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Asia in Focus: ESG INVESTING AND THE BUSINESS AND HUMAN RIGHTS AGENDA



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Acknowledgements

ESG Investing and the Business and Human Rights Agenda is a report written by Ilya Garger, with Sean Lees, and supported by the United Nations Development Programme (UNDP) and the European Union (EU). The findings are based on a literature review and expert interviews conducted between June and August 2023.

Concern is growing in Asia over the rights-related risks that industries pose to people and planet. Increased attention to these risks has pressured companies to mitigate the threats they pose to the environment and society, and driven investment in businesses and financial products that meet Environmental, Social and Governance (ESG) criteria. The present report describes the current state of ESG investment in Asia, examines how investors, regulators and others are responding to challenges, and offers recommendations inspired by the UN Guiding Principles on Business and Human Rights.

Copy-edited by Richard Pierce
Layout by Ysa Calinawan

Expert insights

Appreciation is extended to the following external experts (in alphabetical order by surname) for their time and insights:

Allinnettes Adigue, Global Reporting Initiative
Sasja Beslik, SDG Impact Japan
Hortense Bioy, Morningstar
Melissa Brown, Daobridge Capital
Bradley Busetto, SDG Impact Japan
Curtis Chin, Milken Institute
Jeff Conant, Friends of the Earth
Charles Donohoe, BlackRock
Lisa Genasci, ADM Capital
Valerie Kwan, Asia Investor Group on Climate Change
Douglas Ledingham, Stewart Investors
Jenny Lee, Hong Kong Green Finance Association
Dorothy Lund, Columbia Law School
Benjamin McCarron, Asia Research and Engagement
Ghislaine Nadaud, Robeco
Maud Savary-Mornet, Global Impact Investing Network
Erika Susanto, FAIRR Initiative
Ellie Tang, Fidelity International

John Tobin-de la Puente, Cornell University
Danielle Vrublevskis, ShareAction
Eugene Wong, Sustainable Finance Institute Asia
Wenhong Xie, Climate Bonds Initiative
Marina Zorila, ShareAction

Thanks are also due to the following UNDP colleagues:

Sagita Adesywi, UNDP Indonesia
Nusrat Khan, UNDP India
Kevin Lehmann, UNDP Asia Pacific
Artak Melkonyan, UNDP Asia Pacific
Maurice Wee, UNDP SDG Finance

The authors are also grateful to Belinda Hlatshwayo, Jiahuan Yuan, and Warunpon Wongtanyakon from UNDP Asia Pacific for their support in this project.

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Table of Contents

I. Executive Summary	7
II. Introduction	9
III. ESG Funds in Asia: Seeking Returns in Sustainability, but Struggling to Scale	18
IV. Active Ownership: Cultivating Influence Through Engagement	26
V. GSS+ Bonds and Sustainable Finance in Asia	32
VI. The Infrastructure of ESG: Regulation, Reporting, Taxonomies, and Ratings	37
VII. Asia's Savings as a Resource for Sustainable Investment	41
VIII. Recommendations	44
Annex: Sustainability Regulations in Asia	48

I. EXECUTIVE SUMMARY

ESG investment rests on the recognition that environmental, social and corporate governance issues shape companies' risks and opportunities, and that factoring these into investment decisions can improve long-term returns while potentially fostering more responsible and resilient business. In recent years it has been embraced by investors and asset managers, propelled by the promise of sustainable profits as well as growing public concern over climate, conservation and human rights.

This report examines the capacity of ESG investment to support environmentally and socially responsible business practices in Asia. While the rise of ESG investment has been driven by European and US markets, its power to make a difference will be tested in the region's dynamic emerging markets. Decades of economic growth have raised living standards and generated new wealth, but Asia now produces a majority of the planet's carbon emissions, suffers devastating pollution and faces rampant biodiversity loss. Rapidly growing energy needs and continued dependence on fossil fuels complicate the task of transition. Furthermore, Asia's centrality to the world's supply chains makes its environmental and human rights practices global concerns.

ESG investment has limitations as a force of change, despite the trillions of dollars under management ostensibly guided by its principles. However, it is a key component of an evolving ecosystem of sustainability that has fostered unprecedented transparency, stronger regulation, broader public participation and greater attention by companies to their ESG-related risks, opportunities, impacts and responsibilities. It has also rallied many of the world's largest investors and asset managers to the cause of sustainability, even if the ratio of rhetoric to reality can be difficult to decode. The report's findings include:

ESG-focused funds in Asia have grown, but remain modest in scale

Asia-domiciled funds focused on ESG or sustainability contain roughly US\$83 billion in assets under management. China accounts for about 45 percent of the total and Japan 29 percent. A substantial proportion of ESG funds – roughly half in Asia ex-Japan, though only 13 percent in Japan – are passively managed, tracking indices rather than reflecting fund managers' own analysis. Asia-based sustainable funds represent only 3 percent of the \$2.7 trillion global total, though funds based elsewhere have substantial Asian holdings. Many funds without ESG or sustainability labels also consider ESG factors to varying degrees. Like elsewhere, ESG-focused funds grew rapidly in Asia for several years before stalling in 2022 amid greenwashing concerns, regulatory scrutiny and market trends unfavorable to ESG-focused portfolios.

ESG investment aligns capital with values, but impact can be elusive

A majority of funds are invested in shares of large public companies in which they hold small stakes and exert limited influence. Furthermore, ESG ratings typically measure companies' own risks rather than their impacts, and often fail to reflect commonly

understood notions of sustainability. The conservative nature of the asset management industry also limits investment in innovative or disruptive businesses. However, ESG is a promising framework for understanding risk and opportunity in Asia due to the prominence of environmental, social and governance concerns, and decisions by high-profile investors can have a signaling effect.

Investors are expanding their influence through active ownership

Institutional investors and asset managers have shaken off their reputations for passivity and embraced active ownership, pushing companies to prioritize sustainability, including through the conduct of human rights and environmental due diligence. This is done in the name of long-term value and fiduciary duty, citing the costs of climate change and other issues once dismissed as externalities. Due to the prevalence of controlling shareholders and other obstacles to shareholder activism in Asia, investment stewardship is typically pursued through engagement rather than confrontation.

Green, social and other new bond types are helping fund sustainable projects

The issuance of green bonds, which finance projects that meet environmental criteria, has grown rapidly in Asia over the past decade. Social, sustainability-linked and transition bonds have also emerged as funding options for issuers, with institutional investors and asset managers helping drive the market. These instruments provide ESG-focused investors with tools to fund sustainable practices in a way that shareholdings do not.

Regulations, reporting standards and taxonomies are evolving to provide an infrastructure for ESG

Sustainability-related regulations have been phased in across Asia based on still-emerging international norms, with mandatory reporting frameworks starting to replace voluntary ones. Regulators have also implemented rules for fund labeling to combat greenwashing. Many Asian countries have developed taxonomies to help define sustainable financing, with the ASEAN Taxonomy and China-EU Common Ground Taxonomy aiming to facilitate international capital flows. ESG ratings and index providers have also come under pressure to increase transparency. These moves to improve consistency and comparability will be key to improving the credibility of ESG investment across Asia's diverse economies.

The region's savings are helping drive sustainable investment

Asia's high savings rates have created a pool of capital with the potential to support sustainable investment in the region and beyond. Asia is home to some of the world's largest institutional investors, including pension funds and sovereign wealth funds, and many have embraced ESG strategies. Retail interest is also rising, supported by public interest in sustainability as well as an understanding – often based on personal experience of development's environmental and social impacts – that continued economic growth will require more responsible business practices.

II. INTRODUCTION

On 27 April 2006, United Nations Secretary-General Kofi Annan rang the opening bell at the New York Stock Exchange and launched the Principles for Responsible Investment (PRI), a new framework that could “align investment practices with the goals of the United Nations.”¹

“Investment decision-making does not sufficiently reflect environmental, social and corporate governance (ESG) considerations – or put another way, the tenets of sustainable development,” he said.²

From the podium of the world’s most important financial exchange, Annan then invited institutional investors and their financial partners everywhere to promote responsible business and direct their investments toward sustainable finance initiatives.

That call to action helped reshape the investment landscape, and in recent years financial assets committed to “ESG investing” or “sustainable finance” have surged. The global sustainable fund market now stands at roughly US\$3 trillion, with some estimates putting ESG-influenced assets under management at over 10 times this figure.³

As ESG investing has grown, it has sparked intense debate among finance professionals, policy-makers and academics. Supporters argue that ESG investing is a powerful means by which investors can support responsible business practices on a wide array of human rights and environmental topics. To the critics, ESG is built on an impossible premise, undercut by its lack of conceptual clarity and discredited by its own internal contradictions. But even as the tenor of discussion has grown more heated, so too has the interest in sustainable finance opportunities. Not only do industry voices assert that “ESG is here to stay”, but investment has proven resilient despite regulatory scrutiny, political attacks and uneven financial results.⁴

ESG investing has also grown rapidly in Asia, although it is still behind Europe and North America. Assets in Asia-based sustainable funds grew from about US\$10 billion in 2018 to over US\$100 billion in 2022, before dipping somewhat. In 2022, China was the world’s top issuing country for green bonds⁵, and the Asia Investor Group on Climate

¹ <https://www.un.org/sg/en/content/sg/statement/2006-04-27/remarks-launch-principles-responsible-investment>

² <https://press.un.org/en/2006/sg2111.doc.htm>

³ Global Sustainable Fund Flows: Q4 2023 in Review. Morningstar.

⁴ <https://www.wsj.com/livecoverage/davos2023/card/bank-of-america-ceo-says-esg-movement-is-here-to-stay-fF6faZMTISxTd3pYXgNx> ;

⁵ <https://www.bnnbloomberg.ca/esg-is-here-to-stay-1.1773788>; <https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/why-esg-is-here-to-stay> ; <https://www.economist.com/finance-and-economics/2022/11/16/the-tenacity-of-esg-investing>



Environmental

- Climate change
- Greenhouse gas (GHG) emissions
- Resource depletion, including water
- Waste and pollution
- Deforestation



Social

- Working conditions, including slavery and child labour
- Local communities, including indigenous communities
- Conflict regions
- Health and safety
- Employee relations and diversity



Governance

- Executive pay
- Bribery and corruption
- Political lobbying and donations
- Board diversity and structure
- Tax strategy

Change counts more than 70 investment firms as members, representing US\$35 trillion in assets under management globally.⁶

The increased interest in ESG in Asia is a welcome development. In previous decades, Asia's pro-growth policies attracted enormous infusions of global capital mostly untethered from responsible business principles. During this earlier phase of Asia's growth story, many industries grew rapidly under relatively lax environmental standards, and in a context where technological and human resource capacities to manage waste and land-use issues were still nascent. As both a direct and indirect consequence of this under-regulated growth, the region lost 60 percent of its mangrove forests and 40 percent of its coral reefs.⁷ Between 2000 and 2015, approximately 135,000 square kilometres of natural forest area disappeared, accounting for nearly 11 percent of the world's total natural forest loss.⁸

Today, Asia produces the majority of global greenhouse gas emissions and the region's carbon footprint continues to expand as economies expand.⁹ Other side effects of Asia's economic growth story include alarming levels of air and water pollution, plastic waste and human rights violations including forced labour.

Still, Asia's economic development presents significant opportunities for ESG investment. Asia now has at its disposal vast pools of capital that could be leveraged to finance a transition to sustainable growth, not only in the region but beyond. How investment is deployed by those who have benefited most will help determine how and to what extent responsible business practice is embraced by industry in the region, with implications for the well-being of people and the planet for many generations to come.¹⁰ What is needed next is a better understanding of how ESG investing in Asia can move the needle in the right direction, alongside collective action, technological innovation, conservation and smart policymaking.

Asia in Focus: ESG Investing and the Business and Human Rights Agenda explores the potential and limitations of the financial sector in supporting human rights and sustainable development in the region. It focuses on funds that apply ESG considerations to the selection and management of their investments, mainly in public equities and bonds, on the basis of financial materiality (see page 15). The report demonstrates that much of the promise of ESG investment in Asia remains unrealized – a statement that can be made of other regions as well – and that greater attention to certain practices can help align finance with human rights and sustainable development. Investors should avoid simplistic rhetoric about the “win-win” nature of sustainability, and realistically examine how ESG factors shape companies' risks and opportunities.

