FULLERTON
FUND
MANAGEMENT

Materiality of Asia: Investing away from climate risk

The Economist INTELLIGENCE UNIT

CEO Foreword

Climate change is the defining issue of our time. More extreme weather conditions such as monsoons and typhoons are occurring at a higher frequency, which comes at a cost to the environment, businesses, and livelihoods.

At the same time, climate change has accelerated the transition to a low carbon future, creating unprecedented opportunities in emerging industries such as renewable energy and electric vehicles.

While companies in Asia are aware that climate change poses risks and opportunities, a material understanding of what constitutes climate risks remains lacking – this has potential implications on how well businesses are able to adapt to climate change, and frames the discussion behind this article.

Increasingly, asset owners and asset managers are placing environmental, social and governance (ESG) considerations firmly on their agenda – and those of the companies they invest in. Corporate disclosures on ESG issues have risen in tandem, but the quality of ESG reporting remains uneven across geographies and industries, particularly in a region as diverse as Asia.

By engaging portfolio companies on material ESG and climate risk issues and opportunities, asset owners and asset managers like Fullerton Fund Management can actively encourage companies to adopt higher disclosure standards and align their reporting to internationally recognised frameworks such as the Task Force on Climate Disclosures (TCFD).

Companies with a material understanding of climate risks and opportunities are better able to incorporate them into their risk management and strategic planning, and to build more sustainable enterprises in the long run.

Jenny Sofian
Chief Executive Officer
Fullerton Fund Management

Materiality of Asia: Investing away from climate risk

What constitutes material climate risks remains under debate within the financial industry, with clarity and consensus on the topic elusive. It is clear, however, that unless parties agree on what needs to be measured, the consequence could be an irreversible breach of climate limits—such as those set out in the Paris Agreement.

The business risk and reality of climate change

Asia is on the front line of climate change. Six of the ten largest economic loss events in 2019 occurred in the region, all caused by extreme precipitation (typhoons or monsoons), according to insurance provider Aon.[1] The McKinsey Global Institute estimates that, under some scenarios, the risk of extreme precipitation could rise by as much as fourfold in parts of East and Southeast Asia by 2050.[2]

"Flooding—the damage caused by it and spending to protect against it—poses the biggest climate risk in Asia from an economic perspective," says Upmanu Lall, professor of engineering at Columbia University and director of the Columbia Water Center. "That risk is magnified by the fact that South Korea, Japan, Southeast Asia and southeast China are the global hub of manufacturing," he adds.

1 Aon, Weather, Climate & Catastrophe Insight — 2019 Annual Report. https://www.aon.com/global-weather-catastrophe-natural-disasters-costs-climate-change-2019-annual-report/index.html

2 McKinsey Global Institute, Climate risk and response in Asia, August 2020. https://www.mckinsey.com/featured-insights/asia-pacific/climate-risk-and-response-in-asia-research-preview

When record-high floods inundated the Chinese city of Wuhan and surrounding towns in June and July of 2020, the waters disrupted the personal protective equipment (PPE) supply to global healthcare markets. Wuhan-based manufacturers' operations were heavily disrupted, as were those reliant upon them. The ripple effects, and idled and stranded assets, were a manifestation of the material risks that extreme weather—often attributed to climate change—poses to business operations and supply chains in Asia.[3]

By some measures, businesses in Asia largely understand the impact that climate change has, or can have, on their operations. ESG (environmental, social, governance) reporting by businesses in the region has soared in recent years, according to the CFA Institute, a not-for-profit association supporting finance professionals.[4] The covid-19 crisis does not appear to have put companies off from pursuing ESG practices. In a recent Economist Intelligence Unit study, 72% of Asia-Pacific CEOs said they increased their focus on ESG in the first stage of the crisis.[5] And stewardship codes that guide investors in their ESG engagement with listed companies are proliferating across the region, according to the Principles for Responsible Investment, a UN-supported network of institutional investors, and "are now the rule rather than the exception".[6]

According to Emily Kreps, global director of capital markets with CDP, a non-government organisation that supports environmental disclosure, many companies in China and Japan understand the need to report their environmental impact and have high disclosure rates through CDP. Disclosure, however, is more sporadic in other parts of Asia, she says.

The CFA Institute questions the quality of much ESG reporting in the region, stating that many issuers treat it as a box-ticking exercise. Mr Lall agrees as it relates to climate risks, adding that, the technology industry aside, companies in Asia do not take this into sufficient account in their business strategies.

