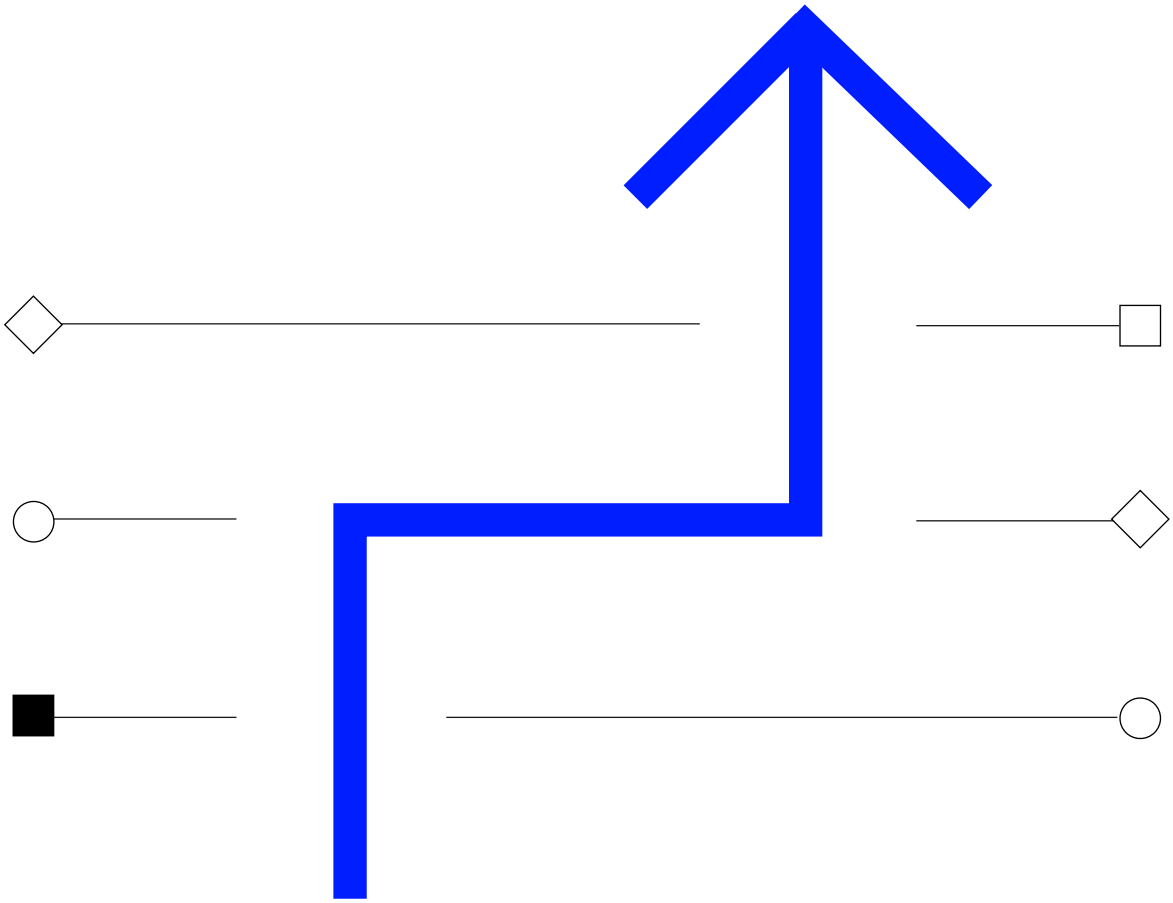

Sustainable Infrastructure Finance

Hong Kong's Opportunity in the Belt and Road Initiative

HKTDC 香港貿發局

REFINITIV™

Introduction

On September 11-12 the Hong Kong Trade Development Council (HKTDC) held the fourth edition of the Belt and Road Summit to share the latest developments related to the Belt and Road Initiative (BRI) and examine how to best leverage Hong Kong's strengths in financing the infrastructure projects related to the initiative. One of the hottest topics of the summit was the business case for adopting sustainable finance in infrastructure projects and the latest sustainable finance industry trends.

