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Singapore Update – Releases Environmental Risk Guidelines for Asset Managers – December 2020

On 8 December 2020, the Monetary Authority of Singapore ("MAS") released Guidelines on Environmental Risk Management ("the Guidelines") for asset managers. The Guidelines address the asset management sector's resilience to, and management of, environmental risk.

Applicability

The Guidelines apply to all fund managers with a capital markets services licence for fund management ("LFMC"), real estate investment trust ("REIT") FMCs, and to registered fund management companies ("RFMC").

The Guidelines cover both funds and segregated mandates.

The Guidelines apply where the types of FMCs mentioned above have investment discretion over funds or mandates.

Where Singapore based FMCs delegate the investment management to sub-managers or advisors, they still retain overall responsibility for environmental risk management and must convey their expectations on environmental risk management to the sub-managers or advisors. FMCs must also assess and monitor the sub-managers' or advisors' compliance with these expectations.

The MAS has specifically stated that FMCs should implement the Guidelines in a way that is commensurate with the size and nature of their activities, and the investment focus and strategy of their funds/mandates.

International asset managers may rely upon Group environmental risk management frameworks, policies and procedures so long as they meet the same standard as outlined in the Guidelines.

The MAS believes that FMCs should protect investors' assets against the impact of environmental risk but that they are also stakeholders in the transition to a environmentally sustainable economy via green investment and working with regulators and other governmental and academic institutions.

Scope

The MAS has defined environmental risk as arising from the potential adverse impact of changes in the environment on economic activities and human well-being.

In summary, the MAS highlights two key risks which may financially impact funds or mandates:

- Physical risk arising from the impact of weather events and long-term or widespread environmental changes and this may impair the value of assets held by companies in the FMC's investment universe;

- Transition risk arising from the process of adjustment to an environmentally sustainable economy including changes in public policies, disruptive technological developments, and shifts in consumer and investor preferences. Actions taken against polluting companies may also impair the value of those companies and portfolios may be exposed to downside risk and volatility where business models are disrupted due to environmental impact; and

- Reputational risk may arise for FMCs that invest in businesses which have a negative impact on the environment and this in turn may impact on their ability to grow AUM.

ComplianceAsia Consulting Pte Ltd. 137 Telok Ayer Street #03-06, Singapore 068602
Tel: (65) 6533 8834 www.complianceasia.com

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Governance and Strategy

The Board of Directors are responsible for approving an environmental risk management framework, setting responsibilities for the Board and senior management for oversight of environmental risk of the assets managed and ensuring that directors have adequate understanding of environmental risk.

Senior Management is responsible for ensuring the development and implementation of an environmental risk management framework, monitoring exposures to environmental risk, regularly reviewing the effectiveness of the framework, establishing an internal escalation process for managing environmental risk and allocating adequate resources with appropriate expertise, including managing the environmental risk of the portfolios.

FMCs must ensure that they effectively assess, monitor, and report all exposures they face, in both the short and long term. The continued review of these policies in light of environmental change is emphasized by the MAS as a central requirement.

Three Lines of Defence

A clearly articulated risk management framework is expected to be put into place. At the heart of this is to be a clearly defined set of roles and responsibilities across business lines and functions. Identification and assessment of risks is to be implemented on a customer and portfolio basis with appropriate internal controls to evaluate risks.

Asset managers should aim to ensure their roles, responsibilities and assessments are mutually exclusive and collectively exhaustive to prevent confusion or non-action. Further, the MAS recommends using a 'three lines of defence' model with business line staff, the risk management function and the internal audit function to reduce the chance of mis-evaluating any risks.

Research and Portfolio Construction

The framework should include how the asset manager incorporates environmental risk considerations in its investment research, portfolio construction, risk management and stewardship practices across different asset classes and investment strategies.

If FMCS have assessed environmental risk considerations to be material, they should embed them in their research and portfolio construction processes in the same way that asset managers consider investment horizon, risk and return profile, economic policy, etc. Environmental, transitional, and reputational risk should feature in these considerations.

Risk Identification and Assessment

The MAS has highlighted the following high-risk areas that they believe asset managers should pay particular attention to as they assess their risk exposure:

- level of greenhouse gas emissions;
- vulnerability to extreme weather events; and
- linkages to unsustainable energy practices, deforestation and pollution.

When constructing a risk rating, asset managers are encouraged to go beyond the typical high, medium or low categorisation. The MAS expects there to be a method of evaluating the severity of risks in the form of a quantifiable scale. It is also recommended that asset managers incorporate

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the customer's exposures to climate transition risk in their assessments, such as the scope and extent of their exposure. The MAS encourages firms to look at global sustainability and certification schemes and third party research when developing the methodology.

