20 August 2021

Submission by email

Banking Supervision Department
Hong Kong Monetary Authority
Two International Finance Centre
8 Finance Street, Central
Hong Kong

ASIFMA and ISDA Joint Response to HKMA Consultation on Draft SPM Module GS-1 on "Climate Risk Management"

Dear Sir/Madam,

The Asia Securities Industry & Financial Markets Association ("**ASIFMA**")[1] and the International Swaps and Derivatives Association, Inc. ("**ISDA**")[2] (together, the "**Associations**"), on behalf of their members welcome the opportunity to respond to the HKMA consultation on the draft Supervisory Policy Manual (**"SPM"**) module GS-1 on "Climate Risk Management" and commend Hong Kong's proposals to provide guidance to AIs on the key elements of climate-related risk management, and to set out the HKMA's approach to, and expectations in, reviewing AI's climate-related risk management.

Our response has been drafted with the support of the professional firm member KPMG, based on feedback from the wider ASIFMA and ISDA membership.

In the following pages, we set out our members' views with regards to the draft Climate Risk Management Guideline, the practical difficulties financial institutions may face, the contributory role of derivatives in enabling effective climate risk management, and our recommendations and request for clarification for certain provisions.

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[1] ASIFMA is an independent, regional trade association with over 150 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[2] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

We thank HKMA for the opportunity to provide feedback and for considering our comments, and would be happy to meet to provide further clarity on our response. Should you wish, please do not hesitate to contact Matthew Chan, Head of Public Policy and Sustainable Finance at ASIFMA (mchan@asifma.org or +852 2531 6560), and Benoit Gourisse, Head of APAC Public Policy at ISDA (BGourisse@isda.org or +32 (0) 2808 8019).

Sincerely,

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1. Introduction

The Associations welcome the HKMA's efforts to set out its approach and supervisory expectations around climate risk management[3], and provide guidance to AIs on the key elements of climate-related risk management that is intended to come under scope of supervisory review.

At a high level, the key concerns and topics we would like to address are as follows:

Areas	Concerns / Issues
Global alignment	• Overall support of global and regional alignment, which will support consistent frameworks within internationally active FIs which are beneficial to the overall objectives • Interest in getting the right fora for advocacy
Role of derivatives in climate risk management	• General feedback on contributory role of derivatives in enabling effective climate risk management
Section 1.4 – Supervisory objectives	• Clarification on the concept of proportionality
Section 1.5 – Application and implementation	• Clarification on the approach • Extension of timeline
Section 2.1 – Climate-related risk drivers	• Alignment on the definition of liability risk
Section 3 – Governance and Oversight	• Clarification on the responsibilities of the board and senior management • Clarification on definition of material risk and exceptions
Section 4 – Strategy	• Clarification on remuneration policy and practice • Clarification on resourcing
Section 5 – Risk Management	• Concerns on climate risk stress testing and its purpose • Concerns on the monitoring of portfolios managed at an entity or group level • Clarification around definition of high-risk sectors and portfolios in monitoring and reporting • Clarification on the type and extent of early warning indicators on physical risk exposures
Section 6 - Disclosure	• Clarification regarding disclosure at group/head office level • Concerns around data challenges for Scope 3 emissions

[3] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/GS-1_for_consultation_20Jul2021.pdf

2. General Comments

We set out below our comments to certain sections and seek clarification with respect to specific areas within the draft guideline.

Global alignment

The industry is supportive of HKMA's intention and commitment to align with international standards and practices (e.g. following TCFD in the context of disclosures). We also welcome the pragmatic approach to allowing the use of Group-level frameworks, where deemed to appropriately meet requirements as per the draft SPM guideline, as this will allow firms to effectively operate across borders and tackle global issues pertaining to climate risk, which requires a global response. Unnecessarily fragmented or divergent approaches introduce complexity and risk constraining the ability to make positive contributions in a timely fashion.

Appendix 1 gives an overview of the timing of the various consultations in the region, as well as globally. The industry would welcome engagement by HKMA and other regional bodies on these issues to support consistency and interoperability between jurisdictions, in order to minimise fragmentation, and to ensure that Hong Kong's concerns and interests are taken into account in global frameworks, while integration of climate/environmental risks are appropriately phased in financial risk management frameworks.

