MSCI's Response on SFC Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers

MSCI

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INTRODUCTION

MSCI ESG Research appreciates the opportunity to comment on the SFC Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers

About MSCI

MSCI ESG Research

For over 40 years, MSCI ESG Research has measured and modelled Environmental, Social and Governance (ESG) risk[a]. MSCI is a leading provider of ESG ratings, indexes and analytical tools. We aim to help investors integrate ESG across their entire investment process; powering better investment decisions.

Our solutions:

*First ESG provider to assess companies based on industry financial materiality, dating back to 1999. Only dataset with live history (12+ years) demonstrating economic relevance[b]. For over 11 years, we have rated companies on their exposure to, and management of, industry-specific ESG risks. We rate nearly 14,000 issuers representing more than 680,000 securities, with 90% of equity and fixed income market value. Our research is used by over 1,400 clients globally. Clients can use ESG ratings to support fundamental and quant analyses, portfolio construction and risk management and thought leadership and engagement.

* MSCI ESG Indexes: MSCI is the world’s largest provider of ESG indexes with over 1,500 ESG equity and fixed Income Indexes leveraging MSCI ESG Research data to support ESG integration, screening and impact approaches. Several global asset owners have selected MSCI ESG Indexes, with over $180 billion allocated in recent years[c]. The indexes can also be used as the basis for exchange-traded-funds and other index-based products.

* MSCI ESG Analytics: Our ESG research, data and indexes are available within MSCI’s analytics sys-tems. MSCI Analytics clients can explore ESG exposures on 680,000 securities and 8 million derivatives to support security selection, portfolio construction, stress testing, and risk and performance attribution analysis.

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related busi-ness practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes.

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a. Through MSCI ESG Research and its legacy companies KLD, Innovest, IRRC, and GMI Ratings
b. Origins of MSCI ESG Ratings established in 1999. Produced time series data since 2007
c. Based on publicly available information in press releases published from 2014 to date

Consultation Questions

We appreciate the Securities and Futures Commission (SFC) for issuing the consultation paper on management and disclosure of climate-related risks by fund managers. Please find below our response to the questions from the consultation paper.

1. **Do you have any comments on the SFC's proposal to focus on climate change or should a broader spectrum of sustainable finance should be considered in developing the requirements? Please explain your view.**

A1.

The notion that there is "climate risk" in financial portfolios has been gaining momentum with investors over the last decade. What started as a somewhat contrarian point of view, that fossil fuel reserves would be "stranded assets" because of future climate policy, has developed into a substantially broader, industry-wide debate. Today, it has become difficult to keep track of the many academic and industry initiatives aimed at evaluating this "new" risk.

Briefly put, the idea behind climate risk in financial portfolios is that climate change impacts the financial performance of companies and therefore also the risk-return profile of the securities they issue. Climate risks are usually divided into two broad categories: transition risks (the risks associated with transitioning to a low-carbon economy – for instance, shifts in policy, technology or supply and demand in certain sectors) and physical risks (the risks associated with the physical impacts of climate change on companies' operations, resulting from for instance extreme temperatures, floods, storms or wildfires).

Climate risk is not theoretical, nor is it confined to a distant future. The World Bank reports that, in 2019 alone, there were globally as many as 57 initiatives to put a price on carbon emissions – with significant policy developments in Canada, Germany, Singapore, South Africa and the Netherlands. New policy developments can materialize in substantial policy risk for investee companies; for instance, in the United States, over 100 gigawatts of coal-fired power plants were shut down during the 2010s. Likewise, on the physical risk side, the recent news flow from Australia has been dominated by the wildfires that affected an estimated 100,000 km2 since July 2019 – an area nearly as big as England (130,395 km2). Last year's Hurricane Dorian was the strongest to ever hit land in the Atlantic; UBS estimated that the losses for the insurance industry alone could mount to as much as US$40bln.

Therefore, it is sensible for investors to measure and manage climate risk exposures. Climate change is one of the most pressing challenges of our time and society must take action on climate change urgently in order to avoid its long-term detrimental effects.

