Subcommittee on Proposed Resolution under Section 3(1) of the Loans Ordinance (Cap. 61)

Response to the Follow-up Questions and Issues Raised

Purpose

This paper sets out the Administration's response to the relevant questions and issues raised by Members of the Subcommittee on Proposed Resolution under Section 3 of the Loans Ordinance (Cap. 61) ("the Subcommittee") as set out in the Subcommittee's letters dated 10 and 13 July 2018.

Objective of the Government Green Bond Programme ("the Programme")

2. The primary objective of the Programme is to promote the development of green finance in Hong Kong as well as to signify the Government's support for sustainable development and determination to combat climate change. The Programme seeks to encourage issuers to finance their green activities through our capital market and develop a broad green investor base through the issuance of high quality green bonds aligned with standards/guidelines widely accepted by global investors.

3. Green finance is a new but rapidly expanding area of financial activities that seeks to bring a positive impact on the environment through emphasis on social responsibility and sustainable development. The concept of green finance, as well as the underlying principles and mechanisms for assessment and evaluation, is at the nascent stage of development, and keeps on evolving as it attracts more public attention and increased investment from around the world.

4. Currently, there are different international organisations issuing green bond standards and guidelines, serving as reference for green bond issuers and investors. These include, amongst others, the Green Bond Principles

("GBP") introduced by the International Capital Market Association ("ICMA")[1] as voluntary process guidelines for issuing green bonds. Its latest version, GBP 2018, provide an indicative list of the most commonly used types of projects supported by or expected to be supported by the green bond market. The eligible green project categories include, but not limited to, renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, terrestrial and aquatic biodiversity conservation, clean transportation, sustainable water and wastewater management, climate change adaptation, eco-efficient and/or circular economy adapted products, production technologies and processes, and green buildings which meet regional, national or internationally recognized standards or certifications.

5. The Climate Bonds Standard ("CBS"), sponsored by the Climate Bonds Initiative ("CBI"), is another set of more commonly-known international green bond criteria. The CBS versions 2.1 requires that projects financed by an issuance should fall into one or more of the investment areas contained in the Climate Bonds Taxonomy which for the time being, include energy, low carbon building, industry & energy intensive commercial, waste & pollution control, transport, information technology & communications, nature based assets and water.

6. These organizations frequently update their standards and guidelines as the market evolves. For example, ICMA held its annual conference in Hong Kong in June this year to seek endorsement of the latest standard, the GBP 2018. Other standards/guidelines may adopt different project categories and/or criteria. Meanwhile, many jurisdictions have developed their own domestic standards and guidelines.

7. As a market development initiative, the Programme must be flexible so that it could evolve with the market and foster the opportunities brought by the development in green finance. We have explained in the Explanatory Note of the proposed resolution and the Legislative Council ("LegCo") brief the use of sums raised under the Programme. We reiterate that the sums raised under the Programme and the proposed resolution will be credited to the Capital Works Reserve Fund ("CWRF") to finance projects with

[1] The International Capital Market Association is a self-regulatory association for the international capital market with over 540 member institutions from more than 60 countries, including banks, issuers, asset managers, infrastructure providers, law firms, rating agencies and other market participants.

environmental benefits under the Public Works Programme ("PWP") approved by the Finance Committee of LegCo ("FC") in the speech of the Secretary for the Financial Services and Treasury when moving the proposed resolution in LegCo.

8. As explained in the LegCo brief, every issuance under the Programme will comply with an issuance framework that aligns with standards/ guidelines widely accepted by global investors for green bond issuance in terms of the use of proceeds for projects providing environmental benefits, the process for evaluation and selection of such projects, the management of proceeds, and the periodic reporting of project information after issuance. To follow the best market practice and set a good example for other potential green issuers, we will engage independent external reviewer(s) to verify and/or certify alignment of issuance frameworks with the standards/guidelines.

Green Projects

9. Only projects under PWP that are approved by FC under the existing mechanism may be considered to be included under the Programme. When selecting green projects to underpin green bond issuances, potential projects will be assessed against the project categorization and criteria under the green bond standards/guidelines adopted for that particular issuance. Checking against the GBP 2018, for example, some government works projects under PWP related to waste water treatment, energy saving, green buildings, waste-to-energy facilities, etc. appear to be fundable by green bond.

10. While external review may not be a mandatory requirement for green bond issuance, we will engage independent external reviewers to verify or certify alignment of issuance frameworks with the relevant standards/guidelines adopted.