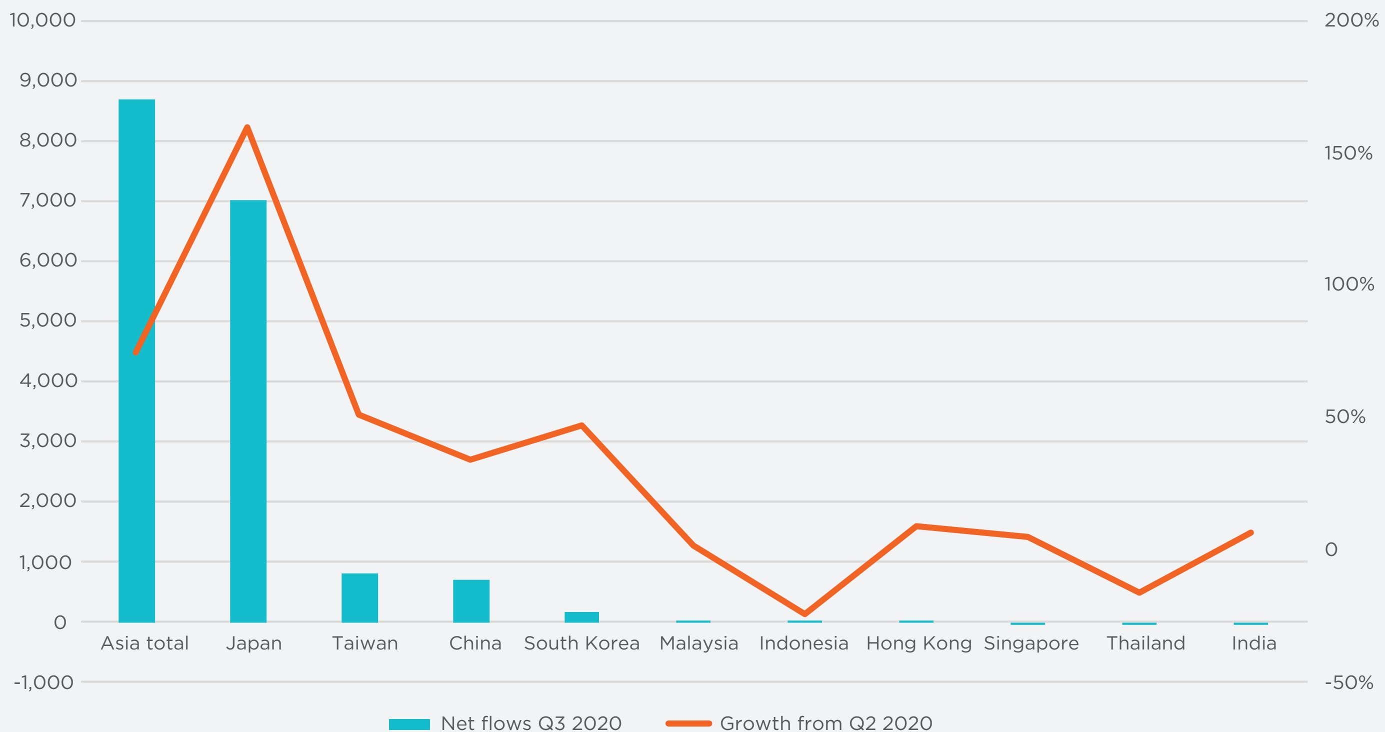
3 The massive Three Gorges Dam, built upriver from Wuhan and in operation since 2006, was partly designed to control such flooding. That Wuhan and other areas suffered flooding (on this and previous occasions), and that the dam itself came under pressure, suggests that the pace of climate change has exceeded what engineers and climatologists expected one or two decades ago.

4 CFA Institute, ESG Disclosures in Asia Pacific, November 2019. The Institute's assertion is based on a summary of estimates from other sources. https://www.cfainstitute.org/en/about/press-releases/2019/asia-pacific-sees-growing-emphasis-on-ESG-disclosures

5 EIU, The Asia-Pacific CEO survey: Business leaders chart the road ahead, November 2020.

6 "Scaling up sustainable finance in Asia: highlights from PRI APAC Digital Symposium", PRI website, September 22nd 2020.

Investment in locally domiciled ESG-linked funds, Q3 2020



Source: Morningstar Direct, as reported in "Asia's ESG funds AUM surge 75% in Q3", ESG Clarity, November 16, 2020. https://esgclarityasia.com/asias-esg-funds-aum-surge-75-in-q3/

Making it material

Asset owners—the world's largest investors—want businesses they invest in to protect themselves against risks, including excess carbon emissions. Influential investors, such as GPIF, Japan's pension fund (with over US$1.7trn[7] under management), are also demanding more insight into corporate operations to better gauge material impacts on financial performance and want to see risks accurately reflected in ESG rankings and reporting. Other government pension funds in Asia are moving in this direction, including Thailand's Government Pension Fund, which issued new rules on ESG investing in 2019.[8]

But what can asset owners do to influence the companies they invest in? Building an understanding of ESG materiality—the impacts that matter to financial performance—is one place to start.

