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Sustainability governance - the four signposts

November 2024

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Foreword

This well-thought-out paper provides high-level ideas on the governance issues of the day and signposts for chairpersons, directors, and sustainability teams to consider. The research shows that sustainability is a top-of-the-agenda issue, but the extent of capture of risks and opportunities requires more work. It is here that the governance professional can provide significant impetus and advice to listed companies and other organisations to derive the full benefits of sustainability reporting.

David Simmonds FCG HKFCG

President, The Hong Kong Chartered Governance Institute;

Chief Strategy, Sustainability and Governance Officer, CLP Holdings Limited

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Ms Ellie Pang FCG HKFCG(PE), Chief Executive, The Hong Kong Chartered Governance Institute.

Executive summary

Amid the rapidly growing expectations of various stakeholders on sustainability, sustainability has become an integral part of matters requiring oversight by management and directors of each organisation. The incorporation of sustainability into corporate governance has become increasingly crucial. In light of these new demands, there are numerous areas where governance professionals can assist in upholding high governance standards, board-level communication and decision-making.

This research aims at uncovering insights into four aspects of practical sustainability implementation:

1

Sustainability governance structure and competency:

How can the organisations' governance framework, governance structure, roles and competence of those charged with governance be enhanced to enable robust and effective oversight of sustainability matters across functions and levels?

2

Business strategies for sustainability-related risks and opportunities:

How could governance professionals consider the sustainability-related risks and opportunities related to their strategy, major transactions, policies, and processes?

3

ESG data for the decision-making process:

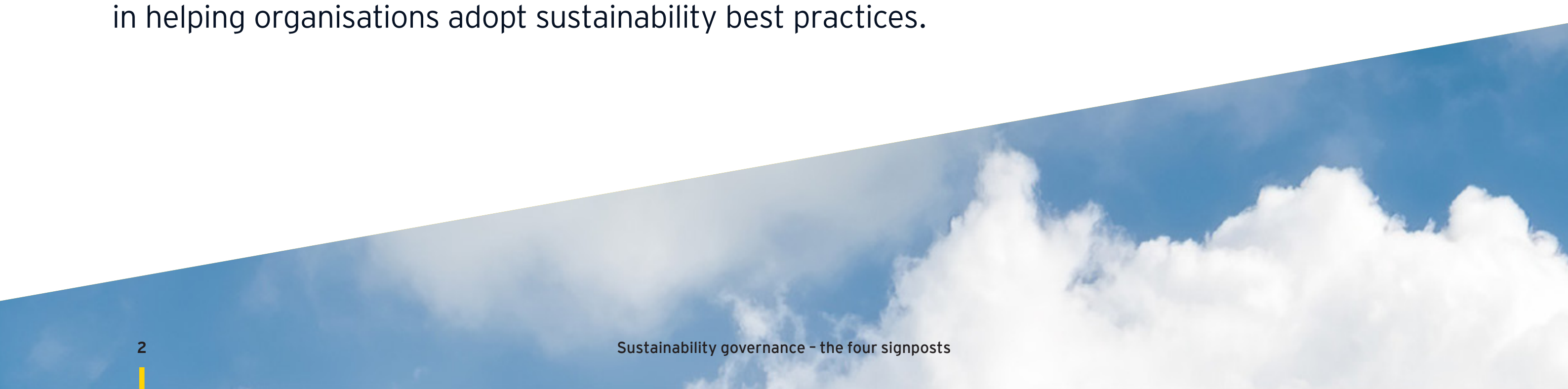
How can environmental, social, and governance data be tracked and utilised to adequately consider sustainability aspects during decision-making?

4

Alignment of management interests to sustainability performance:

How could the interests of management be aligned with sustainability objectives through remuneration policies and schemes?

These are not exhaustive sustainability-related considerations, but these issues will be signposts in helping organisations adopt sustainability best practices.



Methodology

From January to August 2024, HKCGI, in collaboration with Ernst & Young Advisory Services Limited, conducted broad research on sustainability integration in corporate governance among Hong Kong companies. The research analyses the latest corporate publications, including ESG reports, performed for 70 Hong Kong-based companies, focusing on four signposts of sustainability performance. Our research aims to identify key challenges and propose prospects for sustainable corporate governance in Hong Kong.

