CFA Institute

UNDERSTANDING ESG INVESTING IN ASIA-PACIFIC EMERGING MARKETS

November 2022

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Environmental, social, and governance (ESG) investing is taking off globally. Morningstar estimated that by the end of June 2022, global sustainable assets totaled $2.5 trillion. Within that, Asia ex-Japan accounts for $61 billion, or around 2% of the total. Mainland China accounts for more than 75% of the Asia-Pacific (APAC) region's sustainable fund base and is ranked third in terms of market size. Among the rest, Taiwan and South Korea remained the two largest markets by asset size, accounting for 11% and 6% of the region's assets, respectively. Despite a small presence in the sustainable asset market, APAC has just started coming under the spotlight, displaying signs of its potential and contribution.

While ESG is gaining in prominence in APAC, emerging markets (EMs), by design, are at a more nascent stage of development, with relatively high dependence on fossil fuels over the short to medium term and a greater need to address social issues alongside environmental issues. To explore these issues, CFA Institute collaborated with CFA Institute member societies[1] in the region and organized a roundtable to learn the views of industry practitioners. Key topics covered include ESG investing philosophy and transition pathways, how ESG investing is tailored to EM context, and opportunities and risks specific to EMs.

At the center of many of the discussions is the inclusion of brown sectors. Over the past few years, the debate over greenwashing has evolved from being exclusionary to transition oriented. This plays a crucial role in EMs, considering the stage of their economic development, their employment structure, and their energy independence. Notably, the shift in attitude over brown sectors is also reflected by a distinct shift in green taxonomy definitions and coverages; for example, Europe recently included natural gas as part of its green taxonomy, subject to stringent limits on life-cycle emissions. Brown sectors are increasingly being included by ESG funds: According to Bloomberg, as of June 2022, 62% of the 170 (domestic) ESG funds in mainland China invested in the steel sector and 15% invested in coal.[2]

Section 1. ESG Investing Philosophy

The panel acknowledged the distinct ESG outlook among APAC EMs and described it as a result of compliance-driven differences (i.e., what is allowed and what is not). Nonetheless, problems that are urgent and ubiquitous also exist. One participant expressed concern about the pace of carbon regulations in APAC because the region has suffered from extreme events of climate change—environmentally, socially, and economically. Also, despite geographical nuances, the general approach to ESG integration should be more or less the same, be it the factors to be considered or the valuation process.

Depending on taxonomy or policy, the thresholds and areas of focus differ, as do the responding strategies. For instance, the issue of plastic is huge in India but not in China, which aspires to tackle social inequality first, under the common prosperity principle. In this case, company engagement could be an alternative to exclusions. When asked about how to align with companies across various markets that have different targets (such as net zero, for example), one participant shared his experience engaging with market-leading companies, as they tend to be ahead of the rest regardless of the country's target dates.

One participant provided some perspectives on India, where contextualization of ESG investing prevails. Goals are set based on unique national challenges to balance sustainability and energy accessibility. Regulators are active in adopting India-specific criteria and rating. Instead of excluding brown sectors, Securities and Exchange Board of India (SEBI) is more inclined to draw attention to transition, stewardship, and engagement. The Reserve Bank of India shared a similar vision, with its recent discussion paper[3] on disclosure based on the Task Force on Climate-Related

[1]We would like to express our gratitude to CFA Society Thailand, CFA Society Malaysia, CFA Society Philippines, CFA Community Vietnam, and CFA Society Indonesia for co-organizing this roundtable.
[2]"Xi's ESG Boom Funnels Billions into Coal, Liquor, Defense Stocks," Bloomberg News (6 September 2022). www.bloomberg.com/news/articles/2022-09-06/china-s-esg-fund-investing-boom-follows-xi-s-political-agenda.
[3]Reserve Bank of India, "Discussion Paper on Climate Risk and Sustainable Finance" (27 July 2022). www.rbi.org.in/Scripts/PublicationsView.aspx?id=21071.

Financial Disclosures (TCFD) framework, its possible regulatory system in the near future, and the bigger transition plan in the country.

In the Philippines too, a similar trend is observed. Instead of a broad use of exclusion—which may result in a different return profile from the benchmark—the emphasis in recent years has been on integration, transition, and disclosures. Compared to negative screening, which implies unavoidable trade-offs, transition plans and green pathways allow more options in choosing how to invest. But some asset managers in the region, for certain reasons, still apply negative screening.

Another market, Vietnam, has a different approach toward compliance and practice. A local representative advised a "phasing out" approach to company engagement that would be compelling to EMs. (This approach essentially embraces short-term targets—often time bound and incremental—to achieve long-term systemic changes.) Given the economic uncertainties in Vietnam in the upcoming decade, it makes sense to set smaller but achievable portfolio targets.