11. Other factors, such as the cashflow requirement of the projects, length of the contract, the targeted green investors (who may have a specified green investment mandate), recommendation by arranger, etc. will also affect project selection for an issuance. We are not in the position to comment whether a particular project would be included in issuances under the Programme.

12. Proceeds of green bonds should be exclusively applied to finance in full or in part eligible green projects. While green bonds can be used to finance part of a project, the relevant part should be identified/singled out and assessed to have environmental benefits.

13. Green bonds are rather new to the market and more sophisticated when comparing to their conventional counterparts. Most of the green bonds so far issued in the global and domestic markets mainly target institutional investors. The current green investor base in Hong Kong consists of primarily institutional investors and is relatively small. To promote the development of green finance and attract international investors to use Hong Kong for green financing and investing, we should follow the best and most common international practices, and target the most influential international green investors. We therefore consider that Government green bonds issued under the Programme should, at least for the initial tranches, target at institutional investors. We hope that the Programme would help arouse the interest of retail investors and build up their knowledge and understanding on green bonds. We will monitor the development of green finance in both the global and domestic market and review the arrangement when we have gained more experience on green bond issuance having regard to relevant considerations.

14. In the global market, we see a rapid growth in green bond issuances in recent years. The global issuance amount has been raised from over US$40 billion in 2015 to over US$160 billion in 2017. In the sovereign market, since the first sovereign issuance in late 2016, we see a rapid increase of five issuances in the first half of 2018 from only three issuances in 2017. According to market information, there have been issuances of green bond in Hong Kong since 2016. However, since the announcement of government initiatives to promote the development of green finance in Hong Kong in the 2018-19 Budget, we understand that more than ten issuers including international organisations have issued green bonds denominated in Hong Kong dollar and other currencies in Hong Kong. We need to implement the Programme as soon as possible to seize the opportunities brought by the rapid development on green finance and the market momentum after the Budget announcement.

15. All PWP projects proposed to be financed through green bond issuances under the Programme must continue to be approved by FC under the existing mechanism; i.e. paragraph (c) of Cap. 2A. Hence, it will not be affected by the proposed resolution.

Consultation

16. The Programme was widely discussed among the public after its announcement in the 2018-19 Budget. We also briefed the LegCo Panel on Financial Affairs on the Programme among other initiatives to develop green finance in Hong Kong on 3 April 2018. As also explained above, the proposed resolution would not affect the existing funding mechanism.

The Proposed Resolution and the Interpretation of the Loans Ordinance

17. Section 3(1) of the Loans Ordinance requires the “sum or sums” and the “purposes” of loans to be approved by resolution of LegCo. The “manner”, “terms” and “conditions” of such loans are to be agreed between the Government and the lenders and need not be approved by LegCo by way of resolution. The Section only requires the “sum or sums” and the “purposes” to be approved by resolution of LegCo. The Section does not preclude authorization for more than a single borrowing transaction subject to the terms of the resolution. The Government is of the view that the proposed resolution is consistent with the Loans Ordinance. The proposal of multiple issuances is similar to the Government Bond Programme authorized by a past resolution made under the Loans Ordinance.

18. As mentioned in paragraph 2 above, the Programme and hence the proposed resolution is an initiative to promote the development of financial market in Hong Kong which is the policy responsibility of the Secretary for Financial Services and the Treasury. The Secretary is also the Government Official moving a resolution under section 3(1) of the Loans Ordinance for the purposes of CWRF in 2004 which was passed. The Government considers that the Secretary is an appropriate government official to move the proposed resolution.

Capital Works Reserve Fund

19. CWRF is established by a LegCo resolution published in the Gazette as Legal Notice No. 18 of 1982. By virtue of section 29(3) and the First Schedule of the Public Finance Ordinance Cap. 2, it is deemed to be established in accordance with Section 29 of the said Ordinance. As explained in our letter of 12 June 2018 to the Assistant Legal Advisor of LegCo, the way of referring to CWRF in the proposed resolution is considered to be more precise than the wording "Capital Works Reserve Fund established by resolutions passed under section 29 of the Public Finance Ordinance (Cap. 2)". By referring to the number and the publication year of the relevant legal notice, the wording adopted in the proposed resolution should enable readers to identify the relevant legislative instrument that established the Fund more easily.