1 Enhancing sustainability governance structure and competency

Introduction

In today's corporate landscape, the governance of sustainability and climate change issues has become as critical as the oversight of financial performance. Organisations are increasingly recognising that to effectively address sustainability concerns, they must implement robust governance structures specifically tailored to these challenges. This approach typically involves establishing professional sustainability committees to provide seasoned oversight, creating internal task forces to drive initiatives across the organisation, and help enhancing the board's experience in sustainability matters. However, there is no one-size-fits-all in these committees, with some being board-level committees chaired by executive directors or independent directors, while others being management committees. Under current Listing Rules, directors remain liable for oversight, and the insight is that there is an increasing level of concern on the topic.

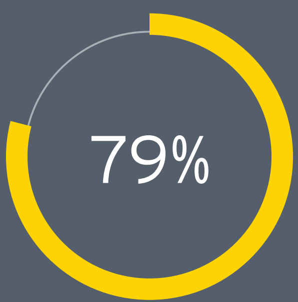
In practice, management will identify operational issues affecting business and escalate material concerns, including material sustainability concerns, to chairpersons and help with reporting to the boards. The presence of sustainability committees will assist in testing the materiality of issues raised by management and help companies formulate targets and metrics as part of the overall governance structures and processes to manage sustainability-related risks and opportunities. Thus, committees with some degree of specialism have value. Also, at the board level, there is a need for directors to have complementary ability to deal with sustainability issues to provide effective oversight.

The current approach to sustainability governance

Our research findings reveal a significant trend in Hong Kong's corporate landscape regarding climate governance and sustainability practices. 79% of the companies have implemented structured approaches to ESG matters by establishing internal sustainability committees. This demonstrates a growing recognition of the importance of dedicated oversight for sustainability and climate-related issues within organisations.

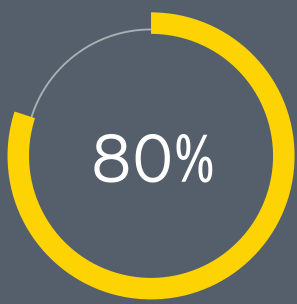
The research also identified the varying degrees of board involvement in sustainability matters. For 80% of the companies, the board's responsibilities extend beyond mere disclosure approval, encompassing comprehensive oversight of sustainability strategies, practices, and reporting. This indicates a mature approach to integrating sustainability into core business operations and decision-making processes.

Research question: Has the company established a dedicated ESG committee overseeing sustainability performance?



of companies have established **dedicated internal sustainability committees** for sustainability performance

Research question: Has the company outlined the roles of the Board in related to sustainability in annual report and/or sustainability report?



of companies' Boards are responsible for the oversight of sustainability strategies, practices and disclosures

Looking beyond Hong Kong, the 2024 EY Europe Long-term Value and Corporate Governance Survey reveals a commendable commitment from board members to help enhance their sustainability experience. A substantial number of directors are actively participating in various sustainability-related capacity-building programs. There are 60% of executive directors believe that they have an effective training approach on sustainability, but this drops to 43% for non-executive directors and chairpersons. Given the rapidly evolving nature of sustainability challenges and regulations, this engagement in ongoing education is essential.

Our viewpoint

These findings suggest that Hong Kong companies are making significant strides in establishing robust sustainability governance structures, with most firms demonstrating a broad and proactive approach to sustainability at the board level.

The increase in the proportion of board members actively engaged in sustainability management can be largely attributed to the update of the Corporate Governance Code in December 2021. This update catalysed the growth of board-level attention to sustainability matters.

In addition, as external stakeholders increasingly demand transparency and accountability regarding sustainability-related issues, companies are responding by establishing dedicated committees to address these concerns. Various factors, including heightened expectations for sustainability disclosures by customers, investors, and lenders and the scrutiny by ESG agencies on hundreds of sustainability areas of concern for each company, drive this trend.

In response to the elevated concerns on sustainability, companies have started transforming their governance structure towards a combination of internal champions with the right responsibilities, experience, skills, competency, and authority to exert influence and deploy resources. One notable change is establishing a dedicated ESG committee, which gives organisations a holistic and coordinated approach to managing and overseeing their sustainability matters. These committees are responsible for implementing ESG policies, ensuring compliance with regulatory requirements, and engaging with stakeholders to communicate the company's sustainability efforts. By centralising ESG oversight, companies can better align their operations with stakeholder expectations and industry standards.