According to the Asian Development Bank (ADB), the infrastructure funding needs in Asia alone will total $1.7 trillion a year, on average, through 2030. Hong Kong, as one of the world's leading financial centers and China's international financial capital, has positioned itself as the financial hub for financing Belt and Road Projects.

Following the summit, HKTDC partnered with Refintiv, which provides information, insights and technology to global financial markets, to produce this whitepaper examining the evolution of sustainable infrastructure financing, and the opportunities that it presents.

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I. Executive Summary

China's Belt and Road Initiative (BRI) is producing vast, often multilateral, infrastructure projects across Asia, creating huge demand for long-term sustainable infrastructure financing.

According to the Asian Development Bank (ADB), developing countries in Asia require at least $23 trillion worth of infrastructure investment from now until 2030, and an additional $3 trillion is needed for climate change mitigation.

This enormous demand for investment, which will require both public- and private-sector participation, has stimulated innovation in infrastructure financing. One area of focus is sustainable investing.

Chinese President Xi Jinping has said that BRI must be green and sustainable and environmental protection must underpin the initiative "to protect the common home we live in."

The Environmental, Social and Governance (ESG) risks associated with the lifespan of an infrastructure project, from design to construction, financing and operation, have direct impact on the financial and operational performances of businesses and assets.

Twenty-seven global financial institutions have signed up to the Green Investment Principles for the Belt and Road, which will incorporate low-carbon and sustainable development practices into the initiative's investment projects.

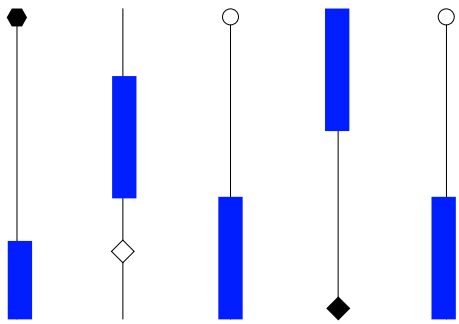
Hong Kong, as one of the world's leading financial centers and China's international financial capital, is well positioned to leverage these opportunities, and it has already begun building the framework needed to become an international hub for sustainable finance. It can meet the requirements of green projects from green finance certification to legal and marketing expertise and advice.

The Hong Kong government is taking initiative to help foster the sustainable finance industry. Last year, Hong Kong's green bond issuance totalled $11 billion, up from $3 billion in 2017, with issuers ranging from multilateral development banks to private sector corporations.

The government launched its first green bond in May 2019, and government bodies such as the Hong Kong Monetary Authority (HKMA) have adopted strategies to further develop the sustainable finance market.

Sustainable finance is not only about avoiding ESG risks, but also about opportunities such as achieving resource efficiencies, reducing environmental footprint, creating jobs, improving community relations and getting long-term risk-adjusted returns from infrastructure developments. There is a strong link between companies having solid sustainable finance strategies and delivering superior returns for their investors.

Belt and Road and its large-scale infrastructure financing gap create an opportunity for Hong Kong to build its sustainable finance industry. With coordinated efforts and innovation, Hong Kong can help shape a brighter, greener future for both investors and corporations.



II. Integrating ESG Factors Into Investment Strategies

The Belt and Road Initiative (BRI) is underpinned by large infrastructure projects, and China's leaders have given clear directives that the financing, construction and operation of these projects must adhere to sustainability standards.

Infrastructure development and operation involves all elements of ESG. Infrastructure assets are integrated within the environment; they employ large workforces, many of whom are exposed to dangerous work, and they operate under regulatory frameworks which require good governance.

Infrastructure investors have traditionally focused on the risk side of ESG. The standard investment decision-making process includes consideration of the company's health and safety track record and environmental due diligence at the point of investment, and regular audits to ensure compliance with regulations and minimization of environmental footprint.

Climate risk has traditionally been incorporated into decision-making not only from an ecological point of view, but also from a sense of financial sustainability. For example, the financial sustainability of conventional energy is under increased scrutiny in the face of falling costs for renewable energy, which has resulted in infrastructure investment funds instituting policies that limit their exposure to industries such as coal-fired power.

However, incorporating ESG into investment decision making also opens up new opportunities, such as investing in long term renewable energy development and emerging areas like renewable hydrogen, where cheap renewable power is used to produce hydrogen, one of the potential fuels for the future.