Additionally, we believe it would be useful for regulators and the industry to understand how and when various regional fora (such as EMEAP [4], APEC [5], ASEAN [6], FSB Regional Consultative Group for Asia [7], etc.) will engage on relevant developments, in order to be a part of important discussions and leverage these engagements for better coordinated efforts. Should other bodies and regulators be committed to a coordinated approach, the Associations stands ready to work together with the HKMA to help push for regional and global coordination, including public-private initiatives. ASIFMA itself is closely engaged in APEC's Sustainable Finance Development Network (**"SFDN"**), a channel for coordination and information-sharing across these economies.

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[4] The Executives' Meeting of East Asia-Pacific Central Banks ("EMEAP") is a cooperative organisation of central banks and monetary authorities (hereinafter simply referred to as central banks) in the East Asia and Pacific region. Its primary objective is to strengthen the cooperative relationship among its members. It comprises the central banks of eleven economies: Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Bank of Thailand.

[5] The Asia-Pacific Economic Cooperation ("APEC") is a regional economic forum established in 1989 to leverage the growing interdependence of the Asia-Pacific. APEC's 21 members aim to create greater prosperity for the people of the region by promoting balanced, inclusive, sustainable, innovative and secure growth and by accelerating regional economic integration.

[6] The Association of Southeast Asian Nations ("ASEAN") was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN: Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei Darussalam joined ASEAN on 7 January 1984, followed by Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up what is today the ten Member States of ASEAN.

[7] The Financial Stability Board ("FSB") established in 2011 six RCGs, one each for the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa region, to expand upon and formalise the FSB's outreach activities beyond the membership of the G20 and to reflect the global nature of the financial system.

To this end, we specifically advocate for these bodies to coordinate on timing, as well as to support consistent methodologies and standards.

Role of derivatives in climate risk management

As markets for ESG investments develop and trillions need to be raised to finance the transition to a sustainable economy, the derivatives market will be critically important in facilitating the raising and allocation of capital for green finance, as well as providing hedging tools to manage the associated risks.

To this end, derivatives perform a critical role in climate risk management by enabling banks, businesses and investors to better manage the climate-related risks to which they are exposed, and to more effectively align their exposures with their risk tolerance and risk management requirements. Derivatives enable hedging of climate risks and generating of financial exposures to sustainable goals. The derivatives market also plays a major role in enhancing price transparency (a crucial building block of effective climate risk management) through the provision of forward information on the underlying commodities, securities or assets, which can ultimately contribute to long-term sustainability objectives. Derivatives transactions will also play a crucial role in ensuring price transparency and liquidity in voluntary carbon credits, as discussed further in ISDA's response to the Taskforce's on Scaling Voluntary Carbon Markets Phase I consultation document.[8]

In January 2021, ISDA published a research report that gives a valuable overview of ESG-related derivatives products and transactions[9]. The report illustrates, with an example list of product structures, the role derivatives play in climate mitigation strategies.

Although the scope of this consultation does not cover derivatives specifically, the Associations would welcome the opportunity to provide the HKMA with further information on the role of derivatives in climate risk management, at an opportune timing.

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8 ISDA response on Consultation Document of the Taskforce on Scaling Voluntary Carbon Markets, http://assets.isda.org/media/9a674bfd/b0ffbc11-pdf/

9 ISDA paper on Overview of ESG-related Derivatives Products and Transactions, https://www.isda.org/a/qRpTE/Overview-of-ESG-related-Derivatives-Products-and-Transactions.pdf

3. Comments to Specific Sections in the Consultation Paper

Section 1.4 – Supervisory objectives

As mentioned in Section 1.4.3 - *"Recognising AIs are at varying stages of development in addressing climate-related risks and that there is no "one-size-fit-all" approach given the differences among AIs in terms of size, structure and business, the HKMA will adopt a proportionate approach in applying the guidance set out in this module. For instance, AIs having a small and simple business operations will not be expected to have an approach to climate risk management as sophisticated as those with more complex operations. However, they should, at a minimum, be able to demonstrate that the requirements set out in sections 3-6 are implemented."*

The industry welcomes HKMA's proportionality approach in applying the guidance to the different size, structure, and business of firms, and would encourage other regulators to also align the concept of proportionality to enable consistency of climate risk management for similar entities across markets.