⁶ Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁷ https://www.unescap.org/sites/default/files/CED5_1E_0.pdf

⁸ https://www.unescap.org/sites/default/files/CED5_1E_0.pdf

⁹ <https://www.pbl.nl/en/Chinanowno1inCO2emissionsUSAinsecondposition>

¹⁰ <https://www.imf.org/en/Blogs/Articles/2023/05/01/asia-poised-to-drive-global-economic-growth-boosted-by-chinas-reopening>

This lays a foundation for steering capital toward companies and activities with positive impacts that also create financial value, and away from those with negative impacts that pose financial risks. Investors can also use their leverage to shape companies' risks and opportunities, advance the business case for sustainability and foster a financial and policy environment in which exploitative and short-sighted business practices are punished while responsibility and foresight pay off. More attention is needed, too, to actively and thoughtfully engaging with investees to improve their environmental and social impacts, and investors must be willing to confront, exclude and divest from companies that cause harm. Since ESG investment depends on reliable and comparable data – including about companies' impacts – due diligence on human rights and environmental issues should be incorporated into the investment process.

The report's first section shows that ESG investment in Asia has seen a rapid rise but remains modest in scale, and that influencing business behaviour is difficult due to the limited power of minority shareholders. The second section of the report examines investors' efforts to expand their influence through "active ownership" including shareholder voting and informal engagement, while the third section explores the potential of investment in green and other sustainability-related bonds, whose proceeds are meant to finance beneficial projects and improve ESG practices. The fourth section of the report shows how evolving regulations and standards are raising transparency and supporting sustainable practices in business and finance, while the fifth section looks at how the region's savings – collected in some of the world's largest pension and sovereign wealth funds – are being mobilized in line with ESG priorities. The report concludes with recommendations identifying best practices and key considerations for aligning investment with environmental and human rights goals.

In formulating recommendations, inspiration was taken from the "Protect, Respect and Remedy" framework of the UN Guiding Principles on Business and Human Rights (UNGPs). The UNGPs are widely considered the world's most authoritative normative framework guiding responsible business practices. They outline the duties of governments and responsibilities of companies and investors in addressing adverse impacts of business operations (See page 17). Several of the 31 principles can serve as guidance to investors looking to promote responsible business. The Sustainable Development Goals (SDGs) likewise provide direction in aligning finance with needed change, while the SDG Impact Standards created by the United Nations Development Programme (UNDP) lay the groundwork for measurement and management of investment outcomes.¹¹

¹¹ <https://sdgimpact.undp.org/practice-standards.html><https://www.imf.org/en/Blogs/Articles/2023/05/01/asia-poised-to-drive-global-economic-growth-boosted-by-chinas-reopening>

Managing uncertainty and market failures

As noted in the UNDP Human Development Report 2021/2022 (HDR), titled “Uncertain Times, Unsettled Lives: Shaping our Future in a Transforming World”, there is a need for new ways to measure and manage evolving risks as the world grapples with political polarization, conflict and environmental crisis.¹² The HDR highlights the importance of investment, insurance and innovation for confronting new challenges. ESG investing is relevant here because it offers a system to categorize and quantify uncertainties, as well as a way forward by mobilizing capital (investment), managing risks (insurance) and financing solutions (innovation). The prospect of private-sector support is particularly appealing as governments – including those of wealthy countries – vacillate on climate commitments and fall short of ambitions articulated in the Paris Agreement and the 2030 Agenda for Sustainable Development.¹³

Among ESG’s components, the environment has attracted the most attention from investors. This is especially so in Asia, where pollution often takes a tangible toll on the daily lives of people from all walks of life and where there is arguably less consensus on social and governance priorities. Among environment-themed funds, the energy transition is the most popular topic, with roughly US\$100 billion invested globally, and numerous investor groups are focused on addressing climate change¹⁴ The Net Zero Asset Managers (NZAM) initiative, which is “committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner”, has 315 signatories with a total of US\$57 trillion under management.¹⁵

“Awareness of the breadth of climate issues and their unintended consequences is growing in Asia, but it is still relatively low.

Ellie Tang
Director for Sustainable
Investing at Fidelity
International in Hong Kong

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¹² Human Development Report 2021/2022. Uncertain Times, Unsettled Lives: Shaping our Future in a Transforming World. United Nations Development Programme, 2022

¹³ Technical dialogue on the first global stocktake. United Nations Framework Convention on Climate Change, 8 September 2023. The Sustainable Development Goals Report, Special Edition. United Nations, 2023.

¹⁴ Morningstar Global Thematic Funds Landscape 2022

¹⁵ <https://www.netzeroassetmanagers.org/>

Institutional investors and asset managers have strong financial incentives to be proactive about climate change and other ESG issues, as their long-term exposure across sectors makes them vulnerable to systemic risks that individual companies might dismiss as externalities. Asia faces some of the most acute risks. According to one report, failure to act on climate change could cost the region 26.5 percent of its GDP by 2048, compared to 18 percent globally.¹⁶ An analysis of 17 Asian banks' lending found that 62 percent of their loan books were in sectors vulnerable to rising sea levels.¹⁷ This makes the Paris Agreement's call to make "finance flows consistent with a pathway toward low greenhouse gas emissions and climate-resilient development" particularly urgent.¹⁸

A mix of "top-down" and "bottom-up" forces is helping to cultivate greater awareness of the material risks that ESG issues pose to business and finance. From above, an evolving infrastructure of laws, regulations and standards is improving transparency, providing investors with data to make informed decisions. From the bottom up, popular attitudes are shaping markets and business behaviour. A survey found that in Asia as well as globally, most people prioritise environmental protection over economic growth, and there is overwhelming support for renewable energy over fossil fuels.¹⁹ As informed and engaged citizens hold governments and companies to account over issues ranging from the environment and human rights to corruption and cronyism, those with power are finding it more difficult to act against the common interest. Investment can be a form of public participation, and surveys have found that younger generations and women are especially inclined to align their money with their values and ESG concerns.²⁰

The HDR notes the potential of investment to help "ease planetary pressures and prepare societies to better cope with global shocks," but the sums required are daunting.²¹ China is estimated to need CNY 100 trillion to 170 trillion (approximately US\$14 trillion to 24 trillion) to meet its decarbonisation goals.²² In Southeast Asia, alignment with a 1.5-degree Celsius global warming scenario requires average annual investment of US\$210 billion through 2050.²³ This includes spending on existing renewable energy technology, electrification of transport, and energy-efficiency projects, as well as investment in new technologies such as green hydrogen and carbon management. With many of Asia's economies in middle-income, high-growth stages,

¹⁶ <https://www.swissre.com/risk-knowledge/mitigating-climate-risk/economics-of-climate-change-impacts-for-asia.html>

¹⁷ <https://chinawaterrisk.org/resources/analysis-reviews/futureproofing-apac-banks-savings/>

¹⁸ https://unfccc.int/sites/default/files/resource/parisagreement_publication.pdf (Article 2.1(c))

¹⁹ Pew Research Center, September 2020, "Science and Scientists Held in High Esteem Across Global Publics"

²⁰ <https://www.cnbc.com/2023/08/27/not-just-math-and-numbers-young-people-are-willing-to-sacrifice-returns-for-esg.html>; <https://www.rbcwealthmanagement.com/en-us/insights/as-women-gain-power-interest-in-esg-investing-grows>

²¹ Human Development Report 2021/2022. Uncertain Times, Unsettled Lives: Shaping our Future in a Transforming World. United Nations Development Programme, 2022

²² <https://www.undp.org/china/publications/technical-report-china-carbon-neutrality-investor-map-china-sdg-investor-map-phase-ii>

²³ IRENA & ACE (2022), Renewable energy outlook for ASEAN: Towards a regional energy transition (2nd ed.), International Renewable, Energy Agency, Abu Dhabi; and ASEAN Centre for Energy, Jakarta.

and with relatively young fossil-fuel-based energy facilities, there is a need for finance that can not only reduce emissions but support a just transition with a minimum of economic and social disruption.

Even though climate-focused finance is more crucial than ever, ESG investment is facing a backlash in some markets, both from those who say it has gone too far and from those who believe it does not go far enough. The ESG concept gained traction because it identified key non-financial issues confronting business, but its broadness invites diverging interpretations, and cracks have emerged among the interests united under its banner. Environmental and social priorities sometimes turn out to be at odds, with fossil-fuel phase-out threatening jobs, while renewable-energy supply chains face human-rights as well as environmental controversies. Even within financial institutions there has been disagreement over how to practice ESG, turning some firms' sustainability leaders into industry critics. Much of the discontent stems from the strategic ambiguity that ESG has carried from its inception: its use as a tool for risk-management and valuation does not always square with its common interpretation as a basis for sustainable business and finance.

And yet capital continues to flow into renewable energy and other environmental solutions. This marks important progress, but also creates new challenges for champions of responsible business and investment. Finance, entrepreneurship and technology may be able to drive transition, but a just transition requires human rights to be protected by governments and respected by business. Mechanisms for seeking redress must also be accessible when rights are violated. **ESG investment can play a role in harnessing private-sector resources to benefit people and planet, but to do so it must be accompanied by sound policy, regulation and enforcement.**

TEXT BOX

The UNGPs and ESG investment

The UNGPs define the responsibility of companies to respect human rights and the duty of states to ensure that they do so, as well as the need for effective remedies when rights are violated. Private financial institutions are not discussed explicitly in the UNGPs but they are subject to the same requirements as other companies. For banks and asset managers, exposure to human rights issues comes mainly from providing financing or other financial services to clients that may be involved in abuses, as well as from share ownership.

Principle 13(b) states that businesses should “avoid causing or contributing to adverse human rights impacts” and should “seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts”. In 2013 the Office of the United Nations High Commissioner for Human Rights (OHCHR) clarified that financial institutions are responsible for the impacts of activities for which they provide capital, and that minority shareholding constitutes a “direct link” requiring the shareholder to “seek to prevent or mitigate” impacts.²⁴

Principles 17 to 21, on human rights due diligence (HRDD), are central to responsible investment, since they detail how companies should identify, prevent, mitigate and disclose human rights impacts to which they are connected. This includes conducting due diligence on an ongoing basis, holding meaningful consultation with affected groups, taking action based on findings, tracking the results and communicating externally. Integrating these practices into the regular course of business is important for a range of financial actors, including institutional investors, banks and advisors.

The UNGPs do not themselves introduce new human rights norms but are instead a framework for the application of international human rights law in the context of business operations. According to Principle 12, these human rights instruments include, at minimum: the Universal Declaration of Human Rights (UDHR); the International Covenant on Economic, Social and Cultural Rights (ICESCR); the International Covenant on Civil and Political Rights (ICCPR); and the International Labour Organization (ILO) Declaration on Fundamental Principles and Rights at Work. The United Nations General Assembly’s recognition in 2022 of the right to a clean, healthy and sustainable environment clarified that negative impacts on nature and climate can also be violations of human rights.

Unfortunately, investment in Asia can take place in jurisdictions where these rights are not recognized or enforced. Defining responsible investment in such situations is thus

²⁴ Response to Chair of the Working Party on Responsible Business Conduct of the OECD by Office of the High Commissioner for Human Rights. 27 November 2013.

complicated. Principle 23 states that businesses should “comply with all applicable laws” and “seek ways to honour the principles of internationally recognized human rights when faced with conflicting requirements”. In Asia, where worker rights and freedom of expression are restricted in many places, investors might become involved in situations where human rights are compromised.²⁵ In the context of the UNGPs, investors are expected to respect human rights principles to the greatest extent possible and be able to demonstrate their efforts in this regard.²⁶

As investors embrace active ownership, respecting international principles increasingly requires engaging with companies about their human rights risks and impacts. According to the UNGPs, the prevention, mitigation and remediation of abuses – like other aspects of the responsibility to respect human rights – is obligatory for investors regardless of financial materiality. Raising investors’ awareness of this is essential as their engagement with companies deepens. But the surest way to align investor and business behaviour with human rights principles is to increase the costs of abusing them. This will involve legislation, regulation and enforcement, together with sustained vigilance by an engaged public, a free press and a vibrant civil society.

