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ESG RISKS AND OPPORTUNITIES IN THE INFRASTRUCTURE INVESTMENT CYCLE

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1. THE RISE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG)

Institutional investors, including infrastructure funds, have historically viewed efforts to adopt best practices against environmental, social, and governance (ESG) metrics as a desirable but largely peripheral issue in assessing their legal and market risk. Nevertheless, the number of ESG regulations and standards adopted globally has nearly doubled in the last five years, in part due

to the risks relating to emerging environmental, social, technological and geopolitical challenges. Infrastructure funds have therefore begun to incorporate ESG as part of their investment strategies, and have embedded ESG as a core part of their purpose and values. As ESG has become a key value driver for purposeful investment, understanding and measuring the impact of ESG is of increasing importance to investors as well as other stakeholders, including asset managers.

2. WHAT IS ESG?

Although environmental and sustainability concerns are key parts of ESG, the concept is significantly broader, and

covers a number of topics relevant to investment managers as they relate to infrastructure investments, including:

Environmental	Social	Governance
<ul style="list-style-type: none"> Emissions & pollution Waste disposal Water use Opportunities in Green Building 	<ul style="list-style-type: none"> Ethical supply chain management Modern slavery Health & safety Labour management and Culture Data security and IT integrity 	<ul style="list-style-type: none"> Money laundering Bribery & Corruption Diversity & Inclusion Directors' duties and commitments to values Tax transparency

Investors and asset managers have been alive to risks arising out of a number of the topics listed above for many years. However, the unification of these topics within the concept of "ESG" means that companies and asset managers will need to ensure that they are meeting a high standard across the whole of the ESG space, not just those of interest or those which have historically carried the most risk.

3. UNDERSTANDING AND MEASURING THE IMPACT OF ESG

From 2017 to 2019, global socially responsible investments grew by 34% to \$30.7 trillion¹. ESG initiatives have been shown to improve the long-term valuation

of a company by enhancing its financial performance, and lowering its financing and operational costs². Policy makers and regulators in Asia have also started to place a greater emphasis on providing increased oversight, and will expect active implementation of ESG policies at all levels of the supply chain by asset managers. As a result, a number of ESG principles and rating standards have emerged as industry-leading benchmarks for assessing ESG performance. The ultimate aim of these standards is to help companies and asset managers appropriately measure and manage their exposures to ESG-related risks, meet the requirements of its regulators, investors and financing parties, and to earn consumer and market trust.

1. Emily Chasan. (2019). "Global Sustainable Investments Rise 34 Percent to \$30.7 Trillion". *Bloomberg*. Retrieved from: <https://www.bloomberg.com/news/articles/2019-04-01/global-sustainable-investments-rise-34-percent-to-30-7-trillion> (accessed 13 July 2021)

2. IFC (2018). "Brochure: ESG Advisory Services in Europe and Central Asia - Creating Value for Companies in the Real Sector". Retrieved from: https://www.ifc.org/wps/wcm/connect/31f5e0e7-562b-4660-86e1-2ecb572bbe10/ECA_ESG_Brochure_July2018.pdf?MOD=AJPERES&CVID=mjo8LXR (accessed 13 July 2021)

IFC ESG Guidelines

The International Finance Corporation's (IFC) ESG policies and guidelines have emerged as a key market standard for investment funds, investors, stock exchanges, and regulators³. Its Environmental and Social performance (E&S) standards act as an international benchmark for identifying and managing environmental and social risks when evaluating opportunities and managing asset portfolios.

The IFC E&S Performance Standards set out the following eight key principles:

- a) Assessment and management of environmental and social risks and impacts;
- b) Labour and working conditions;
- c) Resource efficiency and pollution prevention;
- d) Community health, safety and security;
- e) Land acquisition and involuntary resettlement;
- f) Biodiversity conservation and sustainable management of living natural resources;
- g) Indigenous peoples; and
- h) Cultural heritage.

The Performance Standards establish the importance of an integrated assessment to identify the environmental and social impacts, risks and opportunities of

potential investments, as well as the need for transparent consultations and community engagement. The principles also assess ESG performance management through the investment cycle, and prescribes objectives and requirements to avoid, minimize and, where necessary, compensate and offset, the relevant risks and impacts to the relevant stakeholders and the environment.

The IFC's Corporate Governance Methodology also provides standards against which asset managers may evaluate and improve their corporate governance, including in the areas of leadership and culture, board of directors, and transparency in its corporate disclosures.

MSCI

The MSCI's ESG ratings have been designed to assist institutional investors with identifying ESG risks and opportunities. By collecting public data from thousands of sources, and by analysing a company's ESG risk exposure and risk management ability relevant to industry peers, companies are rated on a "AAA to CCC" scale (i.e. from an ESG leader to a laggard).

The following key issues are of particular relevance to an infrastructure-focused asset manager's ESG performance:

3. IFC. (2021). "Sustainability Overview". Retrieved from: https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/ (accessed 13 July 2021).

Environment	Social	Governance
<p>Environmental opportunities</p> <ul style="list-style-type: none"> Opportunities in green building 	<p>Human capital</p> <ul style="list-style-type: none"> Human capital development Health and safety <p>Product liability</p> <ul style="list-style-type: none"> Product safety and quality Responsible investment 	<p>Corporate governance</p> <ul style="list-style-type: none"> Board diversity Executive pay Ownership and control Accounting <p>Corporate behaviour</p> <ul style="list-style-type: none"> Business ethics Anti-competitive practices Tax transparency Corruption and instability Financial system instability

Based on the abovementioned data, MSCI ascertains the key ESG risks and opportunities that affects an asset manager and its industry, and assesses the effectiveness of its management system.

