SUSTAINABILITY: A ROADMAP FOR GROWTH IN ASIA

Opportunities for financiers and their clients

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Coastal Connection by Bianca Gardiner

KING&WOOD MALLESONS
金杜律师事务所

BUILDING RESILIENCE FOR A STRONGER FUTURE

Following a turbulent year in which:

- the world continued to battle the variants of a coronavirus pandemic;
- some 84 million people around the world were displaced from their homes;
- record drought affected south-western parts of the United States;
- flooding tore through Belgium and Germany; and
- wildfires ravaged Western Australia,

world leaders came together at the United Nations Climate Change Conference in Glasgow (**COP26**), with the common goal to combat climate change, reduce emissions and restrict the rise in global temperatures to 1.5 degrees Celsius.

Now, during the Year of the Tiger, the world must work hard to realise the commitments made at COP26. A dynamic approach is required to:

- identify a common path towards the alignment of green taxonomy;
- invest heavily in clean energy transition;
- prevent carbon intensive projects/activities from circumventing measures to reduce emissions;
- incentivise carbon reduction through a combination of fiscal and economic means (e.g. upscale carbon trading; implement carbon taxes and cease subsidies for fossil fuels); and
- significantly increase the price of carbon whilst ensuring that developed countries shoulder a greater proportion of the cost of transition to a sustainability and socially conscious world economy.

OPPORTUNITIES FOR GROWTH DRIVEN BY SUSTAINABILITY

It is widely recognised that the scale of the collective effort required to keep the rise in global temperatures limited to 1.5 degrees Celsius is vast.

According to the 2021 Production Gap Report, global fossil fuel consumption increased in 2021 as the world continued to recover from the effects of the coronavirus pandemic and investment in fossil fuels outstripped investment in clean energy.

Until now, conversations relating to climate action have understandably focused on the devastating effects of climate change in order to galvanise the multilateral commitments required to significantly and permanently reduce global greenhouse gas emissions.

With climate action safely secured at the top of the global agenda, financiers and their clients can begin to turn their efforts to capitalising on the opportunities that sustainability and sustainable business practice can deliver.

Potential opportunities include:

- attracting and retaining the best talent;
- reducing waste to maximise efficiency and returns;
- generating brand loyalty on a global scale;
- implementing more flexible working arrangements;
- preferential financing and investment terms, including lower interest rates and higher dividends;
- diversifying business models through carbon trading;
- mitigating business risk through carbon offsets;
- setting and refining industry benchmarks for environmental and social governance standards;
- mitigating regulatory compliance risk;
- reducing annual cost bases;
- mitigating transition risk and supply chain risk exposure; and
- using ‘co-benefits’ and ‘value adds’ to generate competitive advantage.

KEY THEMES FOR SUSTAINABILITY IN THE YEAR OF THE TIGER

For financiers and their clients who look beyond sustainability as purely a compliance issue, there are real opportunities for growth driven by increased efficiency, smarter working practices and co-benefits. On this page we highlight a few key themes for the year ahead.

1 **INCREASING MOMENTUM TOWARDS NET ZERO**

The drive for greater efficiency will be multifaceted. Top-down demand as well as bottom-up competition will yield dynamic change to supply chains.

2 **DRIVING HIGHER STANDARDS TO REALISE COMPETITIVE EDGE**

Voluntary adherence to stricter disclosure and compliance requirements will provide opportunities for competitive advantage.

3 **DIVESTMENT OF BLACK, BROWN AND GREY ASSETS**

Preferential funding terms for transition and green projects as financiers refine lending policies and investment portfolios. Investors will compete for portfolio enhancing assets allowing businesses to take advantage of greater demand for sustainable investment opportunities.

4 **CO-BENEFITS**

Sustainability generates a range of co-benefits e.g. stakeholder engagement; support for community projects builds lasting partnerships; engaged and inclusive workforce; efficiency through digitisation; less waste = lower cost base.

5 **FINTECH AND INNOVATION**

Fintech and innovative solutions used to better connect people, communities, businesses and key services in tandem with a more permanent shift towards flexible working and digitisation to combat geographic barriers.

6 **HOLISTIC FOCUS CREATES NEW INVESTMENT OPPORTUNITIES**

Increased investment in green hydrogen and ‘holistic’ energy where by-products of power generation (e.g. heat and biomass) can be utilised. Opportunities for growth and investment as topics such as biodiversity and social inclusion become more mainstream.