²⁵ <https://www.globalrightsindex.org/en/2023/regions/asia-pacific>

²⁶ Guiding Principles on Business and Human Rights: Implementing the United Nations “Protect, Respect and Remedy” Framework. United Nations, 2011.

TEXT BOX

The Investor Alliance for Human Rights and the UNGPs

The Investor Alliance for Human Rights is a “collective action platform” made up of 200 institutional investors representing a total of over US\$12 trillion in assets under management. The alliance also provides guidance and resources for investors to conduct human rights due diligence (HRDD) in line with the UNGPs. Some of the advice of the Investor Alliance on conducting HRDD, with particular reference to active investing in high-risk industries, includes: (1) assessing the quality of portfolio companies’ human rights risk-management policies and processes; (2) assessing the quality of portfolio companies’ management of salient issues and geographic risks; and (3) assessing portfolio companies’ human rights outcomes. In addition, investors are advised to do the following to align themselves with the UNGPs:²⁷

- Adopt a human rights policy that commits them to respect human rights in their own activities and in their investment decisions, and to engage with their portfolio companies on human rights issues.
- Identify and assess the actual and potential human rights impacts of their investments, taking into account the severity, likelihood and scope of the impacts, as well as the context and stakeholders involved.
- Prioritize the most severe human rights risks and impacts in their engagement with portfolio companies and use their leverage to influence the companies to prevent, mitigate and remedy any adverse impacts.
- Monitor and track the effectiveness of their HRDD and engagement activities, using both quantitative and qualitative indicators, and seek feedback from relevant stakeholders.
- Publicly communicate their human rights policy, due diligence processes and outcomes, and disclose how they address any challenges or dilemmas they face in their HRDD and engagement.
- Provide or cooperate in the provision of remedy when they cause or contribute to adverse human rights impacts, or use their leverage to ensure that portfolio companies do so when they are directly linked to the impacts.

²⁷ https://investorsforhumanrights.org/sites/default/files/attachments/2020-04/The%20Investor%20Case%20for%20mHRDD%20-%20FINAL_0.pdf

III. ESG FUNDS IN ASIA: SEEKING RETURNS IN SUSTAINABILITY, BUT STRUGGLING TO SCALE

In 2011, Thailand suffered its worst flooding in half a century. Not only were hundreds of lives lost, but industrial areas near Bangkok were inundated. Multinationals suffered billions of dollars in losses as factories were damaged and supply chains were disrupted for months.²⁸ Investors in companies such as Toyota, Ford and Lenovo had a rude awakening to the impact of environmental risks that are only growing as climate change progresses.²⁹ “The floods were a real heads-up for asset managers. They realized there were many strategic issues they weren’t picking up,” said Melissa Brown, a partner at Daobridge Capital and a longtime analyst and investor in Asia.

Investors in the region are increasingly recognizing the relevance of ESG factors, especially for framing of issues of long-term significance. Funds labelled as “ESG” or “sustainable” have grown in popularity (see graph), and attention to ESG factors has provided companies with management insights. “Sustainability is a driver of returns rather than a detractor. It’s a lens through which to look at both risks and opportunities,” said Douglas Ledingham, a fund manager at Stewart Investors, which runs one of the largest Asia-focused sustainable funds. However, while certain industries such as fossil fuels and tobacco are excluded on principle, he emphasized that sustainability is a means to an end: “Our obligation first and foremost is to protect our clients’ capital.”

For the asset management industry – which looks after about US\$100 trillion globally and \$16 trillion in Asia on behalf of pension funds, insurance companies, sovereign wealth funds, endowments, corporations and individual investors – ESG’s promise of reduced risk and improved returns holds obvious appeal.³⁰ ESG has also helped fund managers tap into growing public concern over issues such as climate change and human rights, while sustainability-related mandates from pension funds and other institutional investors have steered capital toward ESG strategies.³¹ Whether ESG-based investing leads to better returns is a matter of debate, and the diversity of

²⁸ The world’s costliest flood: the 2011 Thailand Flood, 10 years on. Swiss Re Institute, 2021.

²⁹ <https://www.riskmanagementmonitor.com/the-5-companies-hit-hardest-by-the-thailand-floods/>

³⁰ Global Asset Management 2023: The Tide Has Turned. Boston Consulting Group, 2023.

³¹ Fees from ESG funds jump almost 400% despite brutal 2022 for asset managers, Financial News, 16 Feb 2023, <https://www.fn.london.com/articles/esg-fund-revenues-jump-400-percent-20230216>. IMAS 2023 Investment Manager’s Outlook Survey, <https://imas.org.sg/wp-content/uploads/2023/01/IMAS-2023-Investment-Managers-Outlook-Survey-Infographic.pdf>

approaches makes a definitive answer difficult. However, a recent meta-analysis based on roughly 1,400 studies found that companies' financial performance was positively correlated with their ESG credentials.³²

Funds labelled as "ESG" or "sustainable" employ a variety of strategies, often in combination. The most fundamental approach is ESG integration, defined by the PRI as "including ESG factors in investment analysis and decisions to better manage risks and improve returns".³³ ESG integration is not only the basis for most ESG-focused funds, but is often applied to other funds as well. It is important to note that the purpose of ESG integration is to manage investment risk and improve returns, and companies' impacts on the environment and society are only considered relevant if they are deemed financially significant. The table below illustrates climate-related risks and opportunities that might inform investment decision-making.

Climate-related risks and opportunities

RISKS

Transition

Policy and Legal

- Carbon pricing and reporting obligations
- Mandates on and regulation of existing products and services
- Exposure to litigation

Technology

- Substitution of existing products and services with lower emissions options
- Unsuccessful investment in new technologies

Market

- Changing customer behaviour
- Uncertainty in market signals
- Increased cost of raw materials

Reputation

- Shift in consumer preferences
- Increased stakeholder concern/negative feedback
- Stigmatization of sector

Physical

- Acute: Extreme weather events
- Chronic: Changing weather patterns and rising mean temperature and sea levels

Source: TCFD <https://assets.bbhub.io/company/sites/60/2022/12/tcf-2022-overview-booklet.pdf>

OPPORTUNITIES

Resource Efficiency

- Use of more efficient modes of transport and production and distribution processes
- Use of recycling
- Move to more efficient buildings
- Reduced water usage and consumption

Energy Source

- Use of lower-emission sources of energy
- Use of supportive policy incentives
- Use of new technologies
- Participation in carbon market

Products & Services

- Development and/or expansion of low emissions goods and services
- Development of climate adaption and insurance risk solutions
- Development of new products or services through
- R&D and innovation

Markets

- Access to new markets
- Use of public-sector incentives

Resilience

- Participation in renewable energy programmes and adoption of energy-efficiency measures
- Resource substitutes/diversification

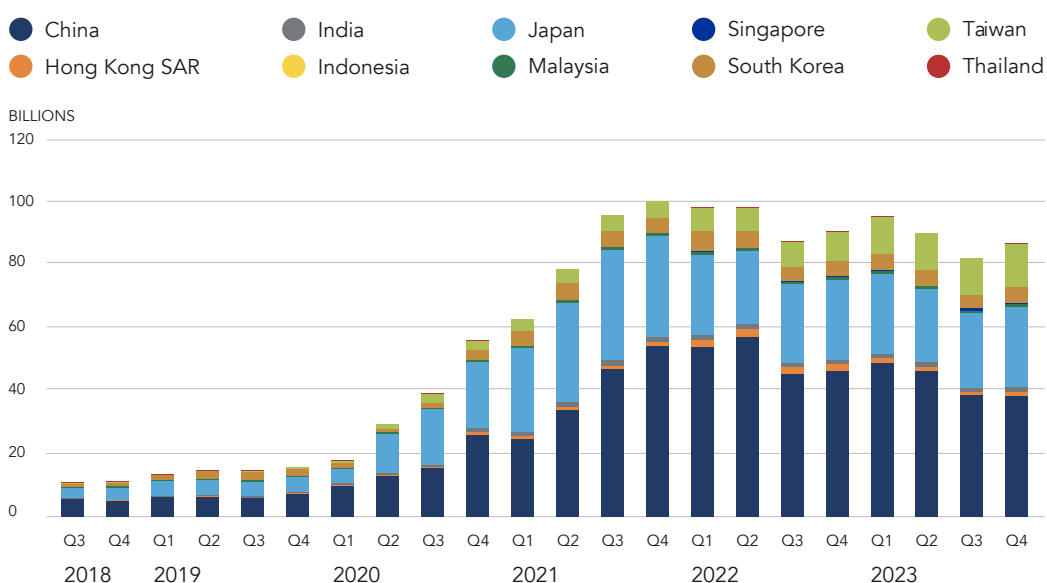
³² U Atz, T Van Holt, ZZ Liu, CC Bruno. Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions. 2022.

³³ <https://www.unpri.org/listed-equity/esg-integration-in-listed-equity-a-technical-guide/11273.article>

In addition to ESG integration, many funds practice negative screening, excluding certain industries or activities associated with serious environmental, human rights and other risks. Funds may also screen out companies that violate, for example, the United Nations Global Compact, the UNGPs or the ILO Fundamental Conventions.³⁴ Some funds practice positive screening, often by seeking out companies with the best ESG credentials among their peers (known as “best-in-class” screening). Like ESG integration, screening is typically framed by institutional investors in terms of financial risk management. Other strategies include focusing on sustainability-related themes such as clean energy, electric vehicles and water management, and selecting companies based on impact, such as alignment with the SDGs and progress toward goals like gender equality and net zero.

By the close of 2023 there were 830 Asia-domiciled funds, representing US\$87 billion in total holdings, that “claim to focus on sustainability; impact; or environmental, social or governance factors”, according to Morningstar.³⁵ Assets in such funds grew dramatically in 2020 and 2021 but have since seen a slight downward trend (see graph below), reflecting flagging enthusiasm for ESG investment worldwide, especially outside of Europe. Most Asian sustainable fund assets are invested in public equities, with a minority in bonds.³⁶ China accounts for about 45 percent of the total and Japan 29 percent. A substantial proportion of ESG funds – roughly half in Asia ex-Japan, though only 13 percent in Japan – are passively managed, tracking indices rather than reflecting fund managers’ own analysis.³⁷

Asia-based Sustainable Fund Assets Under Management



Source: Morningstar Direct

³⁴ MSCI Controversies and Global Norms Methodology. MSCI, 2023.

³⁵ Global Sustainable Fund Flows: Q2 2023 in Review. Morningstar.

³⁶ Morningstar Global Fund Flows, First Half of 2023

³⁷ Global Sustainable Fund Flows: Q2 2023 in Review. Morningstar.

Asia represents only about 3 percent of the US\$3 trillion global sustainable fund market, far behind the US\$2.5 trillion in Europe and US\$324 billion within the US, according to Morningstar.³⁸ Despite being based on funds' stated intentions rather than an analysis of their holdings, Morningstar's classification is relatively conservative and excludes those that employ ESG integration but "do not make ESG considerations the focus of the investment process".³⁹ A more liberal estimate of global ESG fund assets by Refinitiv Lipper put the figure at US\$33 trillion.⁴⁰

Not only is the Asia-based ESG fund market relatively small, but Asia-based managers have been found to trail those in other regions on responsible investment practices. A study by the NGO Share Action ranked European asset managers as the most advanced, with North America and Asia far behind.⁴¹ Criteria included management of "risks and impacts" related to investment governance, climate change, biodiversity and social issues. WWF Singapore compared Asia-based asset managers to European managers with a presence in the region.⁴² It found that those based in Asia were less advanced in management and disclosure of environmental and social impacts, and well as in sustainability-related training and incentives. Japan stood out as the regional leader, with an overall score closer to that of Europe.

Asia-based funds do not represent the full picture of ESG investment in the region, however. Funds in Europe and North America have extensive holdings of Asia-based companies, while Asia-based funds often invest elsewhere. In 2022, European ESG funds' holdings of Chinese assets alone stood at US\$130 billion – more than the total holdings of Asia-based ESG funds – while Japan's four largest ESG funds had at least 95 percent of their assets in foreign stocks.⁴³ Funds based in other regions are also available to investors in Asia, further complicating the definition of "Asian" ESG investment.

