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Smaller firms still 'puzzled' over HK climate risk disclosure demands

By Echo Huang September 1, 2021

While Hong Kong's securities regulator acquiesced to many industry suggestions on its new climate risk disclosure framework, some smaller fund firms remain unsure or reluctant to comply with the baseline requirements, especially given the lack of client demand.

After Hong Kong's Securities and Futures Commission issued its consultation conclusions for proposed climate risk disclosures on August 20, legal experts in the territory have seen many small to medium-size managers seeking their help to understand the technicalities and implementations given the lack of internal resources and experience.

Following the original consultation released in October 2020, the SFC received more than 50 responses and made some amendments that many acknowledge have helped relieve managers' legal compliance burdens, experts say.

They included revising upwards the threshold for the definition of large fund managers from HK$4 billion (US$510 million) to HK$8 billion, meaning fewer firms are subjected to the "enhanced rules", which represent the strictest disclosure requirements. The SFC also extended the timelines of meeting the basic requirements to 15 months for smaller fund managers, up from its earlier one-year timeline.

This means that about 100 to 200 large fund managers need to meet the more onerous disclosure standards, covering requirements such as scenario analysis and identifying portfolio carbon footprint.

This leaves around 1,600 to 1,700 smaller firms licensed by the SFC managing both authorised and unauthorised strategies that will be subjected to the baseline requirements covering governance, investment management, risk management and disclosure, according to the regulator.

These smaller firms include retail fund companies, hedge funds, real estate investment trusts and exchange-traded fund businesses that run collective investment schemes. Those that manage discretionary accounts only are not governed by these disclosure rules.

The baseline requirements ask all firms to outline physical and transition climate-related risks for each investment strategy, and assess, monitor and quantify the possible impacts on their investments.

They also ask

Climate change disclosures baseline requirements

Baseline requirements	Elaborations
Governance	Define the board or the board committee's role in overseeing the incorporation of climate-related considerations into the investment and risk management process
Investment Management	Should keep records to explain why climate-related risks are irrelevant/relevant
Risk Management	Apply appropriate tools and metrics to assess and quantify climate-related risks
Disclosure	Entity or fund-level disclosures, reveal at least annually, communicate with investors

Source: CompliancePlus

managers to provide information on the board's role in adding climate-related considerations into the investment and risk management processes, and its progress on goals for addressing climate-related issues.

A Hong Kong-based senior executive at a foreign ETF provider says her firm plans on simply adding a single line in the product disclosure on climate risk.

The executive, who requested anonymity because she is not authorised to speak to the media, argues that any climate risk disclosure will be mere box ticking, as the firm cannot alter the underlying investments unless the index provider does so.

Josephine Chung, owner and director of Hong Kong-based CompliancePlus Consulting, says the majority of her fund firm clients are still "puzzled" by the baseline requirements as they are not yet sure exactly how or why it should apply to their investment strategies.

This includes some boutique fund managers who are highly skewed towards quantitative or high-frequency trading and may not be investing into individual stocks but rather derivatives, so they do not weigh up fundamentals like other long mutual fund strategies, Chung says.

Many of these strategies' climate-related risks do not have much relevance to their risk management profiles, Chung says.

She adds that managers who run investment strategies such as health care and property funds, for example, may not be attuned to climate-related investment risks if they think there will be little impact on their portfolios.

Another Hong Kong-based compliance expert, who requested anonymity because of the sensitivity of the comments, says most hedge fund managers do not see rising sea levels and global warming as particularly imminent risk management threats.

But now, small local hedge fund managers have to suddenly bear the cost of big-picture policies, which is making them “very confused”, she says.

"On a topic like this, people may try to make themselves politically correct,” the legal expert says. “It’s hard for hedge fund managers saying that 'we are not interested in it’.”

Leonie Kelly, Hong Kong-based director and head of sustainable investment consulting at law firm Ogier, says she saw enquiries from both asset managers and hedge funds about the requirements within an hour after the SFC conclusions were published.

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Some of the major fundamental questions are still around how they can assess the material climate-change risk issues, how to deal with specific strategies, what practical examples there are and how fund managers should even approach climate risk management, Kelly says.

The SFC says that even for investment strategies or funds they think are irrelevant, fund managers should make relevant disclosures and maintain appropriate records. These must be done at least annually and updated as necessary.

A Hong Kong-based responsible officer at a hedge fund says this will be challenging given the need to first find the data, devise calculations and provide reasons, instead of just adding a “broad stroke” conclusion in the annual report.

Given the lack of specific examples, the executive says he is adopting a wait-and-see approach, instead of “spending resources and money to look for legal advice when no one knows what to do exactly”. He spoke on the condition of anonymity because he is concerned about regulatory oversight on such comments.

The SFC has asked managers to refer to some international standards, such as the Task Force on Climate-related Financial Disclosures and Carbon Accounting Financials, and a formula that facilitates the calculation of them.

Poon Suen Son, chief operating officer and general counsel at Income Partners Asset Management, says the firm has been implementing full ESG integration across the firm, including the evaluation of ESG metrics in investment processes and the establishment of an ESG committee.

Poon says that for the Hong Kong-headquartered manager, which has US$2.6 billion in assets under management as of the end of August, the main baseline requirement it still has to work on is the risk management aspect, but for firms that have not begun their preparations for the climate risk disclosure rules it may be quite time consuming.

“I think the challenges for managers who did not have an existing framework would be quite involved and would require a lot of changes in processes, but also buy-in and extensive involvement from senior management, investment and risk teams,” she says.

CompliancePlus Consulting’s Chung says most of her fund manager clients source assets from investors in Hong Kong, China and other Asian markets who are less keen about ESG matters compared with many European insurance and pension funds.

Many of these fund managers are less incentivised to get up to speed on the necessary requirements compared with the large international companies, she says.

In Asia, ESG disclosures are not highly correlated with the ability to complete successful fundraising, Chung says. "For fundraising, people will still focus on performance."

There are also some distinctions to be made between fund houses and investment strategies that primarily target institutional investors, and those that have more of a retail focus.

The responsible officer at the hedge fund says retail investors may not be very aware of ESG guidelines or investment approaches, but some institutional investors have already developed in-house ESG policies and managers would probably refer to those guidelines first.

Retail ESG fund sales, which stood at US$203.6 million, account for about 2.5% of the total net sales of all SFC-authorised products this year as of end-June, data from the Hong Kong Investment Funds Association show.

Another Hong Kong-based senior executive for a local manager echoes similar views, saying that he is not planning on changing his approach due to the climate risk disclosure guidelines.

“This won’t affect my investment decision,” he says, referring to the climate risk disclosure requirements.

The executive intends to mention climate risks in the selection process for regulatory purposes, but his firm will not allocate many resources to address the requirements.

Instead, he will rely on brokers his firm uses that already have some ESG scoring as reasons and justifications for whether his investments are relevant to climate risk.

“If investors don’t care [about climate risk] as much, if you spend time trying to explain this, it would actually make investors question if you are really doing what they pay you [to, i.e. manage their money],” he says.