Despite the commendable efforts in enhancing sustainability expertise among executive directors, there remains a notable gap in training effectiveness for non-executive directors and chairpersons. Companies should prioritise closing this gap by implementing targeted training and development programs tailored to the specific needs of non-executive directors and chairpersons, ensuring consistent and effective sustainability governance across all leadership levels.

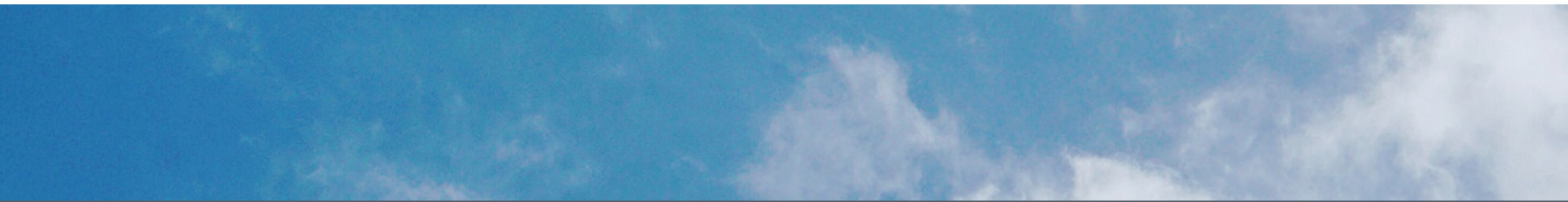
This snapshot shows that Hong Kong-listed companies are generally aware of the importance of sustainability governance and have committed resources to internal sustainability committees. The importance of these committees is expected to increase over time, as sustainability is now a key consideration for investor's allocation of capital and a regulatory issue. The internationalisation of sustainability as a key governance issue has been firmly established, and governance professionals must advise management to commit resources and build up the capacity to manage stakeholder expectations.

2 Integrating sustainability-related risks and opportunities into business strategies

Introduction

In Enterprise Risk Management (ERM), organisations have traditionally prioritised financial risks and opportunities as the primary drivers for evaluation and strategic adjustments. However, a paradigm shift is underway. Integrating sustainability risks and opportunities into business strategies has become a critical imperative. This evolution reflects a growing recognition that sustainability risk considerations are no longer peripheral but central to informed and sustainable strategic decision-making.

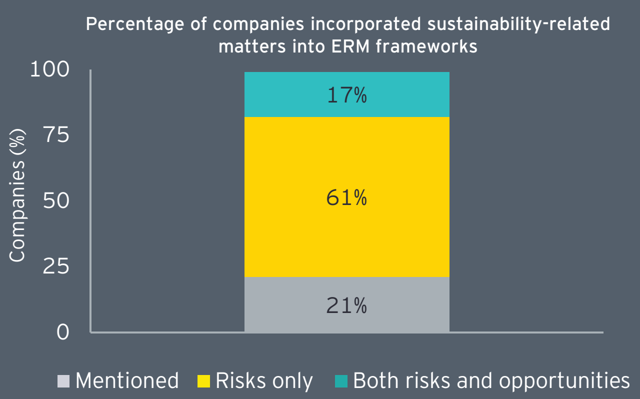
A related issue that is taking centre stage is assurance. There are currently no international standards or qualifications as to who can provide these. The analysis observed that there were only a handful of cases where sustainability reports were supported by assurance, and even then, the assurance was on a limited basis. This international topic is developing and affects the value of sustainability reporting.



Current approach to sustainability-related risks and opportunities consideration

Based on our research, integrating sustainability-related factors into business practices among Hong Kong-listed companies shows a clear disparity between risk management and opportunity recognition. 61% of the companies have incorporated sustainability-related risks into their enterprise risk management frameworks. While only 17% have taken a more comprehensive approach by considering risks and opportunities in their overall risk assessment and business strategy.

Research question: Does the company state that ESG risk and opportunities are incorporated into the enterprise risk management (ERM)?



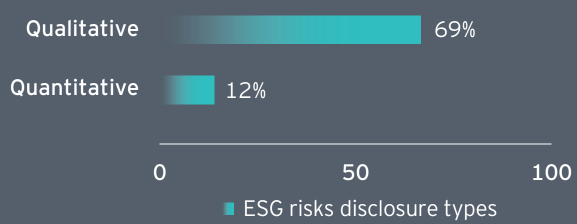
only a **17% of the companies** have adopted a more comprehensive approach by considering **both risks and opportunities** in their **ERM**

This trend suggests that while Hong Kong-listed companies are increasingly aware of sustainability-related risks, they are not yet fully capitalising on potential opportunities arising from climate change and transitioning to a low-carbon economy. The limited focus on opportunities indicates a potential gap in strategic planning and could result in missed business prospects in the evolving market landscape.