Regardless of where they are based and even their sustainability credentials, ESG funds' holdings can appear surprisingly conventional for vehicles of a new investment paradigm. Most ESG funds are fundamentally conservative financial products and are not intended as instruments of change. The top positions of the MSCI AC Asia ESG Leaders Index – TSMC, Tencent, Alibaba, AIA and Sony – reflect the holdings of many ESG funds and indices, with an emphasis on high-profile technology and finance names that score well on ESG metrics due to the nature of their business.⁴⁴

³⁸ Global Sustainable Fund Flows: Q3 2023 in Review. Morningstar.

³⁹ Global Sustainable Fund Flows: Q2 2023 in Review. Morningstar.

⁴⁰ <https://www.reuters.com/business/sustainable-business/banking-turmoil-dampens-shine-esg-funds-end-strong-q1-2023-04-06/>

⁴¹ Point of No Returns 2023 Ranking 77 of the world's largest asset managers' approaches to responsible investment, Share Action, February 2023.

⁴² <https://www.wwf.sg/respond/wp-content/uploads/sites/7/2023/04/TRANSFORMING-AMBITION-INTO-ACTIONS.pdf>

⁴³ <https://www.bloomberg.com/news/articles/2022-03-27/china-stirs-unease-for-esg-managers-blindsided-by-russia-s-war>; <https://www.bloomberg.com/news/articles/2022-02-14/japan-money-managers-shun-local-market-when-placing-esg-bets>

⁴⁴ Nordea 1, SICAV Audited Annual Report 2022

The index is adapted from the MSCI AC Asia Index by factoring in ESG ratings and screening out certain industries as well as companies with ESG controversies. It is worth noting that this represents a basic form of ESG integration, and many managers delve far deeper into companies' ESG risks, opportunities and strategies to inform their investment decisions.

In ESG funds with global scope, Asia tends to be underrepresented relative to Europe and the US. This reflects broadly lower sustainability credentials as well as less consistent reporting, according to observers. The EUR 9.9 billion Nordea Global Climate and Environment fund – the largest that meets the EU's "dark green" Article 9 classification – had 7.4 percent of its assets in Japanese companies and 1.5 percent in Chinese ones at the end of 2022.⁴⁵ The largest non-European Article 9 fund, BlackRock's US\$6.9 billion Sustainable Energy Fund, had 5.9 percent invested in South Korea, 3.2 percent in China and 1.7 percent in Japan.⁴⁶

An analysis of MSCI ratings found that only 6 percent of Asian companies were ESG "leaders", compared to nearly a third in Western Europe and 10 percent in North America, while 38 percent were "laggards", compared to 6 percent in Western Europe and 17 percent in North America.⁴⁷ A comparison of E, S and G scores from Clarity AI found the greatest gap between Asia and other regions to be in governance, with Asian companies averaging 53 out of 100, compared to 70 in the US and 62 in Europe.⁴⁸ ESG risks also vary widely among Asian countries, according to Morningstar.

Corporate ESG Risk Rating Distribution by Country (Percentage of rated universe, 2023)

Business Country	Negligible	Low	Medium	High	Severe
China	0.2%	12.1%	38.2%	30.6%	18.9%
India	0.4%	20.6%	41.5%	27.7%	9.9%
Indonesia	0.0%	16.2%	36.9%	27.7%	19.2%
Japan	1.0%	24.6%	44.6%	23.9%	5.9%
Singapore	6.0%	55.4%	20.5%	14.5%	3.6%
Thailand	0.6%	24.1%	45.1%	25.3%	4.9%

Source: Morningstar Direct

⁴⁵ Nordea 1, SICAV Audited Annual Report 2022

⁴⁶ <https://www.blackrock.com/hk/en/products/229299/blackrock-new-energy-fund-a2-usd>

⁴⁷ ESG and Global Investor Returns Study. Kroll, September 2023.

⁴⁸ ESG 2023. Insightia.

In countries where the state is heavily involved in business, governance is an especially acute concern for fund managers. If “business is state-owned or implicitly state-controlled, we’re unwilling to hand over clients’ capital, because the state’s interests hold higher weight than minority shareholders,” said Stewart’s Ledingham. Some foreign ESG funds divested from a major Asian state-owned oil and gas company after MSCI gave it a “red flag” for controversies related to alleged forced labour.⁴⁹ Funds also divested from a prominent Asian internet company after its alleged involvement in censorship led Sustainalytics to label it “non-compliant” with UN principles.⁵⁰ Mirova, a sustainable-investing unit of Natixis, takes the view that “there is no responsible investment if there is no democracy”.⁵¹ In general, though, ESG-focused asset managers see divestment as a last resort, as it does little to punish a company while forgoing any chance to influence it.

The growth of ESG investment in Asia reflects concern about environmental and social issues, and increased appreciation of their economic relevance. It also represents a gradual reallocation of capital in line with a more expansive and longer-term view of risks and opportunities. But while ESG funds may allow investors to align their savings with their values, this alignment often has limited impact or is even illusory because equity funds, ESG-focused or otherwise, typically hold small stakes acquired in secondary markets and do not provide financing. Inclusion in a respected sustainable fund can signal endorsement of a company’s practices, potentially making it more attractive to other investors, and exclusion can do the opposite. But passively holding shares gives investors little influence on company behaviour. As a result, asset managers have taken up more active measures to signal their commitment to sustainability.

⁴⁹ <https://www.bloomberg.com/news/articles/2023-04-20/china-s-1-4-trillion-wealth-fund-backs-esg-as-us-divisions-grow#xj4y7vzkg>

⁵⁰ <https://www.bloomberg.com/news/articles/2023-02-21/tencent-becomes-a-can-t-touch-stock-for-some-esg-investors>

⁵¹ <https://www.bloomberg.com/news/articles/2023-02-21/tencent-becomes-a-can-t-touch-stock-for-some-esg-investors>

TEXT BOX

ESG, Materiality and Corporate Purpose

When the term “ESG” was coined in the United Nations Global Compact’s 2004 “Who Cares, Wins” report, it joined a procession of concepts – including corporate social responsibility and values-based investing – aiming to align capitalism with social and environmental concerns.¹¹³ However, ESG was the first to be widely adopted in business and finance. It went mainstream because it brought a value proposition that was economic rather than ethical, and presented opportunities instead of obligations.

The pitch to sceptical banks and asset managers was that considering environmental, social and governance issues could help identify risks and opportunities that “have a material impact on investment value”.¹¹⁴ Rather than admonish profit-seekers to do good, ESG offered new tools for doing well, including the insight that a longer time horizon could bring the materiality of non-financial factors into focus.

Materiality – a term introduced in the US Securities Act of 1933 denoting relevance to financial decision-making – became the basis for ESG’s infiltration of the corporate and investment spheres. Companies busied themselves conducting materiality assessments, building materiality matrices, and drawing materiality maps to identify pertinent issues. Rating agencies used materiality to decide which factors to consider in ESG scores, and this in turn shaped indices and portfolios that steered trillions of dollars in investment flows.

But even as the finance industry marketed ESG as responsible investment, key aspects of corporate responsibility were often deemed immaterial. One well-known ESG rating agency judged human rights to be directly material for only 2 percent of companies, the lowest of any ESG issue.¹¹⁵ Broadening the scope to human rights in supply chains raised the figure to 24 percent. Environmental and social impacts of products and services were seen as material for 27 percent of companies; emissions, effluents, and waste for 36 percent. With companies’ impacts on the world often relegated to immateriality, ESG risked becoming a ruse for greenwashing.

To help align ESG practices with common-sense notions of responsibility, the concept of “double materiality” was introduced by the European Commission (EC) in 2019.¹¹⁶ The

¹¹³ United Nations, The Global Compact (2004). Who Cares Wins: Connecting the Financial Markets to a Changing World

¹¹⁴ United Nations, The Global Compact (2004). Who Cares Wins: Connecting the Financial Markets to a Changing World

¹¹⁵ The ESG Risk Ratings: Moving Up the Innovation Curve; White Paper Volume 1. Dr. Hendrik Garz and Claudia Volk. October 2018 (updated January 2019)

¹¹⁶ Guidelines on Reporting Climate-Related Information. European Commission, 2019; https://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf

EC's non-binding recommendation to add impact on people and planet to the scope of ESG reporting is reflected in the European Sustainability Reporting Standards (ESRS), as well as those of the Global Reporting Initiative (GRI). Double materiality reporting is now required under the EU's Corporate Sustainability Reporting Directive (CSRD).

An expansive view of materiality is also implied in the concept of "stakeholder capitalism", whose broad take on corporate purpose is helping shape regulatory and social norms. The standard definition of materiality in terms of information that a reasonable investor would consider important likewise offers room for interpretation.¹¹⁷ For ESG to hold the attention of the private sector – and to fulfil the promise of more resilient, wisely-run business that can sustain economic growth amid global shocks and uncertainty – materiality will need to remain rooted in financial relevance. But with sustainability growing in importance for stakeholders such as consumers, investors and employees, there will be ever less room for companies' impacts to be excluded from business considerations.

¹¹⁷ <https://corpgov.law.harvard.edu/2016/10/13/the-reasonable-investor-of-federal-securities-law/>

IV. ACTIVE OWNERSHIP: CULTIVATING INFLUENCE THROUGH ENGAGEMENT

Investors wishing to influence company behaviour have increasingly turned to “active ownership”. This includes voting at shareholder meetings and engaging directly with management, as well as lobbying policymakers and regulators on systemic issues.⁵² Asset managers have traditionally been passive shareholders and entrusted companies’ decision-making to their executives, but in recent years many have committed to being more active on ESG topics – not only for ESG-focused funds, but across their entire holdings. The concept of “stewardship” has gained currency across the industry, with asset managers pushing for more sustainable practices in the name of long-term value.

In the US, where institutional investors collectively hold majority stakes in most large, listed companies, and asset managers wield substantial voting power, their advocacy on carbon emissions and gender diversity appears to have had some influence.⁵³ In Asia, however, there is less room for this kind of direct pressure. Not only are institutional investors’ and asset managers’ collective stakes smaller and controlling shareholders more common, but rules governing shareholder resolutions and voting are complex, varied and often place minority shareholders at a disadvantage.⁵⁴ Free floats, the publicly traded portions of companies’ shares, average under 50 percent in emerging markets, often allowing controlling shareholders to make decisions unilaterally.⁵⁵ In the US, nearly two-thirds of listed companies have free floats of over 75 percent, giving minority shareholders ample room for collective action; in China, only 8 percent of companies have free floats over 75 percent, and in India the figure is even lower.

Japan, the Asian country whose equity markets are the most amenable to shareholder activism, saw a record number of ESG-related shareholder proposals in 2023.⁵⁶ While these virtually never pass, they can gain enough support to influence management. The CEO of Canon was nearly dismissed after major institutional investors – including Japanese shareholders with policies on gender diversity and other ESG issues – voted against his re-election due to the company’s lack of female board members.⁵⁷

⁵² Policy Frameworks for Long-Term Responsible Investment: The Case for Investor Engagement in Public Policy. PRI, 2014.

⁵³ <https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions>; Lund, Dorothy S. “Asset Managers as Regulators”. University of Pennsylvania Law Review, Vol 171:77 (2023).

⁵⁴ <https://www.clientearth.org/latest/documents/net-zero-engagement-in-asia/>

⁵⁵ <https://www.msci.com/documents/1296102/30823872/Float+Data+Product+Overview.pdf>

⁵⁶ <https://www.reuters.com/sustainability/boards-policy-regulation/nearly-70-japan-firms-expect-more-activist-proposals-2023-06-21/>

⁵⁷ <https://www.ft.com/content/1e05e8f2-83c6-4a7f-a28c-a9ca055604cf>

A proposal by shareholder Kyoto City calling on Kansai Electric to implement a Paris Agreement-aligned climate plan received over 36 percent support.⁵⁸ Japan's three largest banks also faced shareholder proposals to align lending with the Paris Agreement, and while none passed, they are seen as a factor in the banks' recent pledges to stop funding thermal coal projects.⁵⁹ "I believe the signals from investors have driven change," said Benjamin McCarron of Asia Research & Engagement.