ASIA REMAINS A KEY PRIORITY REGION FOR INVESTORS

With the global funding gap for clean energy transition estimated to be in the region of USD100 – USD150 trillion by 2050[1], a sizeable proportion of sustainable and transition finance transactions will be originated in Asia. The region is a priority for investors looking to take advantage of fast growing markets; not least as regards the further opening up of cross-border investment avenues with Mainland China via schemes such as wealth-management connect, bond connect, stock connect, QFII and QDII.

Hong Kong SAR is a leading financial centre for Asia international bonds to be arranged. In 2021, green and sustainability linked bonds accounted for approximately 60% of total bond issuance in the region with China becoming the largest issuer of such instruments in Asia. Consultation continues between the International Capital Markets Association and the Chinese regulators, in particular NAFMII (the National Association of Financial Market Institutional Investors), to further align the principles for the issuance of green bonds.

In 2021, the volume of sustainability linked loan issuances in APAC Ex-Japan saw monumental growth (332%) year-on-year, accounting for approximately US$21 billion. China is also gaining significant momentum in the green loan market with a 195% increase year-on-year to US$4.3 billion, a nine-year record high.[2]

China is set to become the largest carbon market in the world

China's national emissions trading scheme was launched on 16 July 2021 and runs in tandem with eight pilot schemes. China's highly centralized governance style allows for transformative policies to happen at a rapid speed and being the world's largest emitter of carbon dioxide means that China's climate decisions will have global consequences.

Hong Kong SAR as a sustainable finance hub for the Greater Bay Area

With Hong Kong SAR's reputation as a champion of international standards and facilitator for the channel of cross-border capital, the Green and Sustainable Finance Cross-Agency Steering Group co-chaired by the Hong Kong Monetary Association and the Securities and Futures Commission, continues to explore Hong Kong's development as a regional carbon trading centre. Carbon trading will be a key tool to mobilise finance for net zero transition and Hong Kong SAR is well placed to make a significant contribution to upscale carbon markets in the region and globally.

Singapore as a sustainable finance hub for ASEAN

With one of the most developed and open capital markets in Asia, Singapore is well placed to cement its position as a sustainable finance hub for ASEAN. Singapore serves as the Asia hub for the World Bank, and has accelerated its efforts to position itself as a green finance hub for the South East Asian region by promoting green bonds, encouraging transparency and creating a carbon exchange. Singapore issued over S$11 billion of Green Social and Sustainability Bonds between 2017-2020. Green loans and sustainability linked loans over the same period totalled over S$22.5 billion.[3] Singapore's carbon exchange, Climate Impact X (CIX), is slated to launch in early 2022.

ESG strategies in Japan are key to its economic development

With a more developed corporate sector and mature market, Japan is positioning itself to become Asia's leader in ESG-focused investment. Japanese pharmaceutical and tech companies flew the flag for Asia in the 2021 rankings of the world's 100 most sustainable firms in Corporate Knights' Global 100 Index 2021 which included: drug company Eisai Co (ranked 16); Healthcare company Sysmex (ranked 32); hardware manufacturer Konica Minolta (ranked 41); plastics manufacturer Sekusui Chemical (ranked 51) and Takeda Pharmaceutical (ranked 71).

Investment potential in Indonesia as regards sustainable agriculture, fisheries and forest management

Indonesia is located at the heart of global marine biodiversity and comprises a large portion of the Coral Triangle, an area that is home to 76% of the world´s coral species and 37% of the world's coral reef fish species. Indonesia is also home to biologically diverse tropical forests that provide habitat for orangutans, rhinos, elephants and tigers. Indonesia is a top global producer of high-value crops such as rubber, coffee, cocoa and spices. As a region, Indonesia offers significant sustainable investment opportunities within the global carbon markets.