In 2016, Deutsche Asset Management and the University of Hamburg published a study on whether integrating ESG into the investment process had a positive effect on corporate financial performance. They studied the findings of more than 2,000 individual studies between 1970 and 2014, and their conclusion was that in 63 percent of the meta-studies, ESG had a positive impact on financial performance and only in 10 percent of cases was the impact negative.

Investors are increasingly demanding that the companies and projects that they commit capital adhere to international ESG standards. Investors are looking for sustainable initiatives across their asset portfolio in areas such as materials recycling, energy efficiency and vehicle fleet optimization. For example, Macquarie Infrastructure and Real Assets (MIRA) reviewed energy use in the airports in its portfolio and initiated projects to transition from traditional to LED lighting for energy savings.

Management teams are being made accountable for ESGs through Key Performance Indicators (KPIs) tied to executive remuneration, and increasingly those KPIs include non-financial metrics. Building health and safety metrics into the KPI scorecard of senior management team can influence positive behavior.

One of the challenges of measuring ESG impact has been a lack of data. However, the fund management industry is moving towards voluntary disclosure through initiatives such as Global Real Estate Sustainability Benchmark (GRESB), which assesses and benchmarks the ESG performance of real assets, providing standardized and validated data, which is then disclosed to investors.

III. Banks Can Lead The Transition

Hong Kong's banks are well positioned to assist their clients in the transition towards sustainable financing. There is strong demand from customers who want to learn more about sustainable finance and how they can get involved, as they recognize that investors, especially in publicly listed companies, want to see demonstrable impacts of sustainable practices.

This requires banks to train their staff in sustainable finance tools and strategies. They must be able to explain to customers what sustainable finance means in their specific geographical or industrial environment, and how to capture the opportunities that are created. Banks must spend time understanding their customers' access to financial markets as well as their internal processes and supply chains in order to develop green solutions that address their unique needs.

The challenge for banks involved in BRI is to demonstrate, through transactional credentials, that they are not only talking about ESG standards, but putting them into practice as they implement BRI infrastructure investments.

There are many forms of support for banks seeking to expand into sustainable finance. The Hong Kong Monetary Authority (HKMA) has provided a regulatory framework and a clear trajectory of adoption of sustainable financing by the financial community. The Hong Kong Green Finance Association has also worked to put together principles and practices for sustainable financing.

IV. Hong Kong Government Initiatives

The Hong Kong government has undertaken numerous initiatives to create a regulatory and financial ecosystem that is conducive to growing the sustainable finance industry. It sets an example by launching its inaugural green bond in May 2019. The green bond drew strong demand from global investors despite the volatility of financial markets, with orders totaling more than four times the issuance size of $1 billion. The proceeds of the bond will be used to finance public works projects that provide environmental benefits and support the sustainable development of Hong Kong. The ceiling of the Government Green Bond Program (GGBP) is HK$ 100 billion, which has left ample room for future issuances.

Not only does Hong Kong have sophisticated financial markets and world-class professionals, but it also possesses a number of international green advisory firms and external reviewers. State-backed Hong Kong Quality Assurance Agency (HKQAA) launched a Green Finance Certification Scheme in 2018. Hong Kong is also the green finance center for the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) development plan, further strengthening its role in promoting sustainable finance.

HKMA has adopted a three-pronged strategy to further develop a sustainable finance market in Hong Kong. First, the authority has taken a sustained approach to promote green and sustainable banking, which includes encouraging Hong Kong's banking industry to take a more proactive approach to managing climate risk. Second, it has sought to increase the adoption of the responsible investment principles by the Exchange Fund, weave ESG factors into the investment process and more proactively embrace ESG in investments in both public markets and private assets. Thirdly, HKMA has launched a Center for Green Finance (CGF) as a capacity-building measure and serve as a knowledge hub for equipping the industry with the latest trends and insights on sustainable finance.