The rest of the region is less hospitable to shareholder activism than is Japan, and while investors may submit symbolic protest votes on ESG issues, they mostly pursue their goals through behind-the-scenes engagement. "The US proxy voting model is not representative of the reality on the ground in Asia, especially in emerging markets," said Daobridge's Melissa Brown. "The smart investors are the ones who build bridges with companies, are serious and thoughtful and play their cards carefully."

A major focus of engagement in the region has been the banking industry, whose ability to provide or withhold capital gives it leverage to shape corporate behaviour. This is a particularly important sector in Asia, where bank lending represents a larger proportion of corporate financing than in Europe or the US.⁶⁰ "Asset managers can encourage banks to discuss environmental and social issues with their lending clients," said Ghislaine Nadaud, a sustainability specialist at Robeco in Singapore, adding that many banks in Asia are under public pressure to cut lending to major polluters.

While emissions and energy transition are the most common themes for ESG engagement, many asset managers also work with the food industry on "protein transition" and other topics. Asia Research & Engagement's McCarron notes the case of a Southeast Asian agribusiness company that made pledges on animal welfare after investors raised the issue at a shareholder meeting and followed up in discussions with management. "It becomes a question of what you say, and having a good argument," he said, emphasizing the importance of a "genuine desire to have dialogue" rather than making demands.

The difficulties faced by minority shareholders in influencing company behaviour, as well as the technical complexity of underlying issues, have contributed to the emergence of groups that organize and support collaborative engagement by institutional investors. AIGCC is among the investor groups that founded Climate Action 100+, a global initiative that represents over 700 investors with more than US\$50 trillion under management and supports engagement with many of Asia's largest polluters. The initiative focuses on three main climate-related goals: cutting emissions; improving governance; and strengthening climate disclosures and transition plans.

⁵⁸ Japanese investors embrace the power of shareholder proposals. Diligent, 9 August 2023.

⁵⁹ <https://www.reuters.com/business/sustainable-business/japans-three-megabanks-face-votes-climate-change-sources-2023-04-10/>

⁶⁰ <https://www.privateinvestor.com/asia-presents-an-untapped-but-complex-direct-lending-opportunity/>

“We leverage the power of institutional investors by virtue of their role as stewards to the companies they invest in,” said Valerie Kwan, Director of Stewardship and Corporate engagement for AIGCC and Asia co-lead for Climate Action 100+. “When investors engage on the three key goals of the initiative, it’s difficult for a company to push back and say it’s not relevant or beyond their remit.”

Measuring engagement’s impact can be difficult, but asset managers and investor groups typically report on their efforts and track progress in engagement reports. Climate Action 100+ noted that between March 2021 and March 2022, the share of Asian target companies with net-zero commitments increased from 25 percent to 45 percent, compared to 75 percent for non-Asian companies.⁶¹ It found that “Asian companies also saw modest improvements across other indicators, especially in terms of creating decarbonization strategies and setting targets across different timeframes”. Furthermore, after engagement by European investors, Toyota became the only Asian company to detail the climate positions of trade groups to which it belonged – hard-won progress in the effort to shine a light on corporate lobbying.

Investors often engage with companies simply to fill information gaps on ESG issues. “In most cases it’s not to improve the sustainability profile of the company, but to get data needed to make investment decisions,” said Hortense Bioy, Morningstar’s global director of sustainability research. With many institutional investors and asset managers committing to net-zero targets, persuading companies to measure and disclose relevant information is a priority. This increasingly includes detail on Scope 3 (Supply Chain) emissions, which many companies do not yet provide. “A lack of supply-chain awareness and data transparency makes it difficult for companies to account for Scope 3 emissions and strive for net zero as per the Paris Agreement,” said Fidelity’s Ellie Tang.

Investors’ involvement with the management of ESG issues has also been bolstered by the emergence of stewardship codes. These are voluntary commitments emphasizing the fiduciary responsibility to pursue long-term value through voting and engagement, and to provide disclosure on these activities. Japan introduced Asia’s first stewardship code in 2014, and Hong Kong SAR, India, Malaysia, Singapore, South Korea and Thailand have followed suit. Despite lacking legal force, stewardship codes have encouraged asset owners and managers to become more engaged on sustainability, and helped promote active ownership.

⁶¹ Climate Action 100+ Investor Guide for Engaging in Asia: An updated guide for 2022.

TEXT BOX

Challenges for engagement: state-owned enterprises and family business

State-owned enterprises (SOEs) play large roles in many Asian economies and are concentrated in high-emissions sectors such as energy, natural resources and heavy industry. Not only are they resistant to influence from minority shareholders, but they are also generally less susceptible to financial pressure due to the availability of capital from state-owned banks and priorities driven more by policy than profit. SOEs account for large portions of some countries' emissions, and some companies out-emit entire countries. One SOE, for example, emits more CO₂ than the entire nation of Canada.⁶² In China and India, many top emitters are state-owned.⁶³ A comprehensive approach to engagement with SOEs requires "not only engaging with one entity but all the relevant players in the ecosystem," and calls for "an understanding of the SOE's role in supporting the overall national directive," said AIGCC's Valerie Kwan.

Investors' influence in Asia is also complicated by the predominance of family business. Controlling shareholders often monopolize decision-making, and longstanding relationships with local banks reduce their dependence on capital markets. In India, 70 percent of listed companies are family-owned, and the figure is similar for Hong Kong SAR.⁶⁴ In Southeast Asia, family businesses account for over half of the largest companies and most non-state-owned conglomerates.⁶⁵ Family conglomerates dominate many industries in Southeast Asia associated with ESG problems, including sugar, palm oil, timber and mining. Many of these families are not only wealthy but also enjoy close ties to state power. A study found that family businesses have higher ESG risk profiles than non-family ones, with an especially pronounced deficit on environmental issues.⁶⁶ However, some asset managers also see benefits to investing in family companies, citing management continuity, a long-term outlook and opportunities to forge relationships that over time can yield both insights and influence.

⁶² <https://www.alliancebernstein.com/corporate/en/insights/esg-in-action/esg-in-action-chinas-state-owned-enterprises-hold-keys-to-carbon-neutrality.html>

⁶³ <https://www.climateaction100.org/whos-involved/investors/>

⁶⁴ <https://www.forbesindia.com/article/iim-bangalore/what-are-the-hindrances-to-the-growth-of-indian-family-businesses/77357/1>; PwC Global Family Business Survey 2021 – China Report, From trust to impact: Trust, sustainability and transformation amid uncertainties

⁶⁵ https://cfeg.com/insights_research/southeast-asian-business-family-readiness-is-an-afterthought/

⁶⁶ <https://www.famcap.com/2021/09/exclusive-research-family-businesses-fall-behind-non-family-companies-on-esg-and-lose-their-trust-premium/>

TEXT BOX

Palm Oil Engagement: Playing a Small Part in a Large Effort

How far do trillions of dollars go toward improving sustainability in Asia's palm-oil industry, which employs millions of people in Southeast Asia but is also the region's largest driver of deforestation? For the PRI-led Investor Working Group on Sustainable Palm Oil, a coalition of 64 institutions with US\$7.9 trillion under management, engaging with companies to improve their environmental and human-rights practices was an incremental process with hard-to-measure results.⁶⁷ Still, the working group made progress in building relationships with key players, gaining insights into a notoriously opaque business and identifying avenues for future action – including engaging with policy-makers to address systemic problems.

The group sent letters to 24 growers, processors and traders, 13 of which expressed their willingness to engage further. Requests included committing to full traceability, implementing a “No Deforestation, No Peat and No Exploitation” policy, resolving complaints through a transparent and consultative process, and reporting regularly on progress and practices. From 2017 to 2021 the engaged companies improved across a range of indicators, such as making commitments on traceability, burning, deforestation, emissions reduction, labour rights and Indigenous People's rights. Engaged companies also saw improved overall ESG performance, although non-engaged companies improved even more, making it difficult to attribute the trend to investor engagement – especially given concurrent work with the industry by many actors across the private, public and NGO sectors.

Despite their trillions in total assets, institutional investors' stakes in Asian palm oil companies are small. The world's largest asset manager, BlackRock⁶⁸, which did not participate in the PRI group, owned an average 1.23 percent of palm oil companies with which it engaged. Most major palm oil companies are controlled by billionaire families with little to fear from foreign shareholders, leaving investors with limited influence beyond offering advice – one fund manager described engagement as “free management consulting.” Furthermore, most of the measured progress was on companies' promises rather than their accomplishments.

Still, engagement can be a valuable tool for long-term investors, particularly if combined with technical expertise and practical advice. It is most successful “if you present the opportunities along with the risks, and link your suggestions with financial materiality,” said Erika Susanto, director of ESG research for the FAIRR Initiative, which supports engagement in the food industry. Engagement also gives investors insights for

⁶⁷ PRI, Investor Working Group on Sustainable Palm Oil: Engagement Results, 2022; <https://www.unpri.org/download?ac=16991>

⁶⁸ BlackRock, Key Takeaways from Engagement with Palm Oil Producers, 2023; <https://www.blackrock.com/corporate/literature/publication/palm-oil-spotlight.pdf>

continued outreach: the PRI working group's recommendations emphasized the need to address human rights when engaging on palm oil sustainability, and the importance of on-the-ground due diligence. Another takeaway was the need to build demand for higher-priced certified palm oil, which asset managers can potentially accelerate through engagement with buyers and retailers in their portfolios.

While the PRI's palm-oil working group operated less as a trillion-dollar behemoth than a modest petitioner, it expanded the role of investor stewardship in a difficult sector, and contributed to an ongoing, broad-based effort that has coincided with a reduction in deforestation.⁶⁹ "The fact that the largest asset managers are recognizing material risks related to deforestation and human rights is significant," said Jeff Conant, the head of Friends of the Earth's International Forests program. But he cautioned that the benefits of engagement should be weighed against the risks of providing legitimacy to companies with questionable practices.

"Investment policies should require action by companies," he said. "And if engagement fails, investors should exclude those companies and be responsible for environmental restoration and redress of human rights grievances."

⁶⁹ <https://www.sei.org/features/zero-palm-oil-deforestation/>

V. GSS+ BONDS AND SUSTAINABLE FINANCE IN ASIA

Holding shares in public companies allows investors to align their money with their values, and lays the foundation for active ownership. Bonds have the potential to go a step farther, offering an opportunity to finance projects with environmental and social benefits. Still, as with ESG equity funds, bonds geared toward sustainability face challenges in demonstrating impact and credibility.

There are five main categories of ESG-related bonds: green; social; sustainability (a combination of the first two); sustainability-linked; and transition. Collectively known as GSS+ bonds, they are a relatively new asset class that has grown rapidly in Asia over the past decade. Demand has consistently exceeded supply, supported by investor appetite for ESG products. In some cases, this has allowed issuers to pay slightly lower interest than on ordinary bonds, a phenomenon referred to as the “greenium”. With about a quarter of global fund assets invested in fixed-income products, the GSS+ bond market has substantial room to grow.⁷⁰

Companies issue green bonds to fund projects that meet environmental criteria. The most common applications are renewable energy, clean transportation, green buildings, water and waste management, agriculture and climate adaptation.⁷¹ Issuance in Asia grew from US\$1.6 billion in 2014 to US\$143 billion in 2021 before dropping slightly, and the region accounted for US\$513 billion of the cumulative US\$2.2 trillion issued globally through 2022.⁷² China was the world’s top issuing country in 2022, with US\$85 billion in green bonds that reflected international best practices as defined by the Climate Bonds Initiative (CBI).⁷³ Much of China’s issuance has been related to renewable energy and the main issuers have been state-owned banks and energy companies.⁷⁴

Creating credible standards for green bonds has long been a concern, and harmonizing definitions across markets is important for facilitating capital flows. The Green Bond Principles were published by the International Capital Market Association (ICMA) in 2014 and the People’s Bank of China (PBOC) released its green bond guidelines in 2015. China’s rules were brought into closer alignment with international standards in 2022 with the requirement that 100 percent of proceeds be used toward green projects, as opposed to 70 percent previously.⁷⁵ The new rules also exclude “clean coal”, which formerly qualified as a green technology.

⁷⁰ Global Fund Flows: First Half of 2023. Morningstar.