Regarding assessing sustainability-related risks in financial terms, the research reveals that most companies' approaches remain qualitative. 69% of the companies reported only identifying which financial aspects (such as revenue or costs) are affected by ESG or climate risks without translating these risks into specific financial figures. While acknowledging the potential impact, this approach falls short of providing actionable financial insights.

Only 12% of the companies have advanced to quantifying sustainability risks into exact figures or estimated ranges.

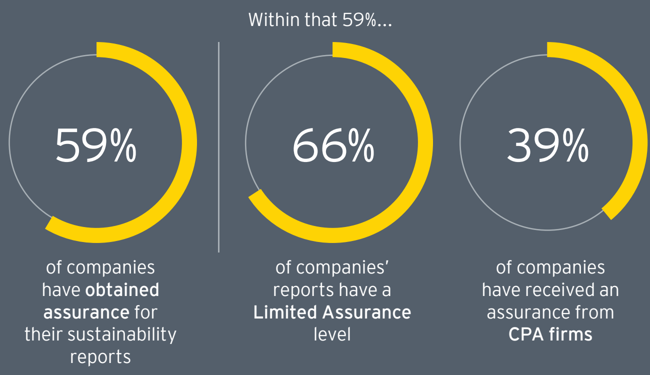
Research question: Does the company quantify ESG risks into financial figures?



69% of the companies disclosed **qualitative financial aspects** while **only 12% of companies** have progressed to **quantifying** sustainability risks into exact figures or ranges

In terms of assurance, 59% of the companies have obtained assurance for their sustainability report. However, the assurance level is often limited assurance, with only 16 companies receiving assurance from CPA firms. This raises concerns about the overall reliability of the data, which is crucial for effective risk management and informed decision-making.

Research question: Has the company's ESG report undergone an assurance process?



Our viewpoint

While a relatively small number of companies in the research have integrated ESG factors into their ERM processes, some acknowledged these factors' significance. This indicates a potential to enhance the effectiveness of their current risk management approach in addressing sustainability risks and opportunities. To help enhance risk management practices, companies may consider utilising scenario analysis to set out two or more plausible scenarios depicting future states relevant to the organisations and identify relevant risks and opportunities accordingly. This technique could help pick up risks and opportunities that appear unlikely to happen or bring any significant impact yet are fairly different in another plausible scenario.

Awareness within organisations of the connection and causality of sustainability factors is instrumental to the effectiveness of assessment of these factors, which enables successful integration of these factors into strategy, major transactions and day-to-day business operations. Implementing training programs and workshops would be important methods to build this capacity within the organisation. While identifying the linkages, such as climate risk, is crucial, a common challenge emerges in expressing these risks in measurable financial terms. The lack of standardised methods for quantification delays the seamless integration of these risks into decision-making processes. Establishing clear metrics and frameworks will facilitate the effective communication of these risks to stakeholders, enabling companies to better assess their impact on overall performance. Most Hong Kong-listed companies are still exploring a suitable approach to quantify financial effects projections.

Another critical area requiring attention is the assurance of sustainability reports. Concerns are raised about the credibility and robustness of these reports. The lack of international standards or qualifications for sustainability assurance further exacerbates this issue, leading to inconsistencies in the quality and reliability of the data. Governance professionals must advocate for more rigorous assurance practices, encouraging companies to seek assurance from reputable firms. By strengthening assurance processes, companies will have a more reliable foundation for integrating sustainability-related risks and opportunities into their business strategies, ensuring that decisions are based on accurate and trusted data.

The governance professional needs to bring the issue to the forefront of the chairpersons and boards and the value proposition that an analysis of sustainability risks and opportunities brings for operations and attracting investors increasingly considering the financial aspects of sustainability.

