



# THOUGHT LEADERSHIP BRIEF

## Hong Kong's Role in Defining Sustainability – Taxonomies as a Blueprint for the Future

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Photo by Micheile Henderson on Unsplash

### EXECUTIVE SUMMARY

As financial markets ramp up their action on climate change, aligning global definitions on sustainability will become ever-more important. Hong Kong is uniquely positioned to establish an interoperable classification framework for mobilising global capital for climate action.

### ISSUE

As the world grapples with the escalating climate crisis, governments, corporates and financial institutions are ramping up action to reduce anthropogenic greenhouse gas emissions. Green bonds are increasingly used as tools for borrowers to signal to investors that issuers/borrowers are committed to using the proceeds raised from a financial product for projects that contribute to climate change mitigation.



The financial benefits of green bonds continue to be debated; some academics have found that investors are willing to accept a lower yield when investing in green bond versus comparable 'vanilla' bonds. Others argue that this greenium (the green premium) is either non-existent, or negligible when considering the additional costs of associated with issuing a green bond. Despite this debate, there is general agreement on the fundamental economic theory that if a greenium were to exist, it would be due to the differential in supply-demand equilibrium between green bonds and that of regular bonds.

As financial market regulators and participants work towards greening the financial system, there will be an increasing need to tilt the playing field towards low-carbon investment opportunities throughout the real-economy and built environment. The conversation around green bonds raises multiple questions about the role of governments and institutional investors. Is it their responsibility to promote investments that counteract our collective failure to manage the environment? Should they leverage lower borrowing costs to encourage issuers to incorporate climate change considerations into their infrastructure spending plans?

## ASSESSMENT

If we chose to act on climate change, then we must consider how to create the conditions and environments that encourage and enable institutional investors to use their capital to incentivize the real-economy to invest in infrastructure that operates in a manner aligned with the Paris Agreement objectives. On the other hand, we also need to provide issuers with a straightforward tool for communicating whether and how their infrastructure plans align with those same climate goals.

To do this at scale, we need to address concerns about greenwashing. Investors, issuers and other stakeholders throughout the real and financial economy will want to coalesce around standardized definitions of the criteria an investment must fulfil in order to be considered as a suitable piece of infrastructure in the low-carbon future.

Classification systems (i.e. taxonomies) can be designed to help determine whether an economic activity or asset can be considered green, and simplify the process through which public and private sector issuers can report on their efforts to improve the environmental performance of their operations. When specifically applied to climate change mitigation, this can be accomplished by defining the acceptable emissions intensity an economic activity must achieve in order to be considered as performing in a manner consistent with a country's contribution to the Paris Agreement objectives. By providing this common-language which acts as a standardized reference point to measure the sustainability performance of economic assets, we can help to improve transparency and reduce greenwashing.

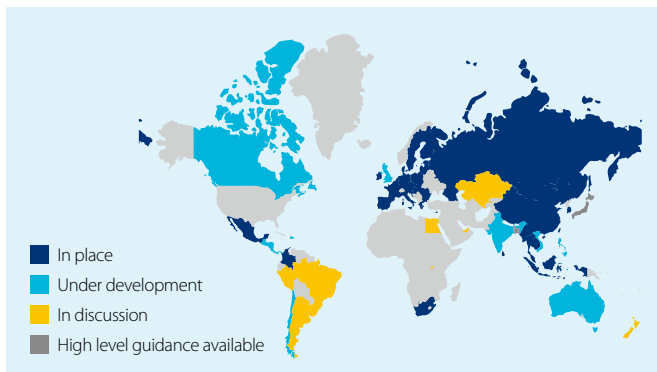
If investors want to credibly show that they are 'greening' their portfolios, they will need to show that the companies and projects that they invest in, are aligned with such performance requirements. Imagine, for example, that a Mandatory Provident Fund (MPF) provider wants to market a fund as 'green' or 'climate-aligned' and state that this fund contributes to Hong Kong's climate change objectives. Reporting on the climate-related performance of this portfolio would require some form of standardized classification system – taking the data about the greenhouse gas emissions of an economic asset or activity, and providing that material in a manner that can be used by asset managers to inform what types of bonds might be eligible within the fund's investment universe, or to show how much of the fund is invested in green projects at any point in time.

But the question of who regulates the labeling of climate change mitigating actions and the role of science remains.

Since the early days of the green bond market, organizations such as the International Capital Markets Association (ICMA) and the Climate Bonds Initiative (CBI) have played a central role in standardizing the definitions and practices for reporting what can be considered sustainable. As the market continues to grow, there is growing acceptance that a regulated definition of what contributes to climate change mitigation is required if the market is to continue growing.