⁷¹ Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁷² <https://www.climatebonds.net/market/data/>

⁷³ Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁷⁴ China Sustainable Debt State of the Market Report 2022

⁷⁵ <https://www.icmagroup.org/assets/Analysis-of-Chinas-Green-Bond-Principles.pdf>

Social bonds, US\$654 billion of which were issued through 2022 – including US\$134 billion in Asia – have mostly been used by governments and government entities to fund affordable housing and social services, as well as by development banks. There have also been notable private-sector issuances, with South Korea’s Shinhan Bank issuing a US\$500 million “gender equality social bond” in April to finance “social projects for women borrowers”.⁷⁶ Another high-profile issuer was Hong Kong’s New World Development, which sold a US\$700 million bond in 2022 with a US\$500 million green component and US\$200 million social portion.⁷⁷ The issuance was five times oversubscribed, highlighting the strong demand for this type of product.

While green bonds can be effective in mobilizing capital for environmentally beneficial projects, “pure green” activities account for less than 8 percent of the global economy.⁷⁸ In Asia especially, transition bonds have the potential to finance a broader set of projects, but the difficulty of defining and regulating them has limited their use. The G20 Sustainable Finance Working Group has developed a set of principles to reduce the risks of “green and SDG washing”, defining transition finance as “financial services supporting the whole-of-economy transition, in the context of the SDGs, toward lower and net-zero emissions and climate resilience, in a way aligned with the goals of the Paris Agreement”.⁷⁹

Japan and China accounted for most of the roughly US\$3.5 billion in transition bonds issued globally in 2022.⁸⁰ Japan Airlines has issued two transition bonds to finance the purchase of more fuel-efficient planes.⁸¹ The bond was bought by some of Japan’s largest banks and asset managers, which have shown a strong interest in the category. Another recent Japanese issuer was Mitsubishi Heavy Industries, with funds intended for a variety of purposes including hydrogen production and power generation involving hydrogen and ammonia co-firing.⁸² However, there has been debate over whether transition bonds truly steer sustainability-seeking capital toward responsible uses or divert it from more worthy causes.⁸³

Green, social and transition bonds are known as “use-of-proceeds” financing, with funds designated for specified purposes. A newer category, sustainability-linked bonds (SLBs), offers flexibility on how proceeds are spent but requires that the borrower meet sustainability targets or pay a stepped-up coupon. The genre has evolved rapidly since the first issuance in 2019, with some innovation coming from Asia: Bank of China issued a novel “sustainability re-linked bond” in 2021, tied to the ESG performance of

⁷⁶ <https://www.ca-cib.com/pressroom/news/first-gender-equality-social-bond-south-korea-shinhan-bank>

⁷⁷ <https://sdgfinance.undp.org/news/sustainable-finance-transition-framework-reach-sdgs>

⁷⁸ <https://g20sfdg.org/wp-content/uploads/2022/10/2022-G20-Sustainable-Finance-Report-2.pdf>

⁷⁹ Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁸⁰ <https://www.jal.com/en/sustainability/esg-finance/>

⁸¹ <https://www.mhi.com/news/22080502.html>

⁸² <https://www.environmental-finance.com/content/the-green-bond-hub/transition-bonds-could-2023-be-the-year-we-see-them-take-off.html>

⁸³ <https://pic.bankofchina.com/bocappd/report/202110/P020211025319145143861.pdf>

sustainability-linked loans in its portfolio.⁸⁴ The SLB market grew in 2020 and 2021 but contracted in 2022 amid concerns over greenwashing. Sustainability requirements have been criticized as too lenient, and interest step-ups triggered by non-compliance as insignificant.⁸⁵ Asia's share of issuance has grown, with China the fourth-largest market by volume and the largest by number of deals.⁸⁶ While the future of this asset class is unclear, it is expected to be bolstered by new guidelines, such as the ASEAN SLB standards and the ICMA's updated Sustainability-Linked Bond Principles.⁸⁷

Hong Kong SAR and Singapore have both made efforts to strengthen their roles as green finance hubs and attract ESG-related deals. Hong Kong SAR, for example, provides grants to subsidize issuers' expenses, which are higher than for traditional bonds due to the need for external review of sustainability credentials.⁸⁸ The city also benefits from its role as a conduit for foreign investment in China. "In the long run, Hong Kong is uniquely positioned to bridge international capital flows between the Mainland and the rest of the world to support China's decarbonisation," said Jenny Lee, Deputy Secretary General of the Hong Kong Green Finance Association.

Despite strong demand for GSS+ bonds, continued growth depends on more consistent and robust standards as well as improvement in verification, monitoring and enforcement. Greenwashing allegations and scepticism about ESG investment have taken a toll on confidence in these instruments, but if concerns are addressed, GSS+ bonds can be powerful tools for channelling capital to projects with environmental and social value. Regulation will be critical to the development of the market, both for reassuring investors and providing clear guidelines and incentives for issuers.

⁸⁴ <https://www.ft.com/content/309a703a-3a5f-420e-afea-38a142a2f21a>

⁸⁵ Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁸⁶ <https://www.theacmf.org/initiatives/sustainable-finance/asean-sustainability-linked-bond-standards>;
<https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/>

⁸⁷ <https://www.scmp.com/business/banking-finance/article/3220395/hong-kong-has-subsidised-over-220-green-and-sustainable-debt-instruments-over-us715-billion>

⁸⁸ <https://www.scmp.com/business/banking-finance/article/3220395/hong-kong-has-subsidised-over-220-green-and-sustainable-debt-instruments-over-us715-billion>

TEXT BOX

China's green bonds and the top-down transition model

China overtook the US to become the largest source of green bonds in 2022, with US\$155 billion of total green-labelled issuance and US\$85 billion aligned with CBI standards.⁸⁹ Its rise was driven by government policy and deals that came overwhelmingly from state-owned enterprises. Ranked by green bond issuance relative to GDP, China falls behind most Western European nations, but still leads the rest of the world.

China's government announced in 2020 that it aimed for peak emissions by 2030 and carbon neutrality by 2060. This helped accelerate the largely state-owned financial sector's support for renewable energy development, also mostly carried out by SOEs. The central bank offered low-cost loans to banks for financing projects aligned with the "30/60" policy, while requiring recipients to disclose data on emissions cuts.⁹⁰ Thanks in part to this programme, outstanding green loans now exceed US\$3.5 trillion, and represent about 10 percent of total bank lending.⁹¹

Green bond issuers were offered incentives by localities such as Beijing, Guangzhou, Hong Kong and Shenzhen, and large asset owners including sovereign wealth fund CIC took an interest in sustainable investing. This in turn helped spark demand from private capital, which saw opportunities in a sector primed by government stimulus, causing the market to take off. "The green bond market has proven to be an important vehicle for achieving the climate goals set by the country's top authorities," said Wenhong Xie, Head of the Climate Bonds Initiative's China Programme.

However, the energy transition requires a broader range of investment than is covered by the "green" label. "Asian economies rely heavily on hard-to-abate sectors which need rapid decarbonisation, and that's where the money needs to be going," said Xie. The central bank is developing a transition taxonomy, with pilot programs underway.⁹² A credible labelling system for transition financing could open up an even larger market than green bonds.

Thanks in part to its top-down approach – which has also included subsidies for renewable developers and support for equipment suppliers – China accounted for 55 percent of the world's investment in clean energy projects in 2022, with US\$273 billion

⁸⁹ Deng Manshu, et. Al., China Sustainable Debt: State of the Market Report 2022. Climate Bonds Initiative, Central China Depository & Clearing Research Centre and CIB Economic Research and Consulting 2023; Michetti, C., et al., Sustainable Debt Global State of the Market 2022, Climate Bonds Initiative 2023

⁹⁰ <https://www.reuters.com/business/sustainable-business/china-central-bank-provide-low-cost-loans-carbon-emission-cuts-2021-11-08/>

⁹¹ http://english.www.gov.cn/news/202306/09/content_WS648290eac6d0868f4e8dcb84.html

⁹² <https://chinadialogue.net/en/digest/chinas-central-bank-to-focus-on-transition-finance/>

going toward new solar and wind farms.⁹³ Green bonds provided a small but growing share of this: about US\$40 billion of proceeds went to the renewable energy sector and met CBI standards.⁹⁴

China's experience shows the capacity of a strong central government to steer capital toward green infrastructure. However, the clean energy push has been accompanied by a large expansion of coal power, with the country accounting for most of the world's planned new coal generation.⁹⁵ Overall emissions have also continued to grow, as renewables have not yet compensated for increasing energy demand.⁹⁶ But emissions could start falling as soon as 2024, and should China's energy transition remain on track, it could hold lessons for others in Asia and beyond.⁹⁷

⁹³ <https://about.bnef.com/blog/a-record-495-billion-invested-in-renewable-energy-in-2022/>

⁹⁴ Deng Manshu, et. Al., China Sustainable Debt: State of the Market Report 2022. Climate Bonds Initiative, Central China Depository & Clearing Research Centre and CIB Economic Research and Consulting 2023

⁹⁵ <https://foreignpolicy.com/2023/11/12/china-coal-climate-change-carbon-emissions-pledge-plants-apec/>

⁹⁶ <https://www.carbonbrief.org/analysis-growth-of-chinese-fossil-co2-emissions-drives-new-global-record-in-2023>

⁹⁷ <https://energyandcleanair.org/analysis-chinas-emissions-set-to-fall-in-2024-after-record-growth-in-clean-energy/>

VI. THE INFRASTRUCTURE OF ESG: REGULATION, REPORTING, TAXONOMIES AND RATINGS

ESG investment emerged as a collaboration between those with financial priorities and those with environmental and social ones, and both camps have sought to mold definitions and practices to their own objectives. Many financial institutions and corporations have, unsurprisingly perhaps, aimed to maximize ESG's economic value while minimizing their obligations. But over the years a web of laws, regulations and standards has developed to bring greater consistency, transparency and accountability to this sometimes chaotic new field.

The problem of "greenwashing", or misrepresentation of funds' and companies' ESG credentials, has accelerated the push for regulation. The ambiguity of definitions and the value of the "ESG" label fostered an environment where marketing was sometimes rewarded over substance. Despite crackdowns on greenwashing resulting in fines for some high-profile institutions, there is still widespread suspicion that labelling does not match reality: a survey found that **87 percent of investors believed sustainability reporting contained greenwashing, with a majority saying that ESG data needed external assurance to be credible.**⁹⁸

Regulators, lawmakers, and standard-setting bodies have rushed to catch up. The EU has been the most proactive jurisdiction in regulating ESG and making compliance mandatory, and as a result its regulatory development has served as a frame of reference for authorities in Asia. The fact that many large Asian companies do business in the EU, and therefore fall under its regulations, has also helped establish EU rules as benchmarks. This section summarizes key initiatives – involving reporting, fund labelling, taxonomies and ratings – to strengthen the infrastructure of ESG and bolster market confidence in sustainable finance.

Reporting

Since ESG investment relies on dependable and comparable data, reporting requirements have been a priority for regulators. Asset managers have also been advocates for clearer and more consistent reporting standards, since their funds'

⁹⁸ Sustainability Counts II: State of sustainability reporting in Asia Pacific (2023). PwC and NUS Business School Centre for Governance and Sustainability.

sustainability claims – which are under growing scrutiny – are built on those of their portfolio companies.⁹⁹

The EU's 2014 Non-Financial Reporting Directive (NFRD) mandated ESG reporting by about 11,000 large companies beginning in 2018, and the new Corporate Sustainability Reporting Directive (CSRD) has strengthened requirements and expanded the scope to about 50,000 companies. ESG reporting rules have been phased in across Asia and the region is steadily moving toward mandatory reporting. However, reporting remains voluntary in some jurisdictions, and several countries employ a semi-mandatory “comply or explain” system.

ESG reporting rates for large companies in Asia are high. A survey by KPMG of the top 100 companies by revenue in 58 countries found that 89 percent of those in Asia carried out sustainability reporting in 2022, compared to 97 percent in North America and 85 percent in Western Europe.¹⁰⁰ This represents a dramatic change from 2011, when only 49 percent of Asian companies reported sustainability data, and the region lagged much of the world. Asia also scored well on the presence of a dedicated sustainability executive or team at the leadership level, with Taiwan, South Korea, the Philippines, India, Thailand and Japan among the top 10 globally, and external assurance of sustainability data, with Taiwan, Japan, South Korea and Thailand among the top 10.