Islamic finance initiatives in Malaysia expand sustainable product offering

Although only a small portion of the global financial market, Islamic finance (which offers returns to investors without infringing Islamic 'shariah' principles) has experienced rapid growth. Malaysia is already a world leader in leveraging Islamic finance for infrastructure development, issuing more than 60 percent of the world's infrastructure sukuk.[4]

[1] https://www.gfma.org/policies-resources/gfma-and-bcg-report-on-climate-finance-markets-and-the-real-economy/
[2] https://www.bloomberg.com/professional/blog/apac-esg-linked-financing-outpaces-green-as-issuance-breaks-record/
[3] https://www.nomuraconnects.com/focused-thinking-posts/sustainable-finance-in-singapore-a-blueprint-for-the-region
[4] https://www.euromoney.com/article/297ljl7o060lbd1wh23nk/esg/malaysia-brings-islamic-finance-and-esg-together

CHINA DRIVING THE MOMENTUM FOR POSITIVE CHANGE

ONSHORE CARBON MARKETS

The domestic carbon markets are set to expand in 2022 in terms of: (i) the sectoral coverage and the types of product that may be traded on the pilot emissions trading schemes (for example, carbon credits generated by the Verified Carbon Standard or validated by local authorities); and (ii) via the upcoming launch of the national China Certified Emissions Reductions (**CCER**) trading centre. See the following page for further details.

SOCIAL AND SUSTAINABILITY BONDS

On 11 November 2021 NAFMII launched its Q&A on Pilot Program of Social Bonds and Sustainability Bonds based on the Social Bond Principles and Sustainability Bond Principles published by the International Capital Markets Association. Under NAFMII's pilot programme, overseas issuers are now able to issue social bonds and sustainability bonds onshore in China's interbank market.

CARBON EMISSIONS REDUCTION FACILITY

On 8 November 2021, the People's Bank of China (**PBOC**) launched a new Carbon Emission Reduction Facility under which the PBOC will provide refinancing with preferential interest rates to financial institutions for loans that support the reduction of carbon emissions (up to 60% of the principal loan amount).

GREEN FINANCE ASSESSMENT OF BANKS

PBOC Shanghai Head Office has issued grading rules on the assessment of green finance performance of banks. The assessment considers both quantitative and qualitative indicators (with a weighting of 80% and 20% respectively). The quantitative indicator relates to total value, risk and growth in green loans and bonds. The qualitative indicator evaluates the implementation of green finance policies, the establishment of green finance system and practices in supporting green industries.

ENVIRONMENTAL DISCLOSURE

In December 2021, the Ministry of Ecology and Environment issued a detailed category specifying new environmental information disclosure rules. Under the category, in-scope entities should provide information on environmental issues such as pollutant generation (see page 8 of this alert). Companies are required to disclose their overall carbon dioxide emissions and the way that they measure such emissions. The new disclosure rules came into force on 8 February 2022.

REALISING GLOBAL AMBITION THROUGH CHINA'S CARBON MARKETS

CARBON TRADING IS A KEY TOOL TO MOBILISE PRIVATE FINANCE FOR NET ZERO TRANSITION. CHINA'S CARBON MARKETS WILL PLAY AN IMPORTANT ROLE IN UPSCALING GLOBAL EFFORTS TO COMBAT CLIMATE CHANGE AND ENABLE CHINA TO REACH ITS NATIONAL EMISSIONS REDUCTION TARGETS.

According to the Taskforce on Scaling Voluntary Carbon Markets, the voluntary carbon markets will need to grow 15 fold by 2030 and 100 fold by 2050 (in each case from 2020 levels) if global greenhouse gas emissions reduction objectives are to be met.