3 Utilising ESG data for decision-making processes

Introduction

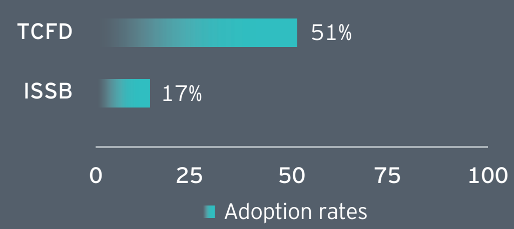
It is essential to have access to accurate and comprehensive climate-related data to make informed strategic decisions regarding ESG and sustainability in business operations. This data is crucial for conducting thorough environmental impact analyses and effectively integrating financial strategies. Nevertheless, there are challenges in data collection, which technology might eventually help resolve. Until then, data integrity will be a continuing issue, including reliance on third-party data, for example, with the calculation of Scope 3 emissions. Also, there are related data transfer issues for out-of-jurisdiction data. The data integrity issue further plays into other issues, such as setting KPIs and related compensation, as data forms the underlying assumption for arriving at these and other operational parameters.

Current utilisation of ESG data for decision-making processes

While half of the companies studied have adopted recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) Framework in their sustainability disclosure, they have not followed up with data and analytics to capture opportunities and to communicate with investors on issues they are concerned with including carbon-pricing. According to 2023 EY Global Climate Risk Disclosure Barometer, the average quality score of disclosures lags behind as well, with an average score of only 52%. Additionally, only 53% of surveyed companies disclosed a transition plan—an area that should see much greater adoption. A well-structured transition strategy is crucial for companies to stay aligned with, or even ahead of, evolving policy goals and market expectations.

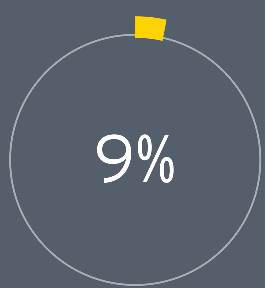
They also need to do a better job regarding disclosures around the International Sustainability Standards Board (ISSB) standards, as over 83% of respondents have not indicated whether they disclosed any ISSB-required information in their sustainability reports.

Research question: Has the company adopted ISSB standards or TCFD framework?



In addition, EY research reveals the adoption of carbon pricing mechanisms for decision marking among companies remains uncommon. Over 90% of the studied organisations neither mentioned nor implemented any form of carbon pricing. Only a small fraction, approximately 9%, utilised either an internal fee approach or shadow pricing approach.

Research question: Has the company reported using an internal carbon pricing mechanism?



of the companies have utilised internal carbon price for decision making

Our viewpoint

When appropriately designed and implemented, the carbon pricing mechanism enables a more intuitive quantification of carbon emissions' financial value. It facilitates decision-makers ability to factor them, among other factors, into their decision-making process.

Currently, there is a lack of standardised metrics and frameworks for measuring ESG regarding scopes, coverages, and data definitions used across companies and industries. The presence of numerous ESG reporting frameworks and metrics often criticised as the "alphabet soup of ESG reporting", hinders the governance bodies' ability to understand, assess and compare performance in sustainability topics.

Most ESG metrics nowadays are designed to measure historical and current impacts of sustainability matters. It naturally leads companies to focus primarily on short-term impacts and neglect potential impacts on a longer time horizon. The lack of forward-looking metrics deters decision-makers from rationally considering the full impact of choices with long-lasting implications, such as decisions on organisational restructuring, product design, site selection, capital investment, etc.

The increasing surge in climate-related litigations and shareholder activism highlights the growing demand for more transparent and reliable ESG data. However, many companies struggle to meet these demands due to a lack of fully integrating ESG considerations into all governance layers, including decision-making processes. This can result in ESG factors being treated as separate from core business strategies rather than integral components.

To address these issues, companies must focus on improving the quality and standardisation of ESG data collection, adopting widely recognised reporting frameworks, and integrating ESG considerations more deeply into their governance and decision-making processes. The governance professional should be aware of these considerations to advise chairpersons and boards on using data to facilitate decision-making and to make a financial case to investors.