When evaluating equities, the impact of environmental risk factors on the long-term profitability of the issuer should be central to considerations. These could include the location of operations of firms, the resources used by them, etc.

For fixed income investments, environmental data should be used to create an impartial and holistic understanding of the environmental and transitional risks present for the investment. Seniority and maturity of investments should be factored into evaluations made.

Direct real estate investments should be evaluated for their possible impact on climate change and the environment, and if any of these factors are likely to impact upon project-end demand. Future changes to environmental regulations should be included in the risk calculations for projects.

Whilst with REITs there is no control over the end investment, assessments of the REIT manager should be conducted.

Passive managers with little decision making in their portfolio construction processes beyond benchmark selection and engagement of index providers on the universe of sustainable indexes should look to stewardship to manage environmental risk.

Portfolio Risk Management and Monitoring

FMCs should put in place appropriate processes and systems to monitor, assess and manage the potential and actual impact of environmental risk on individual investments and portfolios on an ongoing basis. This allows the FMC to make an informed decision as to whether to continue with a particular investment or not.

Scenario Analysis and Stress Testing

Where environmental risk is material in the investment portfolios, FMCs should develop capabilities in scenario analysis to assess its impact on their portfolios, including the portfolios' resilience to financial losses under a range of outcomes including both short and long-term environmental scenarios.

Proper documentation of all stress testing and analysis is expected to be generated.

Stewardship

FMCs should exercise sound stewardship to help shape the corporate behaviour of investee companies positively through engagement, proxy voting and sector collaboration.

This includes supporting investee companies' efforts in the transition towards more sustainable business practices over time, while maintaining the FMC's risk management standards.

Capacity Building

The MAS expects asset managers to properly equip their current staff with sufficient training and resources to ensure appropriate addressing of the risks that present themselves.

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Disclosure

FMCs should disclose their approach to managing environmental risk in a clear and meaningful manner to current and potential customers.

All disclosures are to in the form of well-regarded international reporting frameworks, such as recommendations by the Financial Stability Board's Task Force on Climate-related Financial Disclosures, elements of which include: governance, strategy, risk management, metrics, and targets. Disclosures can be consolidated at a Group level.

Disclosures must be comprehensive and are to be reviewed on a regular basis to ensure that they remain relevant.

How we can help

ComplianceAsia's dedicated projects team provide drafts tailored and specialist ESG Manuals for firms, ranging from internal corporate values to investment protocols. ESG is a fast growing issue and our specialists ensure that the policies and procedures drafted for you are in line with international best practices. For further information on how we can assist you with catering for the growing demand for sustainable investing, please contact a member of our projects team or through the details provided below.

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About ComplianceAsia

ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with key offices in Hong Kong, Shanghai, Singapore, Tokyo and London. We have an unmatched track record of completing complex compliance consulting projects for financial firms in the APAC region.

With over 70 staff, including compliance experts with experience in dealing with the SFC, HKMA, MAS, CSRC, JFSA and Asian exchanges, we provide independent, unbiased advice on Asian financial industry legislation and regulations. Our international client base consists of asset managers, hedge funds, private equity funds, family offices, broker-dealers, insurers, wealth managers and investment banks.

Contact Us Today

HONG KONG
Suite 1102
ChinaChem Tower
34 – 37 Connaught Road
Central

T: +852 2868 9070

SINGAPORE
137 Telok Ayer Street
#03-06
Singapore 068602

T: +65 6533 8834

MAINLAND CHINA
Room 132, Unit 1301-1308
13/F, Shanghai Tower
No.479 Lujiazui Ring Road
Pudong New Area Shanghai

T: +86 147 1431 1859

JAPAN
Level 2
Marunouchi Nijubashi Building
3-2-2 Marunouchi Chiyoda-ku
Tokyo 100-0005

T: +81 3 6837 5483

UNITED KINGDOM
1 St. Andrew's Hill
London
EC4V 5BY

T: +44 (0) 20 7213 0300
M: +44 (0) 7310 972435

www.complianceasia.com

ComplianceAsia

Philippa Allen
CEO
E: philippa.allen@complianceasia.com

Alex Duperouzel
Managing Director
E: alex.duperouzel@complianceasia.com

Lachlan Chubb
Regional Head of Regulatory Advisory and Projects
E: lachlan.chubb@complianceasia.com

Gerallt Owen
Regional Head of Client Relations
E: gerallt.owen@complianceasia.com

Cherry Chan
Regional Head of Ongoing Support and Client Services
E: cherry.chan@complianceasia.com

Rachel Wu
Head of Mainland China Client Engagements
E: rachel.wu@complianceasia.com

Robert Lind
Senior Representative, UK and Europe
E: robert.lind@complianceasia.com

Hanae Kuroda
Compliance Consultant
E: hanae.kuroda@complianceasia.com