With our holistic MSCI Climate Solutions toolkit we aim to empower financial institutions with the tools necessary to build more climate resilient portfolios, protect assets from the worst effects related to climate change and also help identify new, innovative low carbon investment opportunities.

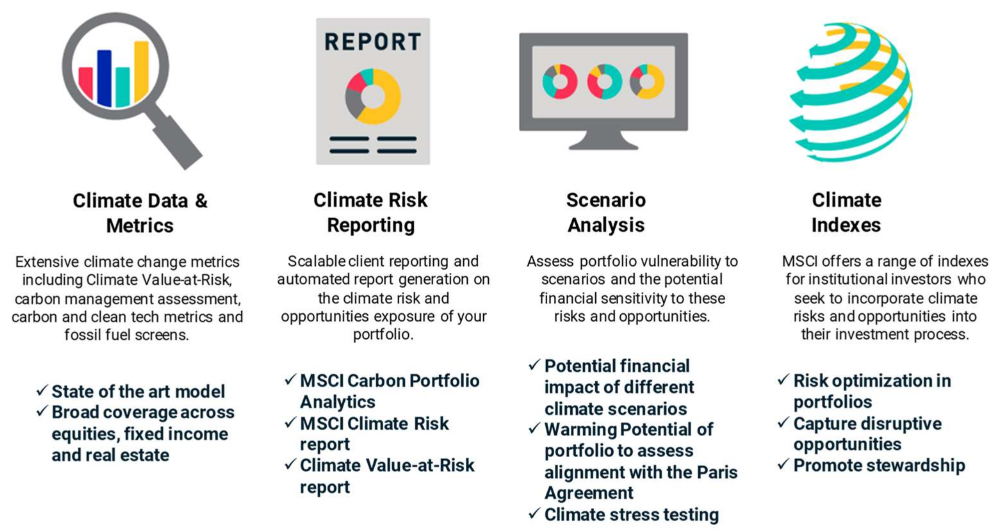

Figure 1: Climate Change Solutions

The MSCI Climate Value-At-Risk (Climate VaR) model provides forward looking and return-based valuation assessments to measure the potential impact of climate change on company valuations. It provides financial institutions – including investment managers, banks, asset owners and insurers – with the means to identify assets that may be at risk from the worst effects resulting from climate change, while helping to identify innovative low carbon investment opportunities, through security specific modelling.

The tool provides insights into the potential stressed market valuation of investment portfolios and downside risks, translating climate-related costs into potential valuation impacts. The tool covers more than 10,000 companies, assessing all their associated equities and corporate bonds within the analysis.

The framework is closely aligned to the TCFD, helping investors seeking to enhance their reporting in a time of increasing regulatory requirements.

2. **Do you agree that at the initial stage, the SFC's proposed requirements should apply to the management of CISs but not discretionary accounts?**

A2.

The MSCI Climate VaR currently covers approximately 10,000 corporate equity and bond issuers. Through sophisticated financial modelling, the Climate VaR assessment is performed at a security level, allowing for a differentiated treatment of equity and bond securities.

In addition to security-level Climate VaR analysis, MSCI also performs asset-level Climate VaR analysis of real estate asset portfolios.

MSCI ESG Research's product development pipeline also includes sovereign bonds, private equity and private credit (including infrastructure investments).

Given the coverage and depth of our own climate modeling capacities, MSCI's view is that applying climate risk disclosure requirements beyond CISs is feasible and may be necessary to invoke meaningful climate action within investment management practices.

3. **Do you agree that the SFC should make reference to the TCFD Recommendations in developing the proposed requirements so as to minimise fund managers' compliance burden and foster the development of a more consistent disclosure framework? Other than the TCFD reporting framework, is there any other standard or framework which in your opinion would be appropriate for the SFC to refer to in developing the proposed requirements?**

A3.