4 Incorporating sustainability management incentives

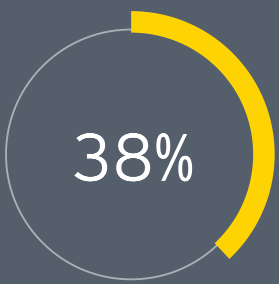
Introduction

The transition to low-carbon, green business operations is a long-term process and goal, necessitating management remuneration that aligns with various stages of development. Consequently, prioritising long-term value creation from sustainability performance should be a key focus of corporate governance. However, data accuracy in forming targets and metrics, setting KPIs, and analysing the impacts of steps taken towards mitigating sustainability risks remain problematic, as well as the lack of assurance standards and professionals. Despite these difficulties, from a business perspective, incentivising and rewarding management seeking to mitigate material sustainability concerns, which investors demand, is required under some rational and defensible criteria. The issue is one of balance, and KPIs relating to sustainability must also play into the organisation's broader objectives, that is, the overall strategy to contribute to sustainable business operations.

Current approach to sustainability management incentives

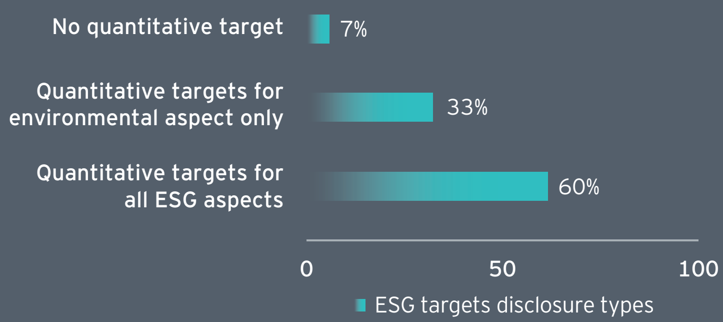
The integration of ESG targets into incentive programs remains limited among companies. Only 38% of companies have considered ESG factors in employee remuneration including that for C-suite executives and top management. Furthermore, while ESG targets should ideally be tied to long-term incentives to drive sustained value creation, only 44% of companies include long-term incentives as part of their remuneration structure. A critical prerequisite for linking ESG targets to remuneration is that these targets must be quantitative and measurable. However, only 60% of companies have established quantitative ESG targets for all aspects, further complicating the effective integration of ESG metrics into incentive plans.

Research question: Does the company incorporate ESG KPIs/targets into their incentives/remuneration programs?

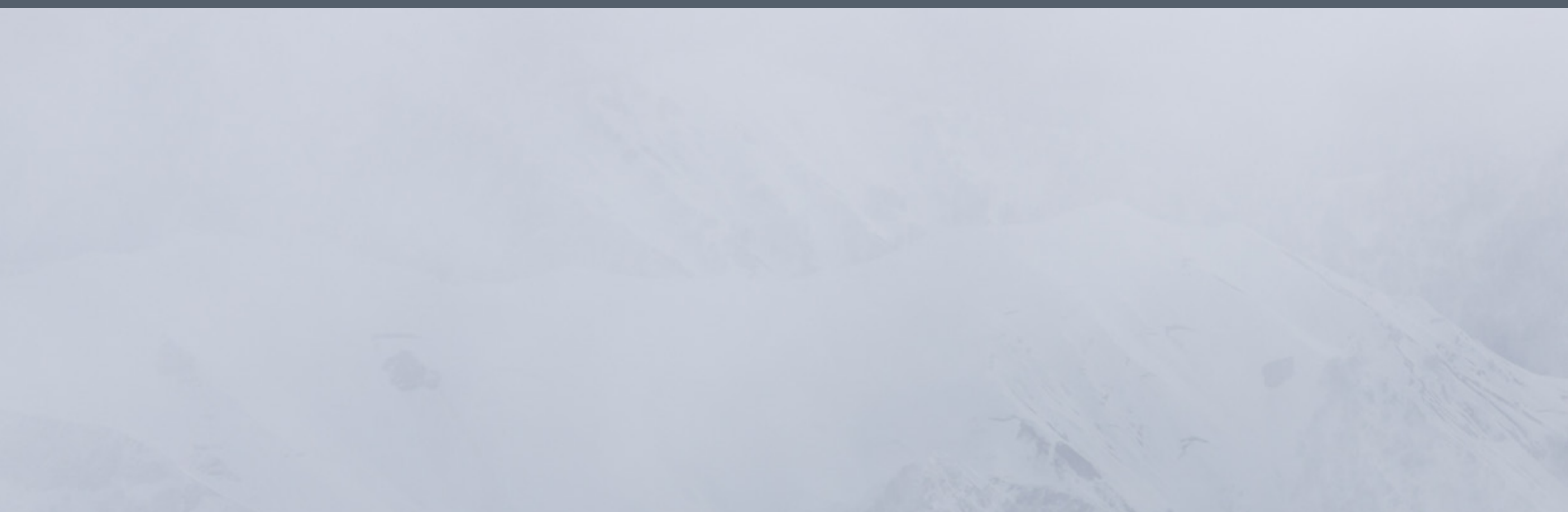


of companies have **considered ESG factors in employee remuneration** including that for C-suite executives and top management

Research question: Does the company have quantitative ESG targets? Which aspects are the targets for?