Most companies in Asia use the Global Reporting Initiative (GRI) standards for ESG disclosures,¹⁰¹ and according to Allinnettes Adigue, director of the GRI ASEAN Network, the quality of ESG reporting in the region has grown along with its prevalence. This in turn has helped make Asian companies more attractive for investors and increased their representation in sustainability-focused indices that serve as benchmarks for fund managers.

Regulators across Asia are considering how to apply the “single materiality” and “double materiality” approaches to disclosure. GRI standards employ double materiality, calling on companies to report not only on how ESG factors impact them – known as single or financial materiality – but also on how their activities impact the environment and society. The European Sustainability Reporting Standards (ESRS), the basis for the EU's reporting rules, also use double materiality. However, the new International Sustainability Standards Board (ISSB) standards – designed to streamline a reporting landscape burdened with an excess of different systems – are based on single materiality. As European standard-setters work out their differences and streamline their systems, some Asian regulators are taking a wait-and-see approach before enacting mandatory reporting.

⁹⁹ Sustainable Asset Management in Asia: 2023 Sustainability Pulse Check, Sedgwick Richardson and Mayer Brown, 2023. /<https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2023/04/sustainable-asset-management-in-asia-2023-sustainability-pulse-check.pdf?rev=b5736416212549479e3b54ce76a84cc2>

¹⁰⁰ Big shifts, small steps: Survey of Sustainability Reporting 2022. KPMG International, October 2022.

¹⁰¹ Big shifts, small steps: Survey of Sustainability Reporting 2022. KPMG International, October 2022.

Fund labelling

The labelling of funds as “ESG” or “sustainable” has come under increased scrutiny by regulators as greenwashing concerns have grown. The EU’s Sustainable Finance Disclosure Regulation (SFDR) was introduced in 2021 to standardize definitions of sustainable investment products. Most major Asian financial markets have devised their own rules or are planning to do so, although standards vary among countries. The SFDR’s categories of “light green” Article 8 funds, which “promote environmental or social characteristics”, and “dark green” Article 9 funds, with a “sustainable investment objective”, have not been adopted in Asia. New regulations in India and Thailand require that at least 80% of sustainable funds’ assets reflect the stated strategy.^{102, 103}

Taxonomies

As financing based on ESG considerations has gained momentum, setting clear standards for qualifying projects has become a priority. With demand for GSS+ bonds exceeding supply, the lack of consistent definitions initially created a grey area that contributed to dubious deals as issuers and bankers sought to access sustainability-seeking capital. The CBI’s 2012 green taxonomy and the ICMA’s Green Bond Principles laid the groundwork for the early years of green bond issuance, but continued greenwashing concerns prompted the creation of the more detailed EU Taxonomy Regulation, which went into force in 2020.

China’s taxonomy, the Green Bond Endorsed Product Catalogue, was released in 2015 and made allowances for “clean coal” and other fossil-fuel projects, while permitting a portion of green bond proceeds to be used for other purposes.¹⁰⁴ It has since aligned more closely with EU standards, and an initial version of the EU-China Common Ground Taxonomy – a joint initiative of the European Commission and the People’s Bank of China – was published in 2021.¹⁰⁵

The diversity of Asian economies has led to a proliferation of taxonomies. Indonesia, Malaysia, Mongolia, Singapore, South Korea and Thailand all boast their own, and they are set to be joined by Hong Kong, the Philippines and Vietnam. The need for a unifying but adaptable set of standards drove the creation of the ASEAN Taxonomy. Launched in 2021, it established tiers rather than simply labelling activities as acceptable or not, with the lower tiers to be phased out over time.

¹⁰² <https://resourcehub.bakermckenzie.com/en/resources/fsr-momentum-monitor/apac/thailand/topics/esg>

¹⁰³ <https://www.bloomberg.com/news/articles/2023-09-07/jpmorgan-says-trailblazing-rules-to-boost-india-s-esg-market>; <https://bakerexchange.com/cv/c19c5d4f3595e3076fd8396c5fde74ea254d6d49>

¹⁰⁴ <https://chinadialogue.net/en/business/chinas-new-green-bond-catalogue-could-be-greener/>

¹⁰⁵ https://finance.ec.europa.eu/system/files/2021-12/211104-ipsf-common-ground-taxonomy-instruction-report-2021_en.pdf

“Our goal was to pursue the sustainability agenda through inclusivity, not exclusivity,” said Eugene Wong of Sustainable Finance Institute Asia, which hosts the ASEAN Taxonomy Board. While the taxonomy was created to be interoperable with the EU’s, which serves as a reference for the highest tier, Wong said that the other tiers were designed to “facilitate an orderly and effective transition toward a sustainable ASEAN.”

Ratings

ESG ratings, which underlie many indices and funds, have also come under scrutiny and regulation. According to MSCI, the largest provider, its ratings “measure a company’s management of financially relevant ESG risks and opportunities” relative to industry peers.¹⁰⁶ While providers are typically clear that their ratings are focused on financial risk rather than impact, the meaning of ESG ratings remains a source of confusion for many investors. Furthermore, a widely cited study found that ratings were inconsistent among different providers due to the use of varying criteria and measurement techniques.¹⁰⁷ Although ratings companies offer a range of data and analytical tools, many investors consider ESG ratings themselves to be of limited value as they aggregate disparate and often unverified data using divergent methodologies.¹⁰⁸

Ratings providers have also attracted scrutiny over potential conflicts of interest, as they sometimes offer consulting services to the companies they rate, and license indices based on their ratings.¹⁰⁹ Japan’s Financial Services Agency in 2022 became the first regulator to create a code of conduct for ESG ratings providers, although the system is voluntary and its aims relatively modest, focusing on transparency and neutrality rather than standardization.¹¹⁰ Singapore is also developing a code of conduct, and the Securities and Exchange Board of India (SEBI) has implemented regulations for ESG rating providers.¹¹¹

ESG’s infrastructure can appear to be a blur of acronyms and bureaucracy, but the emerging architecture of laws, regulations and standards aims to ensure the credibility of future investment. It also helps bridge the gap between risk-management and sustainability. The more companies are required to measure and report, the better they can be monitored and held to account. Indeed, the top ESG risks perceived by companies in Asia are “regulatory enforcement and investigations” and “new regulation”.¹¹² As corporate responsibilities regarding the environment and human rights are written into law, negative impacts will increasingly be financial risks as well.

¹⁰⁶ <https://www.msci.com/our-solutions/esg-investing/esg-ratings>

¹⁰⁷ Aggregate Confusion: The Divergence of ESG Ratings. Berger, Florian; Kolbel, Julian; Rigobon, Roberto. University of Zurich, 2022.

¹⁰⁸ Interviews with investors

¹⁰⁹ <https://www.ft.com/content/b4eaf375-6141-45a7-9f30-d9462605c01f>; <https://www.institutionalinvestor.com/article/2c1i9v3e8g4xsyxwh35kw/culture/does-an-agencys-index-business-influence-its-esg-ratings>

¹¹⁰ <https://www.fsa.go.jp/en/news/2022/20221215/20221215.html>

¹¹¹ <https://www.mas.gov.sg/news/media-releases/2023/mas-proposes-code-of-conduct-for-providers-of-esg-ratings-and-esg-data-products>; Master Circular for ESG Rating Providers (ERPs). Securities and Exchange Board of India. 12 July, 2023.

¹¹² From Strategy to Action – Advancing ESG in Asia Pacific. Baker McKenzie, 2021.

VII. ASIA'S SAVINGS AS A RESOURCE FOR SUSTAINABLE INVESTMENT

Asia's economic growth has helped create a deep base of savings that, if mobilized for sustainable investment, could help finance the energy transition and fill the SDG financing gap which is estimated at US\$4.2 trillion per year in developing countries.¹¹⁸ Household savings rates in the region, and especially in East Asia, are among the world's highest. However, the tendency to save also reflects conservative attitudes toward investment that can make ESG-related products a hard sell unless they are backed by a clear economic rationale.

The strength of technology-heavy, fossil-fuel-light ESG portfolios in 2020 and 2021 helped sustainable funds outperform broader markets and attract Asian retail investors, who had been reticent due to concerns about sacrificing returns. Many gravitated toward the "E" in "ESG", according to Leena Dagade, the lead analyst for Asia ESG at Cerulli Associates. "So far, across markets in Asia, broader environment-themed and climate-related funds have dominated," she said.

Funds have been tailored to local preferences in some countries, with Shariah-compliant ESG products developed in Malaysia and elsewhere. As interest rates rose and the fossil-fuel industry rebounded in 2022, ESG funds underperformed and greenwashing controversy dampened interest, although inflows have resumed in some markets at a more moderate pace.¹¹⁹

As is the case globally, ESG investment in Asia finds the most traction among younger generations. A survey of retail investors in Singapore found that two-thirds of "young millennials" (age 25-34) invested in ESG products, with the figure rising to 82 percent among "Gen Z" (age 21-24).¹²⁰ Overall, 56 percent of those surveyed held ESG investments, which accounted for 31 percent of their portfolios.

High net worth individuals in Asia are an emerging source of capital for ESG investment. In 2022, 32 percent of private banking clients in Asia had invested in ESG products, lagging other regions, but another 37 said they planned to do so in the coming year.¹²¹ The highest figures were in Thailand, Indonesia and India, and the lowest in Japan and Hong Kong SAR. Age was again an important factor, with 36 percent of those under 50 investing in ESG compared to only 13 percent of those over 50.

¹¹⁸ <https://www.jointsdgfund.org/sdg-financing>

¹¹⁹ Morningstar Global Fund Flows, First Half of 2023

¹²⁰ "A Tidal Shift: Purpose Beyond Profit", The Business Times-Amundi ESG Investing report 2022

¹²¹ <https://www.accenture.com/content/dam/accenture/final/industry/capital-markets/document/Accenture-Wealth-Management-Asia-ESG-Investing-Good-to-Grow.pdf>

Despite expressions of interest, many wealthy investors need further convincing of sustainability's financial merits. "ESG is definitely a growing topic," said one private banker in Singapore. "But to a large extent, people are just talking about it and not doing much yet. The challenge is to overcome the idea that sustainability is charity." She added that the greatest interest appeared to be among the very richest clients, who are more inclined to set aside funds for values-based investments.

Many of the wealthiest invest through family offices, which have become an important source of funding for responsible investment in the region, according to a private fund manager. A survey of family offices found that 42 percent of those in Asia engaged in sustainable investing, behind Europe but ahead of North America.¹²² The figure appears likely to grow, as 53 percent believed that they were not investing enough. Among Asian family offices that practiced sustainable investing, 29 percent of their portfolios were allocated to that purpose in 2022, and sustainable investments generated the same average 10 percent return as their overall portfolios. In line with the regional tendency to view sustainability through a pragmatic lens, the survey found that 65 percent of Asian family office investors (versus 36 percent globally) were motivated primarily by a desire to identify new opportunities.

Despite growing interest from individuals and families, institutions have led the way in Asian ESG investment. Japan's US\$1.4 trillion Government Pension Investment Fund (GPIF), the world's largest asset owner, applies ESG integration across its holdings.¹²³ In 2022, GPIF had JPY 12 trillion (US\$79 billion) tracking ESG indices and JPY 1.6 trillion in GSS+ bonds.¹²⁴ It has invested JPY 500 billion in funds based on an index of Japanese companies with strong diversity and gender policies, explaining the decision in terms of risk management.¹²⁵ GPIF's stewardship principles call on asset managers to "proactively engage with investee companies on critical ESG issues", and a recent academic paper linked the fund's stewardship to an increase in Japanese companies' ESG scores.¹²⁶

Sovereign wealth fund China Investment Corporation (CIC) which has US\$1.2 trillion under management, also practices ESG integration in addition to investing in ESG-focused funds.¹²⁷ It has released an action plan for carbon neutrality, echoing the government's goal of net-zero emissions by 2060.¹²⁸ Singapore's GIC, with over US\$740 billion under management, published a detailed sustainability strategy, established

¹²² The Asia-Pacific Family Office Report 2022. Campden Wealth, 2022.

