs as a framework to achieve a more sustainable future for all; companies increasingly setting corporate targets aligned with SDGs

Source: UNSDG, 2019, https://www.un.org/sustainabledevelopment/sustainable-development-goals/

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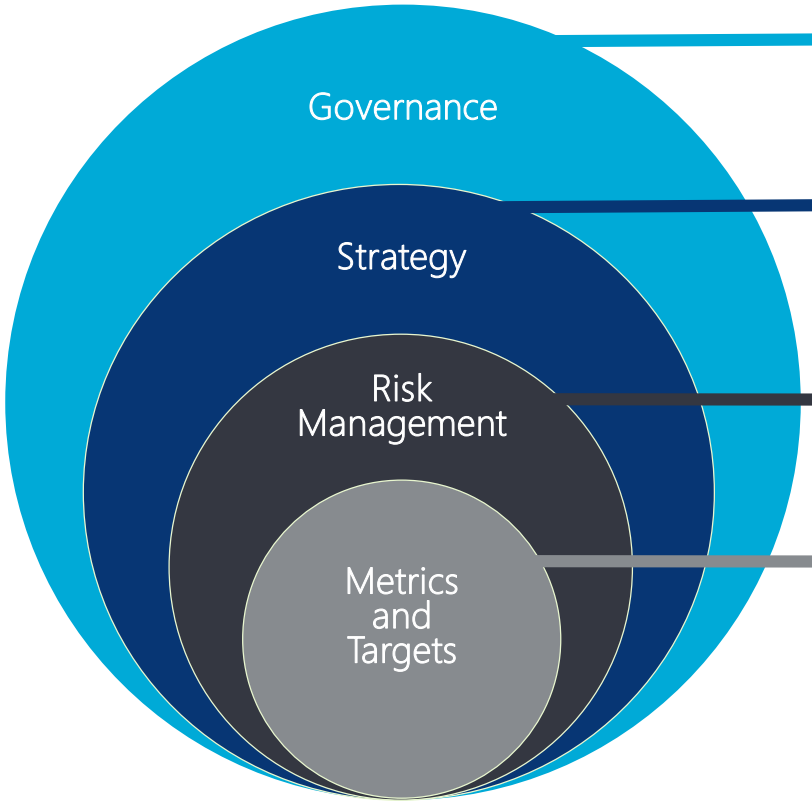
International ESG Reporting Standards

Task Force for Climate-related Financial Disclosure

TCFD aims to could promote more informed investment, credit, and insurance underwriting decisions and to enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks.

The recommendations are structured around four thematic areas that represent core elements of how organisations operate:



The organization's governance around climate-related risks and opportunities

The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning

The processes used by the organization to identify, assess, and manage climate-related risks

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

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Financial Impact by Industry

To assist organizations in understanding how climate-related risks may impact them financially, the Task Force prepared a high-level overview of the types of financial impact of climate-related risks that have been identified for specific industries and groups.

The financial impacts from climate-related risks are grouped into the following general categories:

- **Revenues**
- **Expenditures**
- **Assets and Liabilities**
- **Capital and Financing**

Evidence of Financial Impact

Groups and Industries		Revenues	Expenditures	Assets and Liabilities	Capital and Financing
Financial	Banks	■		■	
	Insurers	■	■	■	
	Asset Owners	■		■	
	Asset Managers	■		■	
Energy	Oil and Gas	■	■	■	■
	Coal		■	■	■
	Electric Utilities	■	■		■
Transportation	Air Freight		■		■
	Passenger Air Transportation		■		■
	Maritime Transportation		■		■
	Rail Transportation		■		■
	Trucking Services		■		■
	Automobiles and Components	■	■		■
Materials and Buildings	Metals and Mining		■		■
	Chemicals	■	■		■
	Construction Materials	■	■		■
	Capital Goods	■	■		
	Real Estate Management and Development	■	■	■	■
Ag, Food, and Forest	Beverages		■		■
	Agriculture	■	■	■	■
	Packaged Foods and Meats		■	■	■
	Paper and Forest Products	■	■	■	■

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Closing remarks

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Closing Remarks

"Attracting and retaining the best talent increasingly requires a clear expression of purpose… In a recent survey by Deloitte, millennial workers were asked what the primary purpose of businesses should be – 63 percent more of them said 'improving society' than said 'generating profit.'" – Blackrock Chairman and CEO, Larry Fink, 2019 Letter to CEOs

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Q&A

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