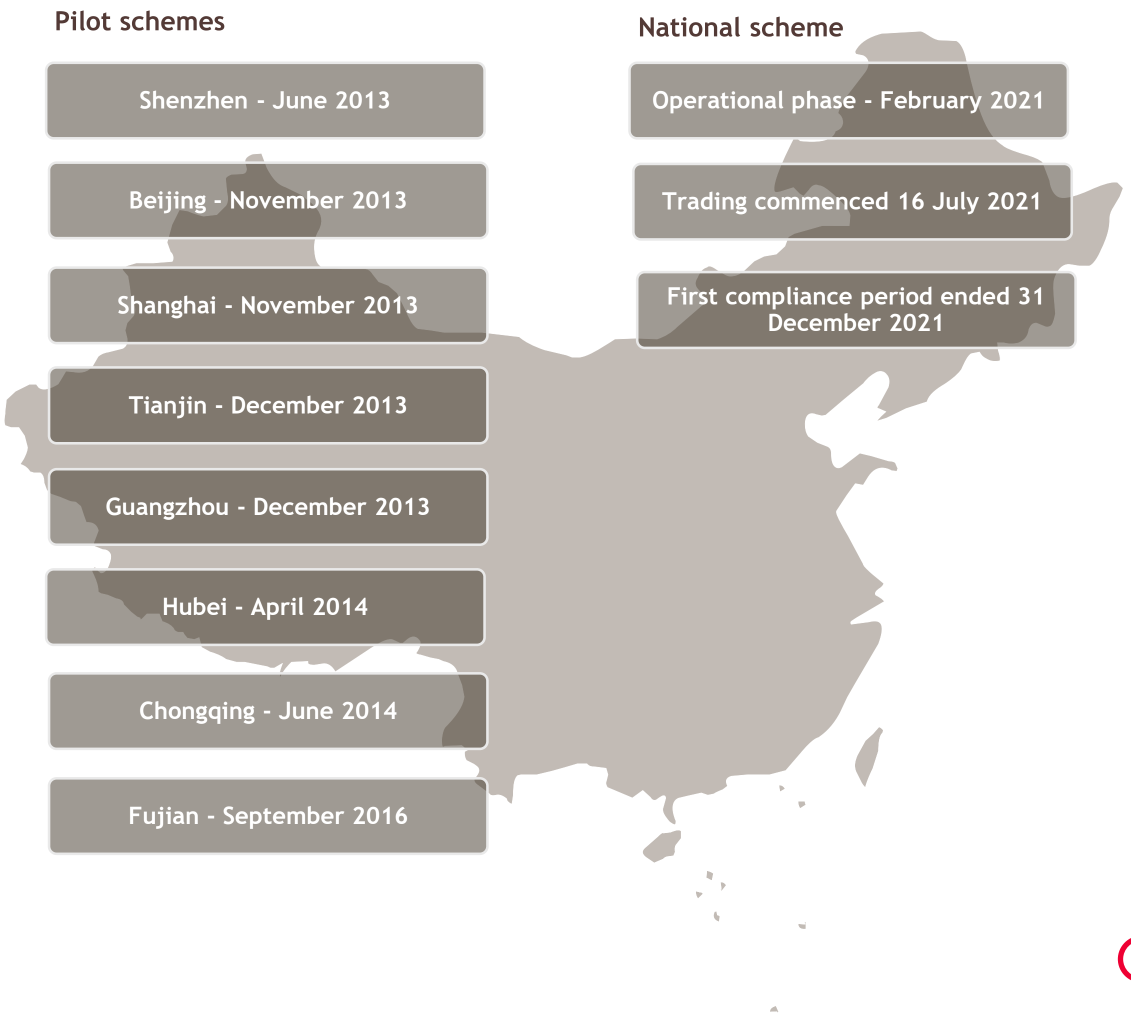
Whilst the role and viability of carbon offsets as an effective means of reducing net global emissions is open to some debate, carbon markets nonetheless provide a forum for businesses to actively engage in the global reduction of emissions and, for those businesses that are able to do so, to take advantage of the opportunities that such markets create to generate income from trading surplus allowances.

Growth in the voluntary carbon markets will be driven not just by the need to offset unavoidable emissions but by businesses desire to deliver 'added value' and 'co benefits' to their customers and stakeholders.

Whilst China has a significant carbon legacy risk, China also has the means and the opportunity to leverage European experience and to put itself at the forefront of positive change and growth in sustainable technology, sustainable infrastructure and sustainable finance.

It is encouraging that traded volumes of credits from projects in Asia doubled between 2019 and 2021 with prices increasing 85 per cent in the same period. However, with the global average price of a unit of CO_2e estimated to be just US$3 (according to a report published by the International Monetary Fund in September 2021 Five things to know about carbon pricing) a substantial value deficit remains to be addressed if the voluntary carbon markets are to successfully galvanise the net zero transition by 2050.

China's national emissions trading scheme (regulated market) commenced trading on 16 July 2021 and runs in parallel with eight regional, trading schemes (pilot markets). These pilot schemes will gradually transition into the national scheme. Whilst the timeline for that transition is yet to be confirmed by the Ministry of Ecology and Environment, there are a number of positive developments which continue to drive China closer to their goal of carbon neutrality.



THE WORLD’S LARGEST CARBON MARKET EXPANDS

CHINA’S NATIONAL CARBON MARKET ENDED ITS FIRST COMPLIANCE PERIOD (履约周期) ON 31 DECEMBER 2021 WITH THE MAJORITY OF IN-SCOPE ENTITIES SUCCESSFULLY FULFILLING THEIR CARBON QUOTA OBLIGATIONS.