Section 2. Market-Specific Developmental Issues

ESG investing has entered the mainstream in the APAC region. Both institutional clients and high-net-worth individuals in the Philippines place ESG considerations at the heart of their investment agenda, as a result of the net-zero pledge by 2050, and the pressure from the central bank to fund green and renewable energy projects. Yet, problems related to transition emerge in the form of a huge cost that needs to be borne by governments, investors, or a mix of the public and private sectors. In EMs and frontier markets—where balance sheets are not as strong—there are challenges in funding the costs of transition, such as unemployment in a significant sector and a potential loss in tax revenue. Also, from a political perspective, politicians (with four- to five-year terms on average) lack incentives to advocate for ESG, where change happens over the long term. Thus, long-term transition plans, even made with good intentions, conflict with short-term developmental needs and remain lower priorities.

In such markets as Vietnam, where brown industries have contributed to impressive economic growth, a participant shed light on community development issues that are worthy of attention in transition. For example, social costs during transition may be the result of unemployment of workers previously employed in brown industries and land acquisition issues for green projects.

State-owned enterprises (SOEs) are vital in many EMs in APAC, as they employ a large labor force and control abundant assets. Traditionally, many SOEs perform poorly on corporate governance issues as well. These facts suggest a similar dilemma to the brown sectors in relation to exclusion. Nevertheless, one participant remarked that they tended not to exclude SOEs in such markets as mainland China, despite the vast amounts of related-party transactions (RPTs) SOEs might have been involved in. They realized there is a spectrum even among SOEs and some have actually started to enhance corporate governance.

That also explains why in India, many investors from ESG funds include SOEs in their portfolios. Importantly, some SOEs have released transition plans to shift away from fossil fuels, and markets are discriminating SOEs based on ESG criteria. By way of illustration, some power companies have recently seen a dip in stock prices due to their poor reputation in tackling ESG issues. Also, the acceleration of efforts to meet ESG targets by SOEs can be a big part of the overall transition, making them difficult to ignore.

Section 3. Transition Plans: Quality of Disclosures and Engagement

A main challenge with transition plans is that roadmaps can be blurry and solid actions are yet to be measured. There is a belief among many companies in the promise of disruptive technologies arriving in the near future, solving the net-zero problem. One participant noted the example of carbon capture, an available technology and a major part of the transition that has not seen great progress over the last decade. In this context, stewardship and engagement can be indispensable when it comes to advocating for small and near-term targets and picking low-hanging fruits. Another participant mentioned the importance of an appropriate framework that best fit a company, to make disclosure both feasible and effective. On the issue of gaps in performance tracking for issuers and asset managers, participants were optimistic that it will improve over the long term, with more guidance and information from regulators. One participant cited the example of SEBI's recent mandate to ensure all ESG mutual funds come up with their own ESG ratings for every individual security and a weighted-average score for each portfolio. The data are collected and analyzed every month to make funds accountable.

Section 4. Regulations: Getting the Balance Right

Speaking of reporting, a participant touched on disparities in progress made by large, medium-sized, and small firms, since smaller firms have limited capabilities to meet certain reporting requirements. In other words, they rely more on government support and guidance. Apart from firm size, other factors that determine reporting outcomes include regulators' ability to deliver specific targets in different areas and whether disclosure of compliance with transition targets is mandated. One participant used the Monetary Authority of Singapore (MAS) as an example, which put forward more specific key performance indicators along with TCFD, instead of letting the market to figure it out. Another participant referenced the carrot-and-stick approach employed by stock exchanges—as a policy setter and a market developer—giving out incentives to disclosure while monitoring listed companies.

The roles played by regulators were well discussed. On top of that, participants noted the significance of large institutional asset owners in parts of Asia. ESG investing should also be asset owner driven rather than purely compliance driven. For instance, all asset managers would follow the lead and bring in new products if, say, a statement to promote green finance were made by sovereign wealth funds. After all, over-regulation could be a concern while ESG investing in APAC EMs has yet to mature. For example, while regulators are right to focus on mis-selling and greenwashing—a major concern in the developed world—rules that are too detailed may hamper innovation in this dynamic region. Indeed, regulators should also facilitate market development.

Section 5. Thoughts on New Technologies, Such as Green Hydrogen

Electric vehicles are becoming the change story in the region, including in India, attributed to more aggressive targets for electric mobility and complementary policy around battery management, recycling, and swapping. As a result, the electrification of vehicles is no longer limited to public transport. Another groundbreaking technology is green hydrogen, frequently dubbed the "ultimate solution." Nonetheless, some participants were skeptical of the actual utilization rate because it is difficult to transport hydrogen over a long distance and countries would need to modify the entire energy supply chain, at high cost. Until the cost-and-benefit analysis can actually be carried out, there are concerns around applicability/scalability of green hydrogen.

Another participant mentioned vertical farming, alongside traditional technologies such as solar and wind energy. A more balanced view was revealed: While the market remains cynical about the actual market share and the contribution to the core transition, some participants believe in the potential in combating climate change. Similarly, many of the disruptive green technologies are at their early stage and not necessarily accessible by public equity investors. Participants agreed on the fact that renewable energy faces constraints in market penetration and scaling up, considering both natural constraints and human factors in the process of commercialization. One solution could be battery storage to ensure stability, which still requires research and development.

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