Section 1.5 – Application and implementation

We note that Section 1.5.2 and Section 1.5.3 both apply to international banking groups operating in Hong Kong, and deal with how firms can leverage their centralised processes and disclosures to comply with local guidelines. In this respect, we welcome the fact that HKMA gives the flexibility for firms to rely on the group/parent framework and work to show how processes may be appropriate for local circumstances. For sake of clarification, we would suggest adding *"Subject to Section 1.5.2"* at the beginning of Section 1.5.3.

While we agree with the need for branches to maintain appropriate oversight of their risks, including those pertaining to climate, we caution that the current wording in this section might give rise to confusion in relation to the roles and responsibilities required by branches. We believe that separate responsibilities (e.g. with regards to appointment of a dedicated climate risk representative) should be limited to subsidiaries of international banking groups, and would thus encourage HKMA to clarify that branches of international banking groups are not expected to put in place their own entity-level framework, as long as they can leverage group/parent climate risk framework and have given this due consideration. This would be in line with HKMA's long-standing practice for other risk areas.

Also, as alluded to within the consultation paper, at an industry level, data capturing tools/metrics required to manage climate risk are still being developed by service providers and market participants. Accordingly, in terms of implementation, for international banks where environmental risk management is principally driven at a central level, and where climate and environment risk requirements are set out by home regulators, implementation would involve both short- and long-term actions that go well beyond a 12-month timeframe. we would appreciate if HKMA could acknowledge that some aspects of mandated entities' builds may continue to be developed beyond the compliance date, and to take a proportionate approach in this regard. We encourage HKMA to consider an extended implementation timeframe of at least 18 months to allow institutions sufficient time to prepare.

Section 2 – An overview of climate-related issues

We note that HKMA has identified liability risks as a separate classification of climate change financial risk in addition to transition and physical risks. We suggest HKMA aligns these risk types to those outlined by the Task Force on Climate-related Financial Disclosures (**"TCFD"**), where liability risks are captured under transition risks. We support this streamlined classification to avoid fragmented considerations of climate-related financial risks.

The TCFD framework, which is supported by HKMA, will also be applied across number of jurisdictions such as the Monetary Authority of Singapore's (**"MAS"**) Guidelines on Environmental Risk Management for Asset Managers [10] which follow similar risk classifications. New Zealand's mandatory climate-related disclosure requirements [11] set to apply from 2022 also adopt the two-pronged risk classification recommended by TCFD. As several other jurisdictions appear to adopt similar risk classifications, we suggest HKMA's guidance include liability risk under transition risks, in the interest of encouraging high-level consistency at the international level.

Section 3 – Governance and Oversight

Section 3.1 refers to the responsibilities of the board and senior management. We would like the HKMA to clarify whether there is a correlation between the "senior management" referred to within the consultation paper, and the Hong Kong management regime (Section 72B of the Banking Ordinance). In addition, consistent with our point above on the approach to foreign branches, it would also be helpful to differentiate expectations of local management compared to global management (e.g. where there are references to the 'Board').

We would also recommend adjusting the language in Section 3.1 to better reflect the climate risk management focus of SPM GS-1. While it is currently mentioned that the board has primary responsibility for an AI's climate resilience, we suggest revising the wording as follows: *"The board has ultimate responsibility for oversight of an AI's approach to managing climate risk and opportunities."*

In Section 3.1.2, AIs are expected to "define and articulate roles and responsibilities for the AI's approach to addressing climate-related issues." Consistent with the ability to rely on group level approaches and with the expectation that global frameworks will similarly cover roles and

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[10] https://www.mas.gov.sg/publications/consultations/2020/consultation-paper-on-proposed-guidelines-on-environmental-risk-management-for-banks

[11] Mandatory climate-related disclosures | Ministry of Business, Innovation & Employment (mbie.govt.nz)

responsibilities, it would be reasonable to expect that the AI can then rely on these definitions/articulations.

In light of our recommendation to better reflect the climate risk management focus of SPM GS-1, we also recommend revising the first sentence of Section 3.1.3 to read as follows: *"While the board remains ultimately responsible for an AI's approach to managing climate risk and opportunities, it may delegate authority to board-level committees."*

Section 3.1.4 refers to senior management being responsible for "ensuring the effectiveness of the framework through regular review, formulation and implementation of relevant policies and processes." Where implementing global frameworks, it should be made clear that it will be sufficient to rely on what is done at a group level in terms of review, in addition to formulation and implementation where this would appropriately address the expectations. Furthermore, we seek clarity around what constitutes "material risk and exceptions", in order that AIs could conduct better assessments to determine and evaluate the extent of applicability of the guidelines.