In-scope coverage of emissions controls to be expanded

China’s emissions controls are expanding both in terms of industry sector coverage and in terms of the volume of units of energy consumed. Examples of industry sector expansion include: manufacturing, iron, petrochemical, paper and civil aviation that emit more than a specified number of units of carbon dioxide per annum. Four government agency institutions including the National Development and Reform Commission and the Ministry of Ecology and Environment, have released a new guideline 高耗能行业重点领域节能降碳改造升级实施指南, concerning 17 energy intensive industries, including oil refining, steel, cement, coal-to-chemicals and nonferrous metal smelting. The guidelines: (i) encourage enterprises with low energy efficiency to adopt advanced equipment and new technology; and (ii) raise energy efficiency targets for some of the biggest emitters.

Moving towards a ‘pay to pollute’ model

Carbon Emissions Allowances (**CEAs**) are currently allocated to in-scope entities subject to the national emissions trading scheme by reference to their historic emissions levels without charge. A move away from free allocation of carbon allowances towards a paid, bidding system for CEAs is however anticipated to align with China’s developing 30.60 strategy.

Diversification of offset credit products anticipated

Enterprises subject to the national emissions scheme will continue to be allowed to offset their carbon emissions through the purchase of existing CCERs generated within the pilot markets, subject to a cap (currently 5% of the annual allocation of CEAs may be offset with CCERs). It is anticipated however that The Bureau of Ecology and Environment will start to introduce additional forms of emission reduction product in due course. By way of example, a plan 深化建设绿色金融改革创新试验区探索构建低碳转型金融体系的实施意见 to support low carbon transition through financial products such as bonds and insurance has been published by Huzhou (one of China’s green finance pilot zones) although it does not currently specify what categories of businesses will qualify.

Expansion of environmental disclosure requirements

The Administrative Measures for Environmental Information Disclosure 企业环境信息依法披露管理办法 require regulated, listed and bond issuing companies to disclose certain environmental information. Environmental information for the previous year must be uploaded to the Enterprise Environmental Information Legal Disclosure Report system by 15 March of the current year and should include information relating to (for example): environmental management, licensing and insurance, pollutant generation, treatment and disposal, carbon emissions, emergency planning and response and violations of environmental laws and regulations (including details of any penalties imposed).

Creation of a China National Emission Trading Market

The development of a national emissions trading market (for trading CCERs and other carbon related financial products) is a high priority for onshore regulators who view carbon trading as key to building China’s emissions reduction capability. Indications are that the onshore stock exchanges are keen to discuss the development of new carbon-related financial products, e.g. carbon pledge, carbon lease, carbon repo and carbon derivatives, in order to significantly upscale trading volumes and pricing as well as attract more investors to participate in the domestic carbon markets.

At the same time, Beijing is expected to relaunch the CCER scheme, its voluntary carbon credits plan, in 2022, nearly five years after it was terminated. The relaunch is expected to redress the balance between fossil fuel based energy producers (which are able to earn income from transferring ‘surplus’ CEAs) and renewable energy companies (which do not receive any benefit from the current emissions trading platforms). In November 2021, the State Council announced that the Beijing Green Exchange will host the national trading platform of CCERs and that the exchange will also eventually be open to offshore investors.[1]

[1] South China Morning Post (31 January 2022): *What is the China Certified Emission Reduction scheme and why is it important for Beijing's carbon neutral goal?*

GLOBAL OPPORTUNITIES FOR CHINA, HONG KONG AND THE GBA

CROSS BORDER CAPITAL FLOWS

Work continues to develop Hong Kong SAR into a regional carbon trading centre, including the development of carbon market opportunities as part of the Guangdong-Hong Kong-Macao Greater Bay Area cooperation and the development of opportunities for offshore investors to participate in China’s emissions trading schemes through existing investment channels such as the bond and stock connect, QFII and QDII schemes.

RENEWABLE AND HYBRID ENERGY

As the world pursues net zero, investment in renewable and hybrid energy projects, renewable and hybrid infrastructure and innovation will continue to grow, in particular as investors and supply chains continue to grapple with ongoing travel restrictions as a result of the global pandemic. China is the world’s largest producer of wind and solar energy and (according to the International Energy Agency) accounts for 43% of global renewable capacity growth.

GREEN HYDROGEN

The international race to lead the green hydrogen economy has already begun. The hydrogen industry is embedded into China’s 14th Five-Year Plan (2021-2025) as one of the its six industries of the future with predictions that by 2030, China's demand for hydrogen will reach 35 million tons, accounting for at least 5% of its energy system. China plans to add 37 new hydrogenation stations by 2025 and build a hydrogen energy industrial chain in the Beijing-Tianjin-Hebei integration region worth more than 100 billion yuan.