Central banks and financial regulators are actively working to provide more clarity around the definitions of sustainable finance within their markets. China, the EU and approximately 30 other countries are at different stages of adopting classification systems for defining what can be considered as a 'sustainable investment'. Such systems are commonly referred to as 'climate finance taxonomies', or if their scope allows, 'sustainable finance taxonomies'.<sup>1</sup>

**Figure 1. Below Illustrates the State of Climate Finance Taxonomy Developments in Different Markets Globally**



Source: <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2023/20230530e1a1.pdf>

Nevertheless, due to the common but differentiated responsibilities and respective capabilities of developed and developing countries alike, it is conceivable that the global market may witness the rise of various, distinct taxonomies that are tailored to the unique policies, preferences and circumstances of individual jurisdictions. For instance, while the EU Taxonomy uses technical screening criteria to establish clear requirements for what constitutes a 'green' economic activity, the China Taxonomy provides a prescriptive 'white-list' of technologies and activities that are considered green. On the other hand, the ASEAN Taxonomy also includes transitional criteria that can be used to label a financial product as sustainable, provided that the entity as a whole is making plans to transition towards net-zero – a feature that has not yet been incorporated into the taxonomies of either China or the EU. Thus, a project or corresponding financial product that is labelled as sustainable in one jurisdiction might not be considered sustainable in another.

This situation could pose a challenge for international institutional investors seeking to report their investment impact to their regulatory headquarters. As financial markets play a critical role in addressing climate change, it is essential to consider how to transfer immense capital from developed to developing countries while respecting regulatory frameworks.

## Hong Kong's Role in Sustainable Finance and Taxonomies

Hong Kong can play a unique role in bridging global investors with local projects, particularly in China, one of the world's largest emitters. A handful of financial institutions have issued green bonds which reference the International Platform for Sustainable Finance (IPSF) Common Ground Taxonomy – a comparison exercise which clarifies, line-by-line, the relationship between the EU and China's taxonomies. It appears that these issuers have indeed, enjoyed lower borrowing costs. By using a sustainability standard that can be understood by both European and Chinese investors, issuers could potentially benefit from a more diverse investor base.

The Hong Kong Monetary Authority (HKMA) recently released its own prototype of a Green Classification Framework for public consultation, with the aim of being compatible with the sustainable finance taxonomies developed globally, thus bridging the gap between different markets and helping to position Hong Kong as a hub for channeling international green capital into China and across Asia.

## Recommendation: Taxonomies and the Broader Climate Finance Framework

As the HKMA considers its next steps on the development of a local classification system, there are some elements that may be worth considering. Firstly, the HK Taxonomy criteria should continue to prioritize development of climate change mitigation criteria, using an emissions-intensity based approach to measure decarbonization, striving to keep carbon intensity as the main metric for criteria development. Doing so will be fundamental to ensuring that a taxonomy provides clear trajectories and thresholds that explain how an activity can be performed to meet the Paris Agreement objectives.

<sup>1</sup> In these instances, the taxonomy provides criteria to clarify whether an investment contributes (or at the very least, does not cause significant harm) to multiple sustainable development objectives including but not limited to biodiversity, circular economy, water and climate adaptation, in addition to climate change mitigation.

On the other hand, it must be recognized that within some markets, the ability to report carbon intensity of an asset may be marred by data availability and there will be a need to rely on certain proxies or labelling systems. In such situations taxonomies and green finance can help define how the real-economy should report in the future, but at the same time we may have to accept that such proxies are currently the best available option and will have to suffice for the time being.

Over time, in order to keep pace with international best practice, the taxonomy may also need to expand to cover other environmental objectives – this might include challenges such as biodiversity, circular economy and adaptation/resilience to climate change. At the very least, there will be a need to ensure that projects which are shown to contribute to climate change mitigation, do not cause significant harm to other environmental objectives and considerations.

Regulators may also need to develop strategies to ensure that the taxonomy and green bond market is proportionately and effectively regulated. Who will verify green bonds? What credentials will be required and who will verify the verifiers?

Finally, it will be worth remembering that taxonomies alone will not solve our market failure and they will only be as useful as the policy environment which surrounds them and ultimately rest on the extent to which it is the government's prerogative to use finance to fix market failure.

Policymakers might want to consider how complimentary policies such as more favorable taxation policies or lower subscription fees for green investors might encourage more institutional investment in green bonds. Additionally, reviewing the industrial policies in the real economy which can impact issuers' credit ratings (such as removing fossil fuel subsidies or providing more policy certainty for green sectors) may also help to level the playing field for climate aligned investments. This will require a wider understanding of the linkages between environmental economics and climate finance.

Zooming out even further, development of taxonomies should be considered in context of the wider debate on climate finance and economics. While green bonds may be a powerful tool for mobilizing capital, they will likely become even more effective when complimented with other economic and financial tools such as carbon prices. Consistency and coordination between industrial and financial policies will be vital.



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