20. Paragraph (b)(v) of the Capital Works Reserve Fund (Cap. 2A) allows sums borrowed under a resolution of LegCo made under section 3(1) of the Loans Ordinance to be credited to CWRF where the resolution so stipulates. Paragraph (b) of the proposed resolution provides that sums borrowed under the proposed resolution are to be credited to CWRF. Furthermore, paragraph (c) of the Capital Works Reserve Fund (Cap. 2A) permits the expense of money of the Capital Works Reserve Fund for the purposes of PWP which may include projects with environmental benefit under PWP. Other than the sub-paragraphs mentioned in the written question raised by Members of the Subcommittee, paragraph (d) of the Capital Works Reserve Fund (Cap. 2A) has a sub-paragraph (ii) which expressly authorises the Government to expend money of the Fund to repay the principal, interest and expenses incurred in relation to sums borrowed under section 3 of the Loans Ordinance where such sums have been credited to CWRF. Therefore, the existing provisions of the Capital Works Reserve Fund (Cap. 2A) are adequate for implementing the Programme. There does not appear any need to establish a new fund or amend Cap. 2A to implement the Programme.

21. Money of CWRF has been expended in accordance with subparagraph (d)(ii) of the Capital Works Reserve Fund (Cap. 2A) in relation to expenses incurred for government bonds issued in 2004 pursuant to a LegCo resolution made under Section 3(1) of the Loans Ordinance in 2004. The Government has been preparing returns on CWRF including such expenditure in the annual Estimates to be laid before LegCo in the annual budgetary exercise and will do so in respect of the relevant expenses in relation to sums

raised under the proposed resolution, hence the Programme, if the proposed resolution is made by LegCo. The Government considers that the arrangement is consistent with the Basic Law including Article 73(3) in relation to taxation and government expenditure.

22. Under the existing arrangement between the Government and the Hong Kong Monetary Authority, CWRF as part of the Operational and Capital Reserves of the fiscal reserves are placed with the Exchange Fund for investment purposes at a fixed rate determined every year[2].

23. As explained in the LegCo brief, sums raised under the Programme will be expended on projects with environmental benefits under PWP. The amount originally earmarked for projects will be retained for other purposes of CWRF. The balance of CWRF will earn a fee under the arrangement explained in the previous paragraph. The Government may transfer money from CWRF to the General Revenue having regard to the balance, commitments including commitments for the purposes PWP, and liabilities including liabilities for bonds credited, of CWRF.

Cost of Issuances

24. The cost of an issuance under the Programme depends on a number of factors including the structure, terms and parameters of the issuance such as tenor, size, currency, credit rating, etc. and the market condition at the time of issuance such as interest rate, investor appetite, etc. As an indication, the annualized yield of a government bond issued under the Government Bond Programme on 12 July 2018[3] is 2.391%. According to market information, expenses relating to a bond issuance to institutional investors may amount to about 0.5-1% of the issuance size. The cost and expenses for a retail issuance are expected to be higher.

Role of the Hong Kong Monetary Authority

25. As mentioned in the LegCo Brief, similar to the arrangements of

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[2] The fixed rate for year 2018 is 4.6%.

[3] For the re-opening of an existing 10-year government bond under the institutional part of the Government Bond Programme with an issuance size of HK$1.2 billion.

the Government Bond Programme, we will make recommendation to the Financial Secretary to exercise the powers conferred on him under the Exchange Fund Ordinance (Cap.66) and the Financial Secretary Incorporation Ordinance (Cap. 1015) to empower and direct the Monetary Authority to assist in implementing the bond issuance under the Programme. The arrangement would ensure that debt securities issued under the Programme, the Government Bond Programme as well as those issued under the Exchange Fund Bills and Notes Programme are in an orderly manner and achieving the objectives of the said Programmes.

External Review Providers for Green Bond/Green Bond Programme

26. External review is recommended or required under different green bond guidelines/standards to allow issuers to demonstrate to the market that their bonds are aligned with the guidelines/standards concerned. Under GBP, for example, ICMA recommends that in connection with the issuance of a green bond or a green bond programme, issuers appoint an external review provider to confirm the alignment of their bond or bond programme with GBP. ICMA also just published in June this year "Guidelines for Green, Social and Sustainability Bonds External Reviews"[4] which aims to promote best practice. On the other hand, under CBS, issuers seeking climate bond certification need to engage a Verifier approved by CBI.

27. We understand that issuers of green bonds globally engage various institutions, such as consultants, audit firms, credit rating agencies and certification agencies, to provide external reviews to assure the investors of alignment of their bonds with green bond standards/guidelines concerned. We are not aware of any international regulatory/supervisory standard on the provision of such external reviews.

Financial Services and the Treasury Bureau
18 July 2018

[4] The Guidelines is available at: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2018/Guidelines-for-Green-Social-and-Sustainability-Bonds-External-Reviews---June-2018-140618-WEB.pdf