¹²³ GPIF 2021 ESG Report; https://www.gpif.go.jp/en/performance/36274589gpif/2023_2Q_1102_en.pdf

¹²⁴ GPIF 2021 ESG Report

¹²⁵ <https://www.ai-cio.com/news/japan-gpif-invests-morningstar-gender-diversity-index/>

¹²⁶ https://www.gpif.go.jp/en/investment/20230420_esg_issues_en.pdf; <https://www.ft.com/content/93d1005d-a50a-4233-bb36-92c5f3f94f52>; https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4506415

¹²⁷ http://www.china-inv.cn/chinainven/Investments/Sustainable_Investment.shtml

¹²⁸ <https://www.pionline.com/sovereign-wealth-funds/china-investment-corp-publishes-carbon-neutral-action-plan>

a sustainable investment fund in 2020 to invest in energy-efficiency technology and climate mitigation, and opened a dedicated sustainability office in 2022.¹²⁹

Due to the global nature of capital flows, Asia's savings are only one of many sources of capital for sustainable investment in the region. However, people are more likely to be motivated by causes that are closer to home, and more knowledgeable about opportunities there. This makes the region's accumulated wealth a potentially important resource for its energy transition, progress toward the SDGs and incorporation of the UNGPs into policy and practice.

¹²⁹ <https://www.gic.com.sg/how-we-invest/investing-sustainably/framework-for-sustainability/>; <https://www.gic.com.sg/thinkspace/sustainability/investing-in-the-path-to-sustainability/>; <https://www.asianinvestor.net/article/cic-gic-lead-sovereign-wealth-fund-efforts-on-esg-in-asia/484933>

VIII. RECOMMENDATIONS

This report concludes with recommendations, inspired in part by the UNGPs, and based on interview and research findings presented above, for how investors and other stakeholders can put ESG insights into practice more effectively. The recommendations also reflect a common theme voiced by practitioners: that ESG investment is a long-term undertaking that requires commitment, patience and expertise, and is still in its early stages.

Practice ESG meaningfully.

The hallmarks of meaningful ESG investment are coming into focus as the practice matures. In Asia, ESG investing is arguably in an earlier stage than in Western markets, allowing investors in the region to leapfrog over some “growing pains”. Investors should not only analyse companies’ ESG-related risks and opportunities but develop ESG-backed investment rationales that take impact into account. Composite ESG ratings in which negative impacts can effectively be “offset”, and which often rely on unverified data and opaque methodologies, should be treated with caution. Fund managers should avoid conflating ESG-based risk management with responsible investment and acknowledge that optimum returns and responsible practices are not always aligned, especially in the short term. In such cases, investors can use their leverage with investees and policy-makers to help align companies’ incentives with the common good. All of this requires adequate ESG-related training, guidance and incentives for fund managers and other investment professionals. ESG factors should also be understood as relevant to all investment, rather than limited to certain funds. The SDG Impact Standards can serve as a guide for enterprises, investors and bond issuers to integrate sustainability and impact into decision-making.¹³⁰

Cultivate relationships with investees.

Effectively engaging with companies in Asia often requires spending time to build relationships with their owners and senior managers, according to investors in the region. Companies with controlling shareholders are often resistant to pressure via shareholder resolutions and voting, but long-term investors who develop ties with decision-makers can and should exert influence informally.

Engage with ideas and expertise rather than demands.

The negative impacts of business on the environment and human rights often result from a lack of capacity, knowledge or motivation to prevent them. This is especially true when abuses take place in supply chains or remote areas. Investors engaging with companies should bring practical recommendations and technical expertise. This includes ensuring that companies are aware of their responsibilities under the UNGPs, and if necessary providing guidance on how to fulfil them.

¹³⁰ <https://sdgimpact.undp.org/practice-standards.html>

Find strength in numbers.

Institutional investors typically have less influence than their assets under management might suggest, due to the limited power of minority shareholders in public companies. Joining forces through collaborative stewardship can help amplify their voices when engaging on ESG issues. The Principles for Responsible Investment, Asia Investor Group on Climate Change and Investor Alliance for Human Rights are among the organizations providing support for collective action by investors.

Engage with banks to align lending with ESG priorities.

Banks are the primary sources of financing for companies in Asia, giving them potentially unparalleled influence in shaping business behaviour. Investors should engage with banks to align their lending with decarbonization goals, the UNGPs and other ESG priorities.

Exercise shareholder rights effectively.

Exercising shareholder rights requires an understanding of laws and regulations in different countries. This is particularly important given the challenges faced by minority shareholders in Asian markets. ClientEarth's guide to net-zero engagement details the legal frameworks in different markets, and notes that shareholder action can exert normative force even if a resolution fails to pass or is non-binding in nature.¹³¹

Conduct and promote human rights due diligence.

Investors should conduct HRDD on investees and consider companies' impacts, rather than focusing solely on financial risks. Due diligence should be ongoing and not simply a pre-investment compliance exercise. In addition to conducting HRDD themselves, investors should promote its effective practice by investees, and encourage its incorporation into laws and regulations.

Include primary data-gathering in due diligence.

Investor due diligence on human rights and environmental issues should include on-the-ground assessment, especially in high-risk industries and geographies. "Ground truthing" is important not only to verify data provided by companies, but to help move due diligence beyond a review of policies and commitments, and toward an assessment of impact that incorporates perspectives of stakeholders including employees and communities.

Support access to remedy.

HRDD should include assessment of grievance mechanisms available to stakeholders, with attention not only to formal processes but real outcomes, especially in jurisdictions where powerful actors enjoy impunity and victims may not receive protection in accordance with written laws and procedures.

¹³¹ <https://www.clientearth.org/latest/documents/net-zero-engagement-in-asia/>

Focus on increased credibility of GSS+ bonds to ensure impact.

Green, social, transition and sustainability-linked bonds offer investors the opportunity to finance beneficial projects or incentivise ESG performance. However, more consistent standards are needed in this space. Monitoring and enforcement are also necessary to ensure these instruments have their intended impact, and to strengthen the long-term credibility and viability of these investment products.

Keep human rights in focus for a just transition.

Decarbonization has taken centre stage in ESG investment, but a just transition also requires the defence of human rights – including labour rights, Indigenous People’s rights and the right to public participation. Mineral extraction related to clean-energy technology, land acquisition for renewable energy and carbon offsetting projects, and employment impacts of industry phaseouts should be monitored by investors alongside progress toward net zero.

Make net-zero matter.

As investors in Asia engage with some of the world’s largest carbon emitters, they should ensure that net-zero pledges are accompanied by comprehensive and actionable transition plans that are supported by regular disclosures. The Science Based Targets initiative (SBTi) defines standards for credible net-zero plans.¹³² The UN High-Level Expert Group on Net-Zero Guidelines for Non-State Entities has issued recommendations on creating effective transition plans and preventing “net-zero greenwashing”.¹³³

Mobilize Asia’s savings for sustainability.

The region’s rapid wealth creation and high savings rates have created a pool of capital that could help support sustainable investment. Pension funds, sovereign wealth funds and other institutional investors should deepen the integration of ESG into their strategies, while individual investment can be encouraged through the development of products tailored to investors’ sustainability priorities.

Target gender diversity.

Investors can help promote gender diversity in company management through shareholder resolutions, voting and engagement, while gender-focused funds and indices can channel investment toward businesses with better practices. Bonds can also be used to support gender equality, with Shinhan Bank having issued a social bond to fund loans to women borrowers.

Seek transparency on corporate lobbying.

Investors should seek disclosure on companies’ lobbying activities, which are sometimes at odds with their sustainability policies. A report by Influence Map found that there was less transparency on corporate lobbying in Asia than in Europe and North America.¹³⁴

¹³² <https://sciencebasedtargets.org/net-zero>

¹³³ <https://zerotracker.net/insights/un-hleg-net-zero-recommendations>

¹³⁴ Corporate Climate Policy Engagement Leaders, 2023. Influence Map, September 2023

Engage with policymakers and regulators on sustainability issues.

Investors should engage with governments to support improved ESG regulation and enforcement. This includes reporting rules that supply investors with decision-useful data not only on companies' financial risks, but on their environmental and human-rights impacts. The development of social taxonomies can be encouraged to direct investment toward activities that respect and advance human rights. Investors can also advocate for policy action on carbon pricing, renewable energy, blended finance to support transition, and the phase-out of fossil-fuel subsidies.

Respect different approaches, while moving forward on consistency.

Local perspectives and priorities should always be considered. The benefits of economic growth are often more tangible than those of sustainability, and external pressure can be counterproductive. For example, public opinion surveys in China have shown strong concern about environmental issues, but a distaste for foreign-imposed solutions.¹³⁵ Developed countries should also demonstrate commitment to their own pledges, or calls for developing countries to embrace their approaches will lack credibility. The ASEAN Taxonomy's adoption of multiple tiers offers a model for accommodating diverse national circumstances while facilitating progress toward the shared goals of sustainable development and just transition.

¹³⁵ Public opinion on climate change in China—Evidence from two national surveys. John Cung-En Liu. <https://journals.plos.org/climate/article?id=10.1371/journal.pclm.0000065>

Annex: Sustainability Regulations in Asia

	ESG Reporting (listed companies)	Sustainable Fund Regulation	Taxonomy	Stewardship Code
China	The country's three main stock exchanges will introduce mandatory sustainability disclosure in 2026	New rules are planned to address greenwashing in the fund market ¹³⁶	The green bond catalogue was revised in 2021, and the Common Ground Taxonomy updated in 2022 ¹³⁷	Regulators have taken steps toward clarifying stewardship responsibilities ¹³⁸
Hong Kong SAR	Currently "comply or explain", with mandatory climate reporting planned from 2025 ¹³⁹	HK's securities regulator strengthened rules for ESG fund disclosure in 2021 ¹⁴⁰	The proposed HK Taxonomy is modeled on the Common Ground Taxonomy ¹⁴¹	The HK Principles of Responsible Ownership code was introduced in 2016 ¹⁴²
India	Required for the 1,000 largest listed companies, with "reasonable assurance" required for the top 150 ¹⁴³	New rules require 80% of fund assets to be aligned with stated ESG strategies ¹⁴⁴	A green taxonomy is reportedly under development ¹⁴⁵	Regulator SEBI's Stewardship Code came into force in 2020, and requires mutual funds to vote on certain issues and provide disclosure ¹⁴⁶
Indonesia	Required for listed companies ¹⁴⁷	N/A	The Indonesia Green Taxonomy was launched in 2022 ¹⁴⁸	N/A
Japan	Required for listed companies ¹⁴⁹	ESG-related fund labels limited to those that consider ESG a "key factor" ¹⁵⁰	N/A ¹⁵¹	Introduced in 2014 and revised in 2021 to promote engagement for mid- to long-term corporate value ¹⁵²
Malaysia	Required for listed companies since 2016 ¹⁵³	Updated guidelines on sustainable funds were published in 2023 ¹⁵⁴	Sustainable & Responsible Investment Taxonomy released in 2022 ¹⁵⁵	Malaysian Code for Institutional Investors introduced in 2014 ¹⁵⁶
Singapore	ESG reporting on a "comply or explain" basis since 2017, with climate reporting being phased in	New reporting guidelines for retail funds came into effect in 2023 ¹⁵⁷	Singapore-Asia taxonomy is in the final consultation phase ¹⁵⁸	Singapore Stewardship Principles for Responsible Investors introduced in 2016 ¹⁵⁹
South Korea	Voluntary, with mandatory disclosure planned in 2025 ¹⁶⁰	ESG fund disclosure standards were being developed in 2023 ¹⁶¹	The K-Taxonomy was created in 2021 ¹⁶²	Korea Stewardship Code introduced in 2016 on comply-or-explain basis ¹⁶³
Thailand	ESG reporting on a "comply or explain" basis since 2017	80% of a fund's assets must be consistent with its name ¹⁶⁴	Thailand's Green Taxonomy was launched in 2023 ¹⁶⁵	The SEC introduced the Investment Governance Code for Institutional Investors in 2017 ¹⁶⁶
Vietnam	Required for listed companies ¹⁶⁷	N/A	A green bond taxonomy is reportedly under development ¹⁶⁸	N/A

Note: The information in this table is based desk research conducted in 2023.

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