Yes. Aligning with global standards, particularly the TCFD, and streamlining reporting requirements are two crucial components to promote the uptake of this important initiative, plus allowing for global comparisons and standardization of climate risk reporting.

The MSCI Climate VaR was designed to align with the TCFD recommendations. The model has four main applications for investors:

- Policy transition scenarios: The policy scenarios aggregate future policy costs based on an end of the century time horizon. By overlaying climate policy outlooks and future emission reduction price estimates onto company data, MSCI's model provides insights into how current and forthcoming climate policies will affect companies

- Innovation transition scenarios: The low carbon technology scenario is based on company specific patent data, providing insight into the strategic investments companies are making to help the transition to a low-carbon economy
- Portfolio warming potential: the warming potential methodology computes the contribution of a company's activities towards climate change, delivering an exact temperature value that signifies what future temperature a company's activities are currently aligned with
- Physical risks and opportunities: The physical scenarios evaluate the impact and financial risk relating to several extreme weather hazards, such as extreme heat and cold and flood risk.

The MSCI Climate VaR was developed by MSCI's Climate Risk Center in Zurich, the focal point for the development of climate change risk analytics and tools. The aim of the Center is to develop strong partnerships with leading academic and research institutions around the world to advance the use of climate science for financial risk analysis.

This methodology has been developed by climate and policy experts since 2015 and has gone through several development cycles in cooperation with large institutional investors such as asset owners and asset managers.

Climate Value-at-Risk provides a truly forward-looking dimension for assessing transition risks and opportunities for publicly listed companies, their issued securities as well as real assets.

4. **Do you have any comments on the proposed basis for determining the threshold for Large Fund Managers, ie, HK$4 billion, and the basis for reporting? Please explain your view.**

A4.

With issuer, fund, and portfolio level data readily available, and a plethora of turnkey or customized climate reporting and analyses available, suiting all types of firms, the threshold of HK$4 billion may be unnecessary or too high. This threshold would mean that the SFC could miss potentially substantive risks for medium sized firms. We recognize that this size requirement aligns with France's Article 173 thresholds, with 80% of the 1,800 firms not required to disclose climate risk information.

MSCI ESG Research firmly believes that climate change presents clear and pressing risks and opportunities to financial markets.[1] In addition to risks to livelihood from increasing temperatures and rising oceans, climate change also highlights the economic and investment risks and opportunities associated with the world’s transition to a low-carbon economy. An extensive body of scientific evidence has established that man-made factors are driving climate change on our planet. Citizens are demanding action from governments, companies and investors, because humans face a catastrophic future unless remedial actions are taken swiftly. Investors everywhere need to incorporate this new reality into their investment practices.

The merits of scenarios are that they provide organizations with a method for producing a forward-looking assessment to understand the strategic implications of climate-related risks, while at the same time informing investors, lenders, insurance providers and other stakeholders of how a particular organization might perform under different transition and physical risk pathways. Hence, scenario analysis provides an invaluable lens through which to assess a company’s targets, strategy and governance of sustainability issues and take a view on whether they are fit for purpose in a changing world.

Globally there is increasingly a drive to encourage the widespread adoption of climate scenario analysis among companies and financial institutions. MSCI welcomes this evolution to build capacity on climate change, encourage climate action and put in place measures for financial institutions to manage climate related risks over time.
To this end, MSCI has established several principles that we believe are fundamental to establishing an effective, transparent and robust climate risk reporting regime. We think that the building blocks of such a reporting regime should include:

1. Criteria that compare positively to existing or other emerging reporting regimes to ensure consistency and easy of implementation;
2. The usage of “hybrid” methodologies, including top down and bottom up data;
3. Low carbon transition scenarios that reflect real world circumstances;
4. Physical climate scenarios that have been assembled by research institutes or referenced by the IPCC; and
5. A scenario modeling time horizon that captures the full impact(s) of climate change.

[1] For more information, see The MSCI Principles of Sustainable Investing: https://www.msci.com/esg-investing

5. **Do you have any comments on the proposed amendment to the FMCC requirements, baseline requirements and enhanced standards? Please explain your view.**

A5.