Materiality can be a contentious and elusive topic because, as Ms Kreps observes, interpretations of what counts as material often differ from business to business.

According to Michael Tang, head of listing policy and product admission at Singapore Exchange Regulation, consensus about what constitutes material climate impacts has grown in the investment industry in recent years, thanks largely to the work of the Task Force on Climate-Related Financial Disclosures (TCFD), which was established in 2015 by the Financial Stability Board. The TCFD's recommendations for voluntary reporting of climate impacts, published in 2017, are steadily gaining adherents, including in Asia.[9] They include businesses in more than a dozen sectors, as well as large government-affiliated institutional investors such as GIC and Temasek, Singapore-based sovereign wealth funds, and Japan's GPIF. However, says Mr Tang, best practices on how companies should measure climate impacts and report them are still developing.

7 SWFI, Top 100 Largest Public Pension Rankings by Total Assets, https://www.swfinstitute.org/fund-rankings/public-pension

8 "Thailand's Government Pension Fund's new ESG rules draw 32 signatories, report says", Asia Asset Management, August 19th 2019.

9 Among the approximately 1,500 "supporters" of the TCFD recommendations as of October 2020, roughly 450 were located in Asia, and about 400 of these were companies. See TCFD press release, "Third TCFD Status Report Shows Progress & Highlights Need for Greater Climate-Related Disclosures and Transparency", October 29, 2020 (https://www.fsb-tcfd.org/news/), and the full list of its supporters on its website (https://www.fsb-tcfd.org/supporters/).

Typical categories of climate-related risks and opportunities

Market and Technology Shifts

Policies and investments to deliver a low carbon emissions economy

- Reduced market demand for higher carbon products/commodities
- Increased demand for energy-efficient, lower-carbon products and services
- New technologies that disrupt markets

Reputation

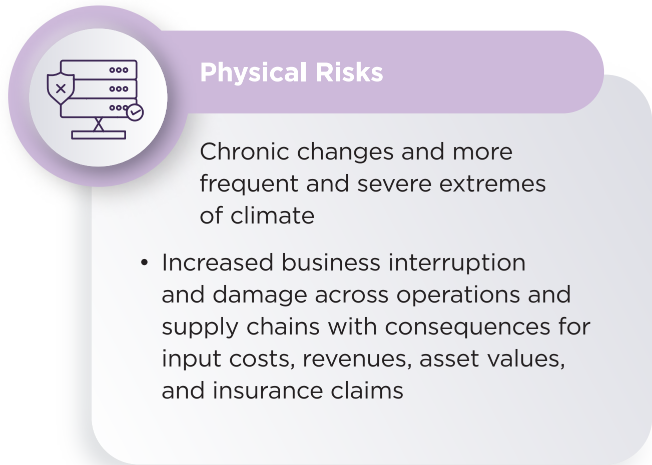
Growing expectations for responsible conduct from stakeholders, including investors, lenders, and consumers

- Opportunity to enhance reputation and brand value
- Risk of loss of trust and confidence in management

Policy and Legal

An evolving patchwork of requirements at international, national, and state level

- Increased inputs/operating costs for high carbon activities
- Threats to securing license to operate for high carbon activities
- Emerging concern about liabilities



Physical Risks

Chronic changes and more frequent and severe extremes of climate

- Increased business interruption and damage across operations and supply chains with consequences for input costs, revenues, asset values, and insurance claims

Sources: CDP, "Climate Change Questionnaire," 2017.

Task Force on Climate-related Financial Disclosures, Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017.

Understanding of material climate impacts is relatively well developed in a few industries. For example, property developers are ahead of others in Asia, observes Mr Tang, since for several years they have had to consider rising sea levels in decisions about where to build certain types of infrastructure and how to mitigate against flooding risk to avoid funding stranded assets.

Mr Lall believes large technology companies have a good grasp on how climate risks impact their Asian supply chains (partly as a result of damages suffered in 2011 after floods in Thailand decimated supply of computer memory products). Tech firms aside, "few manufacturers have a clear picture of this beyond their first- or second-tier suppliers," he says.