GRESB Reporting Standard

The GRESB reporting standard (formerly known as the Global Real Estate Sustainability Benchmark), provides an investor-led ESG benchmark for the real estate and infrastructure sectors, and covers over 1,200 property companies, real estate investment trusts (REITs), funds, and developers in 64 countries. The GRESB's Infrastructure Asset Assessment assesses ESG performance at the asset level for infrastructure asset operators, fund managers and investors through a management component and a performance component. The management component measures the asset manager's strategy and leadership management, its policies and processes,

risk management and stakeholder engagement, while the performance management measures the asset manager's performance in 12 aspects, including implementation; health & safety; energy; employees; waste; greenhouse gas emissions; and customers.

4. REGULATORY EXPOSURE AND MITIGATING ESG RISKS

The regulatory disclosure requirements in various leading jurisdictions in Asia have evolved over the past 20 years, from a largely voluntary framework, to a more stringent "comply or explain" standard for ESG disclosures. As a result, asset managers will need to undertake an assessment on their exposure to ESG risks across the jurisdictions in which they operate, and implement a best practices approach against key industry benchmarks in all ESG areas as part of its overall corporate governance and corporate behaviour.

The Hong Kong Stock Exchange, for instance, has incorporated compulsory ESG reporting guidelines since 2015, while Singapore published a sustainability reporting guidelines in 2016 on a "comply or explain" basis for all listed companies. Similarly, the China Securities Regulatory Commission (CSRC) has proposed a requirement this year for listed companies to include an "Environmental and Social Responsibilities" chapter in their annual reports, to disclose penalties received for violating environmental rules, and to encourage the disclosure of measures taken to lower carbon emissions and help solve poverty in rural areas.

As ESG considerations have become part of the new normal, compliance with ESG standards and expectations will be an essential element to consider for both asset investment and asset management. Such considerations will need to move beyond making aspirational statements, and will need to be fully embedded and integrated into an asset manager's corporate culture.

In order to manage the expectations of investors to comply with certain environmental standards, including their green financing criteria, and to address emerging litigation and regulatory risks surrounding ESG performance misstatements (known as "greenwashing" claims), it will be advisable for asset managers to consider and implement the following measures during the infrastructure investment cycle:

- Pre-Investment Structuring and Investor Closings:
Develop a protocol to ensure that sustainability and ESG risks are structured as part of the investment decision-making process, including by incorporating an ESG assessment framework and ESG due diligence as part of the process. Effective due diligence needs to go beyond a desktop or data room review and should incorporate appropriate financial transaction testing and management interviews.
- Post-Investment, Management and Pre-Divestments:
Design or strengthen the manager's enterprise risk management system by embedding sustainability and ESG risk assessments into the manager's decision-making procedures, including its policies and procedures.
- Validate ESG and corporate social responsibility statements to address increased litigation and regulatory risks relating to potential misstatement and misrepresentation claims.
- Robust corporate engagement strategies must be developed to manage and reduce any adverse impact on ESG issues on a going-forward and ongoing basis. This requires regular reviews and testing of the corporate compliance program through audits of key areas of ESG risk exposure, credible investigations where breaches are alleged and responsive remediation where standards and controls are required to be introduced or enhanced.

PROFILE

Mini vandePol is the head of Baker McKenzie's Asia Pacific Compliance & Investigations Group. She has more than 30 years' experience advising multinationals on a variety of ESG risks, including around sanctions, anti-bribery and corruption, human rights violations related to supply chains, and significant financial misconduct. She regularly assists companies in establishing and enhancing their risk management programs, in assessing risks in transactional opportunities, and in credibly investigating transgressions. She has been recognized by industry publications and awards as a leading lawyer in the areas of white collar crime, compliance and investigations. She is also regularly quoted in the media and is highly sought as conference speaker.

Mini is the representative of Baker McKenzie in the World Economic Forum (WEF) Partnering Against Corruption Initiative (PACI) and has been an active member of the WEF Global Future Council since November 2019. She is also the vice president of the Women's White Collar Defence Association (HK Chapter).

Mini graduated from Australia's Monash University with a Bachelor of Science and a Bachelor of Laws. She is admitted as a barrister and solicitor in Australia and as a registered foreign lawyer in Hong Kong.



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Gerald Lam is a senior associate in Baker McKenzie's Hong Kong Dispute Resolution Practice Group. He specializes in international risk and investigations and has particular experience in advising multinational clients on global anti-corruption and compliance matters in relation to cross-border investments and operations, including on anti-bribery and corruption, international economic sanctions, and AML and financial fraud, with a special focus on the financial services, private equity, life sciences and TMT sectors. He has conducted numerous cross-border FCPA investigations, compliance risk assessments, and investment due diligence spanning multiple jurisdictions.

Gerald graduated from McMaster University with a Bachelor of Arts in Political Science, and from the Chinese University of Hong Kong with a JD and P.C.LL. (Distinguished Scholarship). He is admitted as a solicitor in Hong Kong.



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