Corporations need to be required to disclose more climate-risk related information and data points, so that Fund Managers, Asset Owners and Researchers can improve the granularity and accuracy of climate risk analysis. As climate risk evolves over time, so should the models, data sources and resulting analytics. Therefore, it is our view that the proposed amendments to the FMCC requirements are a necessary step in the process of tackling climate risks.

MSCI ESG Research has seen a wide range of applications from financial institutions using our climate analysis and data. The main themes we observed are below.

1. Engagement: MSCI clients such as pension funds have used the Climate VaR metric in their discussions with portfolio companies to make them aware of the risks of climate change to their business operations, e.g., transition risk from regulations, physical damage to assets and business interruptions. Such clients often take the view that divestment is the last course of action and engagement is preferable. The quantification of costs under different scenarios can be used during company engagements to communicate the potential operational risks posed by climate change.

2. Investment decision-making: MSCI clients such as asset managers have used the technology opportunity component of Climate VaR to identify companies that may have been overlooked by the market. The 'green' patent analysis provides extra-financial information that can be integrated into investment decision-making processes. Product development is another avenue that has been actively explored by clients, utilizing the Climate VaR metric in dedicated ESG products as a quantitative model input in universe selection or screening processes.

3. Risk analysis: Climate VaR metrics can be aggregated across portfolios, so that investment managers can understand portfolio-wide climate risk levels. Some risk departments have set Climate VaR targets or risk tolerance levels for portfolio managers.

4. Monitoring & compliance: Some jurisdictions such as France have introduced mandatory reporting requirements for investors. Notably, France's Article 173 requires investors in the country to comply or explain their portfolio's alignment with the 2°C warming target set out in the Paris Agreement in the United Nations Framework Convention on Climate Change.[1]

5. TCFD reporting: MSCI's analysis is closely aligned with the TCFD. [2] We support clients with their reporting disclosure requirements and our analysis can be used to communicate the risks of assets and portfolios.

[1] https://www.unpri.org/climate-change/french-energy-transition-law-global-investor-briefing-on-article-173/295.article

[2] https://www.fsb-tcfd.org, see https://www.msci.com/tcfd for more information.

6. **To provide a clear picture to investors on whether a fund manager has integrated climate-related considerations into its investment strategies or funds, do you agree that if the fund manager considers that climate-related risks are irrelevant to certain investment strategies or funds, it should make disclosures and maintain appropriate records to explain the rationale for its assessment?**

A6.

Yes, indeed. MSCI would agree with the approach to recommend disclosure and/or explain why not, if climate risk data is reported as irrelevant.

7. **Do you agree that climate-related disclosures (except for the disclosure of WACI) to investors should be made at an entity level at a minimum and supplemented with disclosures at a strategy or fund level to reduce burden on fund managers?**

A7.

Based on our experience, fund level information is required to complete an entity level assessment so, in our opinion, the reporting burden appears the same when considering entity versus fund level reporting. Further, fund level information can vary significantly, hence an entity level aggregation may cover up significant risks at the specific fund level. It is our view that granular fund-level reporting would provide additional transparency in the reporting and evaluation process. Nevertheless, what is more important is that transparency on the climate risk methodological approach, modeling assumptions and aggregation method are disclosed to the SFC. The necessary transparency, comparability and evaluation should therefore be achievable if reporting is required at either entity or fund level.

8. **Do you agree that disclosures of quantitative climate-related data such as WACI should only be applicable to Large Fund Managers having regard to the resources required and the size of assets covered? Do you agree that at the initial stage the disclosure of the WACI should be made at the fund level instead of the entity level?**

A8.

MSCI would disagree with this point. WACI information is readily available for most companies, and can be applied to any fund manager, irrespective of size. It can be used at the fund level.