Investors and asset managers are in a better position to educate companies on material climate impacts than regulators currently are. "What we see investors and financial institutions asking companies for," says Ms Kreps, "is not whether they've identified and reduced all the risks, but rather, 'What plans have you made? And, if you haven't made plans, why not?' Regulators are unlikely to go beyond this to mandate what specifics should be disclosed."

Katherine Ng, COO for listing at the Hong Kong Exchange, expressed a similar sentiment at a 2019 event announcing the exchange's ESG guidelines. When stakeholders in the audience raised questions of enforcement, her response could be paraphrased as: 'failure to report will result in failure to attract investment'. That may seem like a passing of responsibility but Mr Tang largely agrees, believing that his and other regulators' most effective role, for now, is to encourage dialogue on materiality between investors and companies. "What's material in reporting is ultimately what investors consider that to be," he says.

Market power

Mr Tang's comment points to a balance that regulators, in Asia and elsewhere, are trying to strike between what should be mandatory or voluntary for ESG reporting. Although corporate disclosure is clearly on an upswing, it's still far from universal.

In the early years of ESG reporting, financial analysts and investors largely focused on the governance aspect, where an absence of reporting was largely taken as admission of poor corporate governance. That put downward pressure on share prices as the largest investors—primarily asset owners and their fund-managing proxies—shied away from bad actors, threatening a vicious downward cycle for listed companies.

As investor focus has shifted to ESG's environmental pillar, investors and the financial industry as a whole are still struggling with exactly what should go into a report. As with the governance metric, any lack of environmental reporting should come under negative light. Such neglect may indicate deficient understanding on the corporate side or worse, delinquent action.

It is for asset owners and asset managers, through the power of market consensus, to convince companies that disclosing climate impacts is important not just for regulatory compliance, but also for the most material metric: attracting investment. At a basic level, says Mr Tang, companies need to understand that climate risks are only going to increase, and addressing them is necessary to ensure the future viability of their business. Owning up to risks is the first step toward protecting against them.

Viewpoint

How Asian companies can better manage climate risks and opportunities

Climate change is creating new business risks and opportunities that companies in Asia have to manage.

On the risk side, Asian companies can identify physical risk and transition risks associated with climate change and integrate them into their strategic and operational planning. For instance, companies can assess the vulnerability of their assets and operations to the increasing frequency and intensity of floods, droughts and typhoons associated with climate change.

Equipped with such assessments, companies can improve the physical security of their assets (e.g. flood resilient buildings and facilities) and prevent the disruption to their operations and their supply chain.

The commitments by the governments in the region to become carbon neutral also create transition risks for Asian corporates in energy-intensive industries such as power, oil and gas, construction materials, chemicals, and electronics manufacturing. In China, the government is piloting carbon emissions trading schemes in 13 cities which represents 5% of the global GHG emissions[10] and aims at launching a nation-wide scheme. With a price on carbon, companies are incentivised to operate more efficiently and reduce their carbon emissions.

In addition to addressing and managing climate-related risks, companies in Asia can leverage opportunities presented by the shift to a low-carbon economy. Companies can reduce their operating cost by investing in higher efficiency solutions in production. They can also capitalise on the increasing demand for climate-friendly technologies, including clean transportation, digitalization and renewable energy.

Loic Dujardin
Head of ESG
Fullerton Fund Management

10 Source: China: ESG with Chinese characteristics, IPE, September 2020. https://www.ipe.com/reports/china-esg-with-chinese-characteristics/10047485.article

The report was written by Denis McCauley and edited by Jason Wincuinas. The report includes sections of independent commentary from Fullerton Fund Management.

Additional insights were obtained from in-depth interviews with the following subject matter experts and we thank them for their time:

Emily Kreps, global director, capital markets, CDP

Upmanu Lall, professor of engineering, Columbia University; director, Columbia Water Center

Michael Tang, head of listing policy and product admission, Singapore Exchange Regulation (SGX RegCo)

Disclaimer: No offer or invitation is considered to be made if such offer is not authorised or permitted. This is not the basis for any contract to deal in any security or instrument, or for Fullerton Fund Management Company Ltd (UEN: 200312672W) ("Fullerton") or its affiliates to enter into or arrange any type of transaction. Any investments made are not obligations of, deposits in, or guaranteed by Fullerton. The contents herein may be amended without notice. Fullerton, its affiliates and their directors and employees, do not accept any liability from the use of this publication.

While every effort has been taken to verify the accuracy of this information, The Economist Intelligence Unit Ltd. cannot accept any responsibility or liability for reliance by any person on this report or any of the information, opinions or conclusions set out in this report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor.