



# Green Classification Framework for Hong Kong

## Hong Kong ESG Taxonomy and Global Regulatory Synergies

While the European Union has been leading on ESG initiatives – EU Taxonomy, Pillar 3, and Sustainable Finance Disclosure Regulation (SFDR) – the impact of climate change does not recognize borders, and so climate-risk assessment is becoming increasingly vital around the world. Enter Hong Kong, leading on the other side of the planet with its **Prototype of a Green Classification Framework**, a taxonomy that applies to all regulated banks under the Hong Kong Monetary Authority (HKMA).

The financial sector plays a particularly vital role in the transition to a low-carbon future. It can steer capital flows towards environmentally sustainable investments and away from high-emitting activities, thereby fostering green innovation and development. A green taxonomy is essential within each financial market as it defines a common language and criteria for assessing the environmental sustainability of financial products and investments. As with the EU Taxonomy and other similar initiatives, this framework enables investors to identify and invest in activities that contribute to environmental objectives while avoiding those that harm them.

To further demonstrate the interconnectedness of the global financial markets and the planet's fate, Mainland China and the European Union have established the Common Ground Taxonomy (CGT) initiative under the International Platform on Sustainable Finance (IPSF). Any synergies – whether premeditated or accidental – across the avalanche of taxonomies swirling around the financial industry, would be a welcome respite for banks of all sizes and resources.

### What is the regulatory framework and current context for Hong Kong's ESG Taxonomy?

The Hong Kong Special Administrative Region (HKSAR) is committed to supporting global efforts to combat climate change and achieve the targets of the Paris Agreement. In 2021 it launched the *Hong Kong's Climate Action Plan 2050*, which outlined four key strategies to decarbonize the economy and reach carbon neutrality by that time:

- ▶ Net-zero electricity generation
- ▶ Energy saving and green buildings
- ▶ Green transport
- ▶ Waste reduction

Today, the HKMA has requested feedback on the *Prototype of a Green Classification Framework for Hong Kong* by June 30, 2023. The prototype presents the structure and core elements of the proposed taxonomy framework that will form the backbone of Hong Kong's ESG regulations.

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## The Regulatory Framework: Key ESG Reference Taxonomies

The prototype has synergies with some global initiatives:

- ▶ Mainland China and the European Union's **Common Ground Taxonomy** initiative.
- ▶ **EU Taxonomy**, widely accepted as the foundation for the national taxonomical systems, comprises advanced technical-screening criteria, activity thresholds, and supplementary documents related to the issuance of financial instruments, disclosures, sectoral-operational principles, etc.
- ▶ **ASEAN Taxonomy**, still a work in progress, includes the first batch of criteria published in March 2023. This multilayer "traffic-light" system allows ASEAN states to choose different decarbonization criteria baselines depending on their economic capabilities.
- ▶ **Climate Bonds Taxonomy** (CBT) is the oldest and one of the most developed taxonomies used as a reference for the prototype. At the heart of the CBT lies a suite of sector-specific eligibility criteria that set climate-change benchmarks for screening assets and capital projects.

Core to these taxonomies are principles around the alignment with the Paris Agreement, proof that there is no greenwashing, interoperability with other taxonomies, science-based criteria and thresholds, and the foundational "do no significant harm" (DNSH), and social safeguards.

### The Context

A green taxonomy also help to align investment decisions with climate goals and reduce the risk of stranded assets, supporting Hong Kong's role as a bridge between the Mainland and the rest of the world, and reinforcing its position as an international green-finance hub.

Hong Kong would gain unique benefits from a green taxonomy.

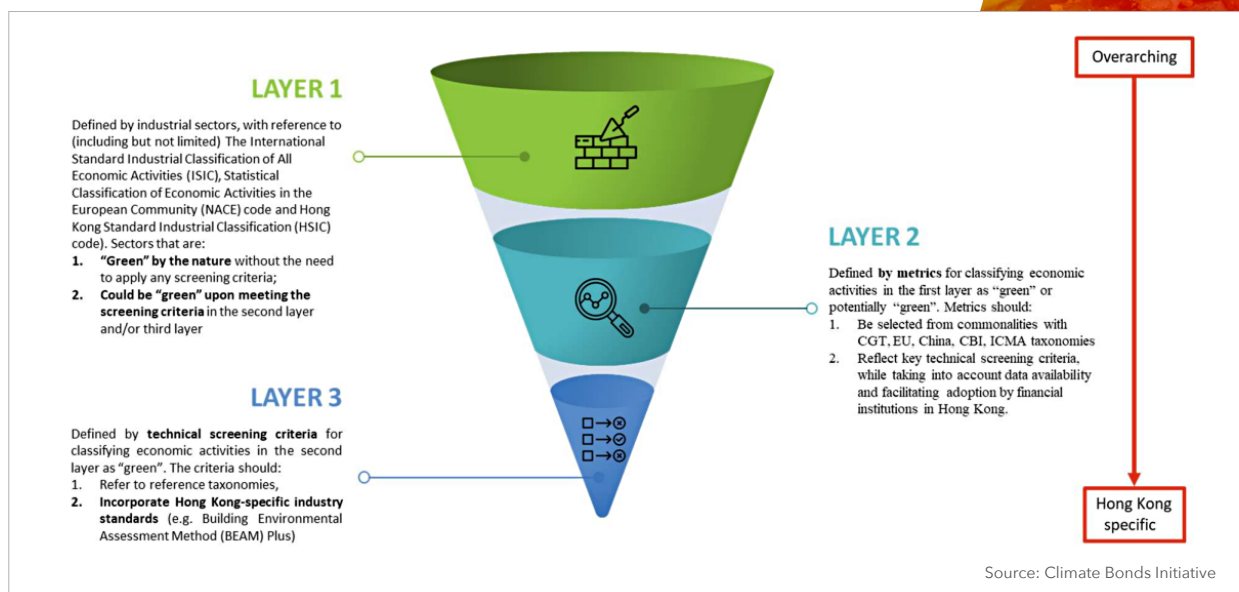
1. It would be the first market to operationalize CGT and by so doing strengthen its position as a hub, positively contributing to the growing need for interoperability among standards within the green-finance space. An operationalized CGT also provides international issuers and investors with a tool for reporting and communicating sustainability impacts and meeting the global regulatory and investor requirements.
2. A credible and scientifically robust taxonomy helps Hong Kong capitalize on opportunities presented by the Mainland to develop into a green finance center in the Guangdong-Hong Kong-Macao Greater Bay Area.
3. A locally tailored green taxonomy supports Hong Kong's goals for carbon neutrality by 2050.

# What are some of the functional and technical challenges created by Hong Kong's green framework?

Introduction of this taxonomy impacts functional, technical, and architectural areas in a financial institution; and not just because there are so many of them (ASEAN, EU, etc.). Functionally, the Climate Bonds Initiative covers regulatory classifications financial institutions will have to consider – a global taxonomy architecture with local regulations embedded.

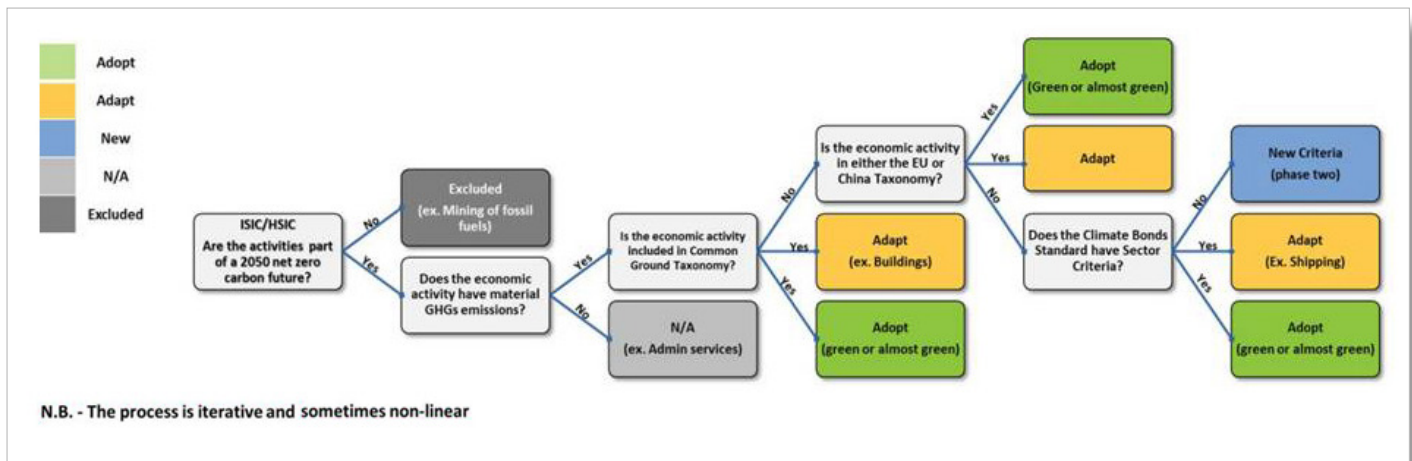
## Climate Bonds Initiative Layering and Decision Tree Components

The Hong Kong Taxonomy proposes three layers of green definitions with varying degrees of preciseness depending on the complexity of the activities and applicability for Hong Kong.



- ▶ **Layer 1** This layer maps activities to **standardized industrial classification codes** and categorize them as one of the following:
  - Automatically eligible and immediately adopted because they are universally considered green based on existing taxonomies, such as solar and wind, without the need for any major refinement; or
  - Potentially green. These activities activities, such as a building, are considered green subject to meeting specific technical screening criteria.
- ▶ **Layer 2** This layer identifies **key metrics** based on existing global guidance and other national/regional taxonomies, including:
  - Existing metrics that can apply to an activity
  - Metrics relevant in the local context
  - Metric that can be adopted by financial institutions in Hong Kong
- ▶ **Layer 3** This layer proposes **technical screening criteria**; specifically, existing global guidance and other national/regional taxonomies including:
  - Criteria from existing taxonomies that can be applied to an activity
  - Adaptations to either the metric or ambition level of an existing criteria to apply locally
  - New metrics and criteria required to be usable in the local context

The paper also mentions that the thought process was based on the decision tree below:



Technical challenges include:

- ▶ Data sourcing strategy/data collection
- ▶ Operating-model alignment
- ▶ Taxonomy design based on global regulations
- ▶ Need for a strategic data management and stress testing framework

## What other initiatives are happening across Asia Pacific?

In addition to this discussion, HKMA is also preparing for the second round of Climate Risk Stress Testing.

Other Asia-Pacific regulators are actively putting out updates including the following:

- Monetary Authority of Singapore: MAS Net Zero Action Plan
- Bank Negara Malaysia issued a new policy document and supplemental guidance setting out new requirements for financial institutions on managing climate risk and conducting scenario analysis
- Australian Sustainable Finance Taxonomy project led by ASFI. Phase 2 begins in July 2023
- Mainland China regulators, according to Bloomberg regulators, are working with advisory bodies and rating agencies to formulate a framework for mandatory ESG-related disclosures for companies listed in China
- Thailand: Joint Press Release TBA launches ESG Declaration, a strong collective commitment to expediting sustainable development toward better and greener economy (bot.or.th)

## What's next for banks in the region?

As is so well indicated by Hong Kong's Green Classification Framework Prototype, global ESG interconnectedness is real; the Paris Agreement affects the EU Taxonomy, which along with ASEAN and CBT affects the Hong Kong initiative. Given the synergies rapidly developing across different taxonomies there will be a critical design element in the architecture and strategic rollout plans for regional banks.

Financial institutions must now establish end-to-end, transparent execution of ESG-related stress-testing solutions including calculations, report allocation, and report generations. Implementing a modular solution that scales and supports sustainable datasets across regulations and countries would ease institutions' data burdens.

**Given that the starting point for financial institutions in Hong Kong will be ESG taxonomy elements, data points and rules of global regulations, Adenza's data-driven solutions are very well placed to help financial institutions there.**

**Contact Adenza** to start a conversation about how we can help you navigate the technical and functional challenges wrought by this framework.

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