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Hong Kong proposed enhanced climate disclosure requirements – ISSB paradigm shift for corporate governance, strategy and sustainable finance landscape

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October 2023

Background

In April 2023, the Stock Exchange of Hong Kong Limited (**SEHK**) published a consultation paper (the **Consultation Paper**) which contains amendments to the Hong Kong Exchanges and Clearing Limited (**HKEX**) Listing Rules to require all SEHK-listed issuers to comply with enhanced climate-related disclosures in their ESG reports. The proposed amendments are intended to be largely aligned with the IFRS's International Sustainability Standards Board Climate-related Disclosures Standard (**ISSB Climate Standard**), the Exposure Draft of which was published in March 2022 and the official adopted version issued on 26 June 2023.

Alongside the ISSB Climate Standard, the ISSB also published the General Requirements for Disclosure of Sustainability-related Financial Information, being the first two Sustainability Disclosure Standards under the IFRS. These are broadly welcomed by the market as bringing a new chapter for corporate sustainability reporting, with the expectation to be used across jurisdictions and capital markets as a global baseline for sustainability-related financial reporting.

The ISSB Climate Standard has been developed with the framework of the recommendations of the Taskforce for Climate-related Financial Disclosures (**TCFD**) and the IFRS will take over from the TCFD in further global efforts to drive the practice and quality of corporate disclosures on climate-related risks and opportunities.

HKEX had significantly upgraded the ESG reporting requirements for SEHK-listed companies since July 2020, in particular imposing mandatory disclosure on board engagement on material ESG risks and issues, and introduced "comply or explain" requirements on environmental aspects including reporting on greenhouse gas emissions and climate-related issues and impact. In this connection, significant materials and guidance have since been provided to the market to encourage and facilitate issuers to make TCFD-aligned disclosures. Further, Hong Kong Green and Sustainable Finance Cross Agency Steering Group expressed clear policy intent to mandate TCFD by 2025 and for the financial sector to manage climate risks and accelerate the growth of green and sustainable finance in Hong Kong. Along with the Hong Kong government's 2050 net zero carbon goal that would require industry-wide transformation to a low-carbon economy, climate-related disclosure requirements are of critical importance to support organisations, both corporates and financiers, to manage climate risks and opportunities and move towards concrete and strategic transition pathways.

Mandating climate-related disclosures is also key for Hong Kong's position as a leading capital markets and sustainable finance hub, aligning and keeping high standards for issuers along with international developments of the ISSB standards for sustainability reporting. When the final requirements are introduced after the public consultation, this will be a new chapter for corporate issuers on climate-related financial disclosures in annual ESG reporting alongside their annual financial reporting.

Overview of the enhanced requirements

It is proposed for the enhanced climate-related disclosures to be introduced through a new Part D to ESG Reporting Guide of the HKEX Listing Rules, while the ESG Reporting Guide would be elevated to be the ESG Reporting Code, Part D to be mandatory. The new requirements are expected to be adopted in 2024, while certain requirements shall be under interim provisions for the first two reporting years following the proposed effective date of 1 January 2024, such as disclosures on financial effects of climate-related risks and opportunities, scope 3 emissions (further discussed below) and certain cross-industry metrics.

Mirroring the principles in the ISSB Climate Standard and TCFD, the proposed requirements focus on four key areas covering governance, strategy, risk management, and metrics and target.

- ***Governance*** – issuers will be required to disclose their governance process, controls and procedures for overseeing and managing, specifically, climate-related risks and opportunities; this includes (among other things) disclosure on appropriate skills and competencies available to oversee strategies to respond to climate-related risks and opportunities, the management's role in assessing and managing climate-related risks and opportunities and how the board's oversight is exercised, and whether dedicated controls and procedures are applied to climate-related risks and opportunities.
- ***Strategy*** – the existing ESG Reporting Guide already requires issuers to generally disclose the board's management of ESG issues and describe the significant climate-related issues which have impacted or may impact the issuer and the relevant actions taken to manage them, while the proposed requirements more specifically expect issuers to consider the different nature and types of climate-related risks which may impact the issuer, in particular highlighting the need to consider such potential risks on a forward-looking basis over the short, medium or long term, and also to consider what such risks would mean or could impact the issuer's business model, strategy, cash flows, finance and cost of capital, over the following disclosure requirements:
  - the issuer's assessment of material climate-related risks and, where appropriate, opportunities, and their impact on the issuer's business operations, business model and strategy, which should cover expected time horizon for identified physical or transition risks to have material impact on the issuer and the link to its strategic planning horizons and capital allocation plans;
  - the issuer's transition plans in response to identified climate-related risks and opportunities, including changes to the business models and strategies, any adaptation and mitigation efforts, and any climate-related targets set, including in particular any greenhouse gas emission targets and the extent to which the target relies on the use of carbon credits (whether through carbon removal or emission avoidance);
  - the resilience of the issuer's strategies (including its business model) and operations to climate-related changes, developments or uncertainties, including disclosure on the extent of assets and business activities at risk and the implications for its strategy and business model (such as how it would need to respond to the anticipated effects during transition to a low-carbon economy, access to finance and cost of capital, products and services shift or reskilling of workforce), which shall be assessed using a method of climate-related scenario analysis that is commensurate with the issuer's circumstances; and

- the current (quantitative where material) and anticipated (qualitative) financial effects of climate-related risks and opportunities (if any) (including financial position, financial performance and cash flows), with an expressed expectation that issuers should account for climate-related matters in its financial statements in accordance with financial reporting standards as applicable.