We believe that there are significant benefits to requiring a more quantitative approach to climate stress testing and reporting. MSCI has developed numerous metrics that have been used for climate stress testing and risk reporting, most notably carbon footprints, Climate Value-at-Risk and Warming Potential.

As shown by the TCFD, managing climate-related risks through a forward-looking approach requires: (i) the development of scenarios that illuminate the materiality of climate-related physical and/or transition risks; (ii) the translation of such scenarios into relevant corporate metrics for a financial institution (or supervisor); (iii) the interpretation of such results in terms of immediate responses (e.g. changes in portfolio mix or need for new climate-related prudential regulation).

The **Climate Value-at-Risk model** provides a multitude of data points and quantitative metrics for both transition & physical climate risk reporting on portfolio-level which are aligned with the TCFD recommendations. The TCFD taskforce itself has highlighted the model and its research in its 2019 status update as a viable solution that can provide informative metrics and allow institutions to report in a transparent and comparable manner to stakeholders. The methodology has been developed by climate and policy experts since 2015 and has gone through a number of development cycles. It should also be highlighted that the Climate VaR model was selected as part of the 2018 UNEPFI investor initiative by 20 large institutional investors to help them pilot the disclosure requirements of the TCFD recommendations.

Our climate risk reports include analysis of an extensive set of carbon risk management and exposure metrics, sourced from sophisticated in-house research and climate models, from stranded assets to clean technology investments and scenario analysis. These reports can help inform strategies to tilt the portfolio towards lower carbon emissions / intensity, or identify high risk companies with weak carbon management strategies relative to peers.

Our tools provide analysis on stranded asset exposure, together with assessments of carbon risk management practices and energy initiatives, in an effort to indicate possible exposure to environmental legislation and preparedness for transition to a low carbon economy.

Figure 2: MSCI ESG Climate Risk Reporting

We would be glad to speak with you about our work, how we support institutional investors in managing climate risks and disclosure requirements, and the feedback we have received on our metrics thus far.

9. **Do you think the following transition periods are appropriate?**
    a. **a nine-month and a 12-month transition period for Large Fund Managers to comply with the baseline requirements and enhanced standards respectively; and**
    b. **a 12-month transition period for other fund managers to comply with the baseline requirements.**

If not, what do you think would be an appropriate transition period? Please set out your reasons.

A9.

MSCI participates in a range of working groups, stakeholder consultations and industry dialogues on climate risk disclosure. Based on feedback we have heard on this same topic, we think that the proposed timelines are clear and reasonable.

Conclusion

MSCI would like to thank SFC for your work in issuing the consultation paper on management and disclosure of climate-related risks by fund managers. We think that you have taken an important step in making Hong Kong and the Asia Pacific region a leader in the fight to understand, quantify and tackle climate change risks. Please let us know if you have any immediate questions or concerns pertaining to this submission.

Contact us

clientservice@msci.com

AMERICAS

Americas	1 888 588 4567 *
Atlanta	+ 1 404 551 3212
Boston	+ 1 617 532 0920
Chicago	+ 1 312 675 0545
Monterrey	+ 52 81 1253 4020
New York	+ 1 212 804 3901
San Francisco	+ 1 415 836 8800
São Paulo	+ 55 11 3706 1360
Toronto	+ 1 416 628 1007

EUROPE, MIDDLE EAST & AFRICA

Cape Town	+ 27 21 673 0100
Frankfurt	+ 49 69 133 859 00
Geneva	+ 41 22 817 9777
London	+ 44 20 7618 2222
Milan	+ 39 02 5849 0415
Paris	0800 91 59 17 *

ASIA PACIFIC

China North	10800 852 1032 *
China South	10800 152 1032 *
Hong Kong	+ 852 2844 9333
Mumbai	+ 91 22 6784 9160
Seoul	00798 8521 3392 *
Singapore	800 852 3749 *
Sydney	+ 61 2 9033 9333
Taipei	008 0112 7513 *
Thailand	0018 0015 6207 7181 *
Tokyo	+ 81 3 5290 1555

* = toll free

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