CARBON OFFSET

China continues to develop its carbon capture, utilisation and storage (CCUS) capacity and could add eight new onshore CCUS projects by 2025 to 14 already in operation with a combined annual capacity of 2.1 million tonnes.[1] CNOOC also launched China’s first offshore CCUS project in 2021, which is expected to store more than 1.46 million tonnes of carbon dioxide. CCUS technology could reduce China’s carbon emissions by 60% by 2050.

[1] https://www.scmp.com/business/china-business/article/3137245/climate-change-chinas-plans-double-carbon-capture-capacity

TECHNOLOGY AND INNOVATION

In 2021, the new-energy vehicle industry in China set records, making up 15.7 % of the domestic auto market. In addition, China is the largest producer of solar power and dominates the global solar photovoltaics (PV) market. According to data from the International Energy Agency, China’s PV manufacturing accounts for about 71% of the world’s total capacity. Global renewable electricity capacity is forecast to increase by more than 60% between 2020 and 2026, with China expected to remain the industry leader.

LOOKING AHEAD…

REALISING THE GOALS SET AT COP26 IS A SEISMIC GLOBAL CHALLENGE THAT CAN ONLY BE ACHIEVED THROUGH COLLECTIVE ENGAGEMENT AND COLLABORATION. IN THE RACE TO REACH NET ZERO, THERE WILL BE NO WINNERS UNLESS ALL NATIONS CROSS THE FINISH LINE. IN 2022, THE CHALLENGE WILL BE TO ENSURE THAT THE SLOWEST GET FASTER WITHOUT THE FASTEST LOSING SPEED.

2022 is poised to be another record year for sustainable finance. But in order to deliver the scale of global emissions reductions required to limit the rise in global temperatures to 1.5°C, domestic compliance and voluntary carbon markets will need to work together in alignment with targeted fiscal and economic policies.

In unchartered waters that mix numerous political and regulatory undercurrents, the momentum for change must be driven by the synergies that transcend doctrinal and technical differences. Results will ultimately only be achieved through interoperability of taxonomies and reporting standards both of which require a top-down approach starting with central government.

In a race where there will be no winners without all participants crossing the finish line, it is incumbent upon legislators and regulators to adopt a principle-based approach (consistent with the standards set by the United Nations, international NGOs and leading industry bodies) in setting compliance standards. Importantly, the ability to comply must be available to all, with those most able to bear the financial burden of clean energy transition sharing a larger portion of the cost.

The financial sector must mobilise private capital at scale and at speed. From providing funding for emissions reduction projects and renewable energy, to reducing financial support for carbon intensive activities; from divesting portfolios of black, grey and brown assets, to investing in community projects.

Financiers and investors in Asia are well placed to capitalise on the opportunities created by expanding carbon markets, offset projects and renewable energy generation capacity in the region. As the volume of trading activity increases, so too will the price per unit of carbon, the returns for investors and the number of reasons for more businesses to participate. Vigilance against greenwashing is paramount.

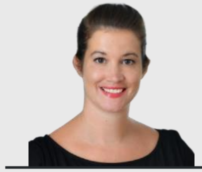
The momentum needed to achieve net zero will be generated not by a single force, but by the aggregation of individual actions that each of us takes.

RICHARD MAZZOCHI
Partner | Hong Kong SAR
Tel +852 3443 1046
richard.mazzochi@hk.kwm.com

MINNY SIU
Partner | Hong Kong SAR
Tel +852 3443 1111
minny.siu@hk.kwm.com

GU JIEYU (JANET)
Partner | Nanjing/ Shanghai
Tel +86 025 5872 0808
gujieyu@cn.kwm.com

SU MENG (MOLLY)
Partner | Shanghai
Tel +86 21 2412 6057
sumeng@cn.kwm.com



LEONIE TEAR
Counsel | Hong Kong SAR
Tel +852 3443 8375
leonie.tear@hk.kwm.com

CLAIRE POTTER
Registered Foreign Lawyer | Hong Kong SAR
Tel +852 3443 1093
claire.potter@hk.kwm.com

LV YANI
Associate| Shanghai
Tel + 86 21 2352 6504
lvyani1@cn.kwm.com

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White Clouds and Moon by Du Feichen