V. The Growth Of Green Bonds

When the Green Bond Principles (GBP) were first developed by the International Capital Market Association (ICMA) in 2014 they were a purely market-led initiative. A small number of banks who were already issuing and underwriting green bonds agreed on a set of basic voluntary guidelines for issuers. The ICMA, a neutral trade association, currently serves as a secretariat for the GBP, as well as the Social Bond Principles (SBP) and Sustainability Bond Guidelines (SBG), handling the administrative and the organizational aspects of the principles.

The GBP community has grown to about 300 members and observers who are global institutions and includes issuers, underwriters and investors in green bonds, and also regulators, policymakers, environmental NGOs, universities, consultants and rating agencies. The GBP, today, are driven not only by the market but also by the official sector, policymakers, climate scientists and others with a stake in a sustainable world. They also have a robust governance structure to ensure neutrality and consistency and are overseen by an executive committee of elected members.

The GBP are intended to serve as high-level guidelines that recommend transparency and disclosure to allow the market to have a better sense of the sustainability of their investments. They define, in broad terms, a credible green or social bond based on four pillars.

The first pillar is the use of proceeds, which must be used for environmental or socially beneficial projects. The second pillar is the process for project evaluation and selection. The issuer must disclose the kind of projects, how they're selecting the projects, why these projects have environmental or social benefits, and demonstrate that they do not have any environmental or social disadvantages.

The third pillar is management of proceeds. That means that the issuer must account for the monies as they are allocated to environmental or social projects to give investors a certain amount of comfort.

The fourth pillar is reporting of the monies that are allocated to projects and the environmental or social impact of these projects.

The principles are designed to give investors the information they need to evaluate the impact of green bond investments in their portfolio. They deliver a concept that is regarded as robust, consistent and workable, offers value driven by transparency and better reporting and allows markets to integrate environmental and social standards by both issuers and investors.

HKMA has undertaken informal initiatives to educate the market on these principles, such as sponsoring the GBP Annual General Conference in 2018. It also has incentive programs to help subsidize some of the extra costs of issuing green bonds by corporate issuers in the market.

The GBP have influenced the ASEAN GBP and the emerging EU Green Bond standard, which has not yet passed legislation, and the China Green Finance Committee, which has developed green finance recommendations and a green finance catalogue.

Green bond issuance in the international green bond market has grown from $14 billion in 2013 before the GBP were announced to $180 billion in 2018. ICMA is expecting about $250 billion in issuance in 2019, with Asia Pacific accounting for about 20 to 30 percent of this issuance, driven largely by China. However, when compared to the $100 trillion of issuance in the international bond market, the $680 billion in issuance so far over the entire lifetime of green bonds is relatively small, which is indicative of the growth possibilities in this market.

The challenge is to encourage faster development of sustainable finance, more issuance and greater investment for sustainable projects while maintaining the integrity of the market. The GBP's insistence on transparency of the use of the proceeds and emphasis on ongoing reporting, unlike with regular bonds that limit themselves to company and working capital disclosures, helps prevent greenwashing. Investors and stakeholders are calling for clear taxonomies, harmonized standards, better labels, better indices and deeper disclosure.

Green bond issuers, whether they are corporate agencies, supra-nationals or sovereigns, are all at different stages of being green. The green and social bond market should not be limited only to those participants who already have high ESG scores. At the same time, it is also important to ensure that the principles support and encourage improvement and transparency.

ICMA and others need to strive to strike a balance between keeping the standards flexible enough for the market to grow but also solid enough to ensure confidence in the greenness of the bonds.

Though green bonds have been the most prominent and public example of green instruments in the market, they are not the only way of financing sustainable investments. As the narrative moves from GBP and SBP to sustainability, there is a strategic question over the role of green bonds in the future. In other words, what is the future role of the GBP in a larger financing environment that includes private equity, bilateral loans and project finance?

The increased role of sovereign issuers in sustainable finance has been a welcome development. This is a trend pioneered by the Chinese government in 2014-2015. Before that, the global green bond market was largely market-led. As the bond market grows in size and importance, the involvement of the official sector and policy makers is bound to increase. However, this must be done in a balanced, proportionate way and in symbiosis with market practice as represented by the GBP and other market-meeting standards.