Additionally, it would be helpful for HKMA to clarify whether the requirement in Section 3.1.5 is intended to be applied at branch level, and whether this is expected to be a 'standalone role' or could be combined, for example, as part of the remit of the CRO.

Section 4 - Strategy

Linked to the point above on proportionality and reliance on group level approaches, it should be recognised that the strategy formulation approach of global AIs will reflect many of the expectations articulated by the HKMA within a centralised global framework.

<u>Remuneration</u>

In Section 4.3.5, it is mentioned that AIs should ensure that their remuneration policy and practices are consistent with their climate strategy. AIs may further consider integrating climate considerations into the remuneration system, for example, by linking achievement to climate-related targets with the evaluation of variable remuneration. In order to align with remuneration related guidance in other jurisdictions, we recommend revising the section to read as follows: *"AIs should consider climate risk in the development of incentives and remuneration practices."* We believe that the linking of remuneration to specific climate-related targets is currently not practical to implement, given the lack of available metrics to set targets against.

For AIs which are local subsidiaries or branches of foreign banks, we would like HKMA to clarify whether the remuneration policy and practices requirement would apply to the local entity level, or whether foreign banks can leverage on their group and/or head office' s KPIs.

The industry would also like to confirm whether expectations to implement climate considerations into the remuneration system/process could be satisfied by implementation at the global and divisional aggregate remuneration pool level.

Resources
In Section 4.3.6, it is mentioned that AIs should ensure that sufficient resources, whether financial or non-financial, are allocated to climate strategy implementation. Potential enhancements include, for example, building capacity, seeking expert advice, recruiting talents and strengthening relevant data system and framework. We would like HKMA to clarify if the expectation is for all AIs to develop resources at the local entity level, or if AIs which are local subsidiaries or branches of foreign banks can rely on resources across the organisation (i.e Group or head office level), as long as resources are considered to be adequate.

Section 5 – Risk Management

Scenario analysis and stress testing

In Section 5.3.1, it is mentioned that AIs should build capability to measure climate-related risks using various methodologies and tools. It is suggested that AIs should adopt the techniques of climate-focused scenario analysis and stress testing to regularly assess vulnerability under different plausible climate scenarios having adverse impacts on them. The HKMA suggests that AIs should consider the requirements outlined below when setting scenarios and determining the approaches, and that proper documentation should also be maintained. However, since the business nature/composition of certain entities poses practical challenges regarding performing stress testing for all legal entities, as such we would like the HKMA to clarify that mandated entities can determine their stress testing approach in accordance with the "nature, scale and complexity" of their business activities in Hong Kong.

Climate-related stress testing is still at a nascent stage. Given that modelling for traditional credit-related stress testing is more advanced than it is for climate, the industry thinks that the implementation process, and any resulting regulatory changes, should be considered carefully and iteratively. We would also like to note the limitations in climate risk assessments, particularly for physical risk assessment, given that the available risk data and methodologies are not yet mature enough for banks to be able to fully assess physical risks associated with its clients. To this extent, we would like to reiterate the importance that high quality and comparable corporate disclosures (such as TCFD/CDP) from clients should come first, as these are key to enabling banks to accurately measure the physical risks associated with its clients.

Section 5.3.3 appears to draw a link from climate to capital adequacy/limitations. We would like to highlight that the incorporation of climate factors into capital requirements should be further examined when there is greater data availability, and to the extent that there is material proof that a risk deferential should be reflected in prudential legislation. To date, other regulatory bodies, when addressing climate risk management, have not proposed requirements for capital assessments.

Monitoring and reporting

In terms of monitoring, Section 5.4.3 reads as follows: *"At portfolio level, AIs should consider focusing on certain risk factors having regard to the materiality. Such monitoring should, at a minimum, cover the AI's exposures to certain sectors which are more vulnerable to transition risks, and collaterals which are more likely to be impacted by physical risks."* It is important to note that often, in respect to certain foreign banks, portfolios are managed at an entity and group level (rather than solely at a branch level). We would like the HKMA to clarify that for SPM GS-1, when applying the climate risk frameworks in respect of the Hong Kong branch, it may continue to assess and monitor risks across its portfolio at a more holistic level rather than purely at a branch-level. (As an example, where the Hong Kong branch may enter into trades with higher climate risk weightings with a client, but other branches may enter into "green" transactions or transactions with lower climate risk weightings with the same client.) In such instance, the SPM GS-1 should allow for risk to be managed at a group/entity level, rather than just at a branch level.