- ***Risk management*** – while there is currently no specific requirement to disclose the risk management process on climate-related risks, the proposed enhanced requirement will mandate issuers to disclose the process to identify, assess and manage climate-related risks, including how they assess likelihood and effects of such risks, how climate-related risks are prioritised relative to other risks (including use of risk-assessment tools), monitored and managed in the overall risk management process and, where applicable, any process used to identify, assess and manage climate-related opportunities (if any).

- ***Metrics and target*** – the existing ESG Reporting Guide requires issuers to disclose emissions, waste, energy consumption and other environmental key performance indicators on a "comply or explain basis" whereas, under the proposed requirements, in place of the said requirement on emissions, issuers are expected to disclose specific items, key ones being:

  - scope 1, scope 2 and scope 3 greenhouse gas emissions[1] – disclosure of scope 3 emissions should include categories of significant upstream and downstream activities along the value chain that have been included, the basis of selection and measurement for including or excluding in its value chain, while during the interim period of two years, issuers who have not yet disclosed required information on scope 3 emissions should disclose information to enable investors to understand the issuer's upstream or downstream activities along the value chain and its work plan, progress and timetable for making the required disclosure;
  - the amount and percentage of assets or business activities vulnerable to physical and transition risks, respectively, as well as the amount and percentage of assets or business activities aligned with climate-related opportunities, and the amount of capital expenditure, financing or investment deployed towards climate-related risks and opportunities, with a two-year interim period for complying with quantitative disclosure on each of these;
  - if applicable, for issuers who maintain an internal carbon price to disclose such internal carbon price and how it was applied in the issuer's decision-making; and
  - how climate-related considerations are factored into executive remuneration policy.

Implications for corporate governance, strategy and the sustainable finance landscape

The enhanced disclosures are likely to have a significant impact on the way in which issuers govern their business as well as corporate finance considerations.

As issuers are required to provide more detailed information on their climate-related risks and opportunities, including how they control and manage climate-related risks, their impact on the issuers' business operations and strategy, supply

1. Scope 1 emissions are defined as "direct greenhouse gas emissions that occur from sources that are owned or controlled by an issuer, for example, emissions from combustion in owned or controlled boilers, furnaces, vehicles or emissions from chemical production in owned or controlled process equipment."

   Scope 2 emissions are defined as "indirect greenhouse gas emissions that occur from the generation of purchased electricity, heat or steam consumed by an issuer. Purchased electricity is defined as electricity that is purchased or otherwise brought into an issuer's boundary. Scope 2 emissions physically occur at the facility where electricity is generated."

   Scope 3 emissions are defined as "indirect emissions outside of scope 2 emissions that occur in the value chain of the issuer, including both upstream and downstream emissions. Scope 3 emissions include these categories (consistent with the GHG Protocol): (1) purchased goods and services; (2) capital goods; etc... Scope 3 emissions could include: the extraction and production of purchased materials and fuels; transport-related activities in vehicles not owned or controlled by the issuer; electricity-related activity (for example, transmission and distribution losses), outsourced activities, and waste disposal."

chain, upstream and downstream value chain, available skills and resources, along with clear expectation for setting climate-related targets and transition planning, these should lead issuers to consider the resilience and long-term viability of assets and business models, and the ability to generate returns in a sustainable manner that mitigates or reduces climate-related risks, towards operating in a low-carbon economy.

In our view, the clear expectation for disclosure of transition plans in response to identified climate-related risks and opportunities, including changes to business models and strategies, any adaptation and mitigation efforts, and climate-related targets, will mark an important shift from corporate sustainability reporting on historical emissions data removed from corporate strategy, towards forward-looking GHG emissions target-setting as part of corporate strategic planning.

Such target-setting by issuers, and cumulatively across the economic system and through the value chain, is necessary towards Hong Kong's and global target-setting and net zero commitments. We suggest issuers should describe or disclose how their target-setting relates to their transition plan and strategy, how the transition changes or efforts are intended to meet the GHG emission targets, and although it is not mandatory, issuers should consider or aim to adopt where possible targets that are science-based or Paris-aligned[2]. This could be described as additional basis or rationale for targets set or net zero commitment (if any) of the organisation, for issuers to make concrete and ambitious target-setting but also safeguard against greenwashing.

The enhanced climate disclosure requirements may also help to drive innovation in climate-related technologies and business models. Companies that are able to demonstrate their ability to manage climate risks and capitalise on climate-related opportunities may be more attractive to investors and customers, which could create incentives for companies to develop new products and services that are better suited to a low-carbon future. As it stands, the proposed requirements are scheduled to be effective from 1 January 2024, and issuers should already start considering and preparing to meet the proposed requirements.

More comprehensive and reliable information on climate risks to investors are likely to lead to more informed investment decisions, which, in turn, could drive capital towards companies that are better positioned to manage climate risks and take advantage of climate-related opportunities. By requiring companies to provide more detailed and reliable information on their climate-related risks and opportunities, HKEX is promoting greater transparency and accountability in the corporate sector, which could ultimately help to drive more sustainable business practices and investment decisions.

With more robust transition planning in issuers' corporate strategy and assessment of how climate-related risks and opportunities could impact the issuers' business model, strategy, cash flows, finance and cost of capital, this would lay foundation and drive more use of sustainable financing instruments such as green or sustainability-linked loans, green or sustainable trade or supply chain financing, or issuance of green or sustainability-linked bonds, and specifically transition finance. These will support Hong Kong's continued efforts in promoting sustainability across the corporate finance as well as broader banking sector and financial markets.

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2. Paris-aligned means target-setting with the goal towards limiting global temperature warming to well below 2°C and pursuing 1.5°C compared to pre-industrial levels, according to the 2015 Paris Agreement of the UN Climate Change Conference.