60% of companies have set quantitative targets for **all aspects of ESG**



Our viewpoint

The research findings highlight a significant gap between corporate sustainability rhetoric and actual incentivisation practices. ESG targets are inherently long-term, aiming to drive sustainable value creation, enhance corporate resilience, and address environmental, social, and governance challenges over extended periods.

For ESG targets to be effectively incorporated into remuneration structures, they must be quantitative and measurable, allowing for clear evaluation and alignment with long-term incentives. However, the fact that only 60% of companies have established quantitative ESG targets for all three aspects, combined with the limited use of long-term incentives, suggests that many organisations are not yet fully equipped to integrate sustainability into their executive compensation strategies.

To address this gap, companies must prioritise the development of quantitative ESG targets and incorporate them into long-term incentive plans. This approach would help ensure that sustainability is a meaningful component of executive compensation and align management rewards with the long-term interests of stakeholders, driving sustained value creation and responsible corporate behaviour. The governance professionals should be aware of these matters and steer chairpersons, directors and the sustainability teams to consider.

Conclusion

Hong Kong's corporate governance landscape has made commendable progress in integrating ESG principles, with increased board-level oversight and the establishment of sustainability committees. However, challenges such as data integrity, lack of standardised assurance practices, and gaps in aligning management incentives with sustainability performance continue to hinder further advancement.

To bridge these gaps and promote robust ESG governance, governance professionals must take proactive steps:

Strengthen board-level commitment to ESG: Governance professionals should drive awareness by equipping board members with the necessary knowledge and confidence to make strategic decisions related to sustainability. This includes providing clear, actionable insights that align sustainability risks and opportunities with business strategy.

Enhance ESG-related expertise and training: It is crucial to close the knowledge gap among non-executive directors and chairpersons. Governance professionals should advocate for targeted training programmes to build ESG competence across all levels of leadership.

Integrate ESG risks into strategic decision-making: Companies should prioritise the integration of sustainability-related risks and opportunities into their overall business strategies. This involves utilising scenario analysis and setting forward-looking metrics.

Advance data collection and assurance practices: To support informed decision-making, governance professionals need to ensure that ESG data is reliable, comprehensive, and standardised. Encouraging companies to adopt robust data assurance processes and seek third-party verification will enhance the credibility of sustainability disclosure.

Align management incentives with sustainability performance: Governance professionals should guide organisations in linking executive remuneration to long-term ESG goals, ensuring that sustainability is embedded in incentive structures and is quantifiable through measurable KPIs.

As companies continue to face mounting stakeholder expectations and regulatory pressures, governance professionals are uniquely positioned to lead this transformation. By focusing on these key action areas, they can help organisations not only meet compliance standards but also turn sustainability into a competitive advantage and a driver for long-term value creation.

Contact us

EY

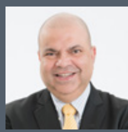
Mr Ee Sin Tan
Partner
Climate Change and Sustainability Services
Hong Kong and Macau
Ernst & Young

Tel: +852 2629 3917
Email: ee-sin.tan@hk.ey.com

HKCGI

Ms Ellie Pang FCG HKFCG(PE)
Chief Executive
The Hong Kong Chartered Governance Institute

Tel: +852 2830 6029
Email: ellie.pang@hkcgi.org.hk



Mr Mohan Datwani FCG HKFCG(PE)
Deputy Chief Executive
The Hong Kong Chartered Governance Institute

Tel: +852 2830 6012
Email: mohan.datwani@hkcgi.org.hk

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With over 75 years of history and as the Hong Kong/China Division of The Chartered Governance Institute (CGI), the Institute's reach and professional recognition extends to all of CGI's nine divisions, with about 40,000 members and students worldwide. HKCGI is one of the fastest-growing divisions of CGI, having over 10,000 members, graduates and students with significant representations within listed companies and other cross-industry governance functions.

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