One critique of the green bond market is that projects financed by green bonds would have been financed even if these bonds did not exist, so are green bonds really causing additional investments in sustainable projects? On the other hand, green, social and sustainability bonds fit an investor need for market recognized sustainable assets. They provide increasingly cost-effective funding and could also change the way issuers think and act.

VI. Conclusion

Adopting sustainable investment practices for BRI infrastructure projects not only helps to address ESG risks, but also generates positive value for investors, employees and the citizens and societies that will use the infrastructure. Sustainable finance strategies not only reduce risks but enhance value and the entire society.

The BRI's need for responsible investment capital has created an opportunity for Hong Kong's sustainable finance sector, and companies and financial institutions that act on this opportunity will improve their long-term competitiveness and performance.

EXPERT TALK

Linking Financial And Operational Sustainability: The MTR Experience

Hong Kong's MTR Corp was one of the first infrastructure developers and operators globally to incorporate ESG standards into its financing framework with a green bond framework adopted in 2016, followed by a green finance framework in 2018. In 2016 the company issued its first green bond, arranged by HSBC, to raise $600 million.

Financial sustainability is critical to MTR because it lays the foundation for future asset maintenance, replacement and improvement. Railway projects require planning horizons of 50 years and more, and they are also highly capital intensive, both in initial investment and subsequent replacement capital expenditure. This makes financial sustainability an important strategic factor. Unsustainable financial planning can result in an inability to keep up with asset replacement needs, which leads to poor transit system performance and even greater financial woes.

MTR's financial sustainability model is underpinned by two pillars; first, rail plus property model and second, its fare adjustment mechanism. Railway projects often cannot make or justify a commercial rate of return by relying only on fare recurring income. Railway projects relying solely on fare income are often limited to internal rates of return in low single digits.

Under the rail plus property model, MTR is granted property rights and the property development profits resulting from such rights can make up the company's required commercial rate of return. The model not only provides MTR with a one-off fund derived from the initial sale of residential property units for the construction of the railway line but it also enables the operator to generate recurrent annual rental income through retention of the shopping malls above the stations or depots, which are used to finance future asset replacement.

The second pillar of MTR's financial sustainability is the fare adjustment mechanism, which is based on a formula that incorporates inflation as well as the wage index. The formula enables MTR to increase its fares in line with its cost structure, thereby preserving its operating margin, ensuring sufficiency of cash flow for future asset replacement and thus, enhance operational sustainability.

ESG initiatives also lay the foundation for sustainability by meeting and balancing the current and future demands of various stakeholders. Operational excellence and sustainability can only be assured through proper ESG framework.

From an environmental standpoint, MTR has focused on efficient use of energy and land resources, pollution prevention, climate change and green financing. From a social standpoint, stakeholder engagement takes the form of ensuring safety for customers and staff and investing in community initiatives. From a governance standpoint, the focus is on good governance structure, a diversified board, risk management and corporate social responsibility.

VIII. About Refinitiv

Refinitiv serves more than 40,000 institutions in over 190 countries, providing information, insights and technology that drive innovation and performance in global financial markets.

Refinitiv recognizes the increasingly critical importance of transparent, accurate and comparable ESG data for the financial industry. We are building content collection capabilities, analytics models and tools which allow customers to use Refintiv's data as the backbone of their ESG process.

To learn more about Refinitv's offering with ESG data, please visit the following website:
https://www.refinitiv.com/en/financial-data/company-data/esg-research-data

IV. About the HKTDC

Established in 1966, the Hong Kong Trade Development Council (HKTDC) is a statutory body dedicated to promoting Hong Kong trade. Its mission is to explore opportunities for Hong Kong companies, especially small- and medium-sized enterprises, and connect them with business partners around the world.

The HKTDC is dedicated to helping businesses seize opportunities arising from the Belt and Road Initiative. The HKTDC Belt and Road Portal (www.beltandroad.hk) is a business facilitation and market intelligence platform featuring the latest news and insights, market updates and investment projects and professional services providers database to help you stay ahead on the Belt and Road and get connected with the right partners. The Belt and Road Summit, jointly organised by the Hong Kong Special Administrative Region Government and the HKTDC, is an annual flagship event bringing together government and business leaders from around the world to explore multilateral cooperation and concrete business opportunities.

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