We would also welcome further clarity around the definition of "high-risk sectors / portfolios" and would suggest that HKMA consider providing guidance on this with consideration of existing global frameworks (e.g. the UNEP-FI sectoral sensitivity heatmap[12]).

In Section 5.4.6, it is mentioned that *"in monitoring the physical risk exposures of an AI's own facilities, operations and major outsourced arrangements, it may consider appropriate indicators that provide management with early warning of operational risk issues."* It would be useful to have further clarity on the type and extent of early warning indicators on physical risk exposures that is expected by HKMA, in particular, what the expectation would be for branches, in consideration of the entity's particular business size.

Section 6 - Disclosures

As mentioned in a recent ASIFMA-FOSDA paper on ESG and data challenges, the future growth of ESG investment in Asia is inextricably linked to data – its availability, accessibility, reliability and comparability. Our survey finds that market participants deem 'inconsistent data' as one of the greatest data challenge in the further uptake of ESG and sustainable finance.[13] According to the report, firms and investors are navigating a confusing landscape of disclosure frameworks, incentive structures, data collection methods, and external assessments developed and

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12 https://www.unepfi.org/publications/banking-publications/beyond-the-horizon/

13 https://www.asifma.org/wp-content/uploads/2020/12/asifma-fosda-esg-and-sf-data-challenges-and-opportunities-in-asia-f20201221c.pdf

implemented in various markets and jurisdictions by both the public and private sectors. Variation is evident not only between markets, but also within markets. There is also no single binding global taxonomy, which further complicates navigating through the ESG landscape. In this respect, the industry has been advocating for greater harmonisation between the different emerging standards, and a principles-based approach that allows for tailoring to each region's specificities and level of economic development.

In the absence of a harmonised approach, reporting will be costly and time-consuming for reporting parties that operate on a global scale as they may have to comply with duplicative, and potentially conflicting reporting regulatory regimes. In addition, users of the reported information may find it difficult or confusing to receive data from various reporting standards and requirements, threatening the overall reliability of sustainability reporting.

Disclosure at group or head office level

As referenced in a recent ASIFMA response to the MAS' Consultation Paper on Proposed Guidelines on Environmental Risk Management (Banks) [14], the industry believes that the disclosure framework should be aligned with international standards, and we therefore welcome HKMA's effort in finding reliance on group level disclosures to be appropriate. We are supportive of HKMA's recommendation to take reference from international reporting framework including the Financial Stability Board's (**"FSB"**) Task Force on Climate-related Financial Disclosures (**"TCFD"**) Framework. We do see merit in the HKMA clarifying that when providing group or head-office-level disclosures, AIs are able to assess themselves, whether it is appropriate to specifically address local branch/subsidiaries in such disclosure or make specific separate disclosures. This would assist AIs in being able to determine how to read paragraph 6.2.9 in the context of paragraph 6.2.10.

In this regard, we encourage the HKMA to work with international organisations, including the International Financial Reporting Standards Foundation (**"IFRS"**), and leverage global standards that are being developed for sustainability reporting in order to ensure that investors are able to readily access reliable sustainability-related information from companies and financial institutions, especially from those that operate on a global scale.

Scope 3 disclosure

While we note that the SPM GS-1 gives due recognition to the present challenges firms face with regards to reporting on Scope 3 emissions, concerns remain for the industry as to the adequacy of methodologies used to calculate allocations of Scope 3 in this early stage, which may potentially lead to unintended consequences of firms disclosing incomplete information to the public.

We thus recommend HKMA to revisit its ask in Section 6.2.12 around the disclosure of Scope 3 emissions at a later stage, once there is more clarity around the thinking on this topic, with further agreement across the industry on how to adequately capture/allocate this type of emission.

[14] https://www.asifma.org/wp-content/uploads/2020/08/asifma-response-to-mas-erm-guidelines-banks-v20200807-final.pdf

4. Appendix 1

1 – Regulatory focus on Climate Risk in key jurisdictions