Annex

Due Diligence Processes for Green and Sustainable Products

The Hong Kong Monetary Authority (HKMA) has recently undertaken a round of thematic examinations focused on the development and ongoing management of green and sustainable products. The objective is to ensure that the authorized institutions (AIs) examined have put in place proper systems of control to ensure that these products and the related funds are managed in a way consistent with their climate strategies, thereby reducing any potential exposures to greenwashing risks.

The thematic examinations mainly focused on AIs' processes relating to the offering of green and sustainable products, including the approval and launching of products, clients due diligence and transaction approval, and post-offering reviews and controls. The due diligence processes for a range of corporate and retail green and sustainable products of selected AIs were reviewed. These products[1] include green loans and green trade facilities, green mortgages, green personal loans, green deposits, sustainability-linked financing (including sustainability-linked loans and trade facilities), and green and sustainable investment products.

This note summarises some good practices identified by the HKMA over the course of these thematic examinations. The good practices are grouped under five high-level principles, namely:-

(i) Setting up a robust product governance framework for green and sustainable products;
(ii) Conducting comprehensive "greenness assessments" of clients and transaction due diligence for green lending;
(iii) Performing post-offering monitoring and controls to ensure the proper management of green and sustainable products;
(iv) Enhancing transparency and accountability in respect of green and sustainable products; and
(v) Building appropriate expertise in product development and comprehensive due diligence processes.

1. Setting up a robust product governance framework for green and sustainable products

A robust product governance framework for overseeing and managing green and sustainable products is essential to ensure the compatibility of these products with the institution's climate strategies throughout their lifecycle.

Observed good practices

- Building on their existing approval framework for new products and services, AIs

[1] Please refer to the Glossary at the end of the document for more information.

have put in place **additional policies with respect to internal approval and reporting procedures** for green and sustainable products. For instance:-

- Some AIs have **established dedicated committees** to assess and approve green and sustainable products or the use of green and sustainable-related product and transaction labelling. These dedicated committees usually comprise senior representatives from the management and various business functions with the requisite expertise, and they are independent from the deal teams to avoid any unintended conflict of interests. To facilitate their oversight, management information reports covering the performance of green and sustainable products are submitted to these dedicated committees regularly. Cases of a complex and sensitive nature, and those with disputes over green and sustainable categorisation are escalated to these committees for consideration, advice or final decision. Some AIs have also assigned the risk oversight responsibility with respect to greenwashing risks to these dedicated committees.

- Some AIs have **embedded climate-related risks, including greenwashing risks in their product due diligence processes** by documenting the ways that these risks should be identified and managed. They have clearly delineated the roles and responsibilities of the three lines of defence throughout the entire due diligence process. While climate-related risks are generally considered as part of the inherent risk framework (e.g. as part of reputation and strategic risks), some AIs have set up standalone guidelines on managing climate-related risks and developed separate guidance on climate-related greenwashing risks to facilitate staff members to identify and mitigate such risks. These guidelines are approved by authorized parties (e.g. dedicated committees) and are reviewed and updated periodically, taking into account the latest development in this space.

- AIs have developed **internal product-specific guidelines on the design, origination and classification framework for green and sustainable products**. These internal guidelines are developed with reference to existing international or industry practices and principles, and some AIs also have their internal guidelines reviewed by independent third parties. Some widely adopted market principles and standards include:-

  - For *green loans and green trade facilities*: Green Loan Principles (GLP) [2] of the Loan Market Associations (LMA), Asia Pacific Loan Market Association (APLMA), and Loan Syndications and Trading Association (LSTA);

  - For *sustainability-linked financing*: Sustainability-linked Loan Principles (SLLP) [3] of LMA, APLMA and LSTA; and Sustainability-linked Bond Principles (SLBP) of International Capital Market Association (ICMA)[4];

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[2] Green Loan Principles: https://www.lsta.org/content/green-loan-principles/

[3] Sustainability-linked Loan Principles: https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/

[4] Sustainability-linked Bond Principles: https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/

- For *green deposits and green bonds*: Green Bond Principles (GBP)[5] of ICMA.

On green product classifications, some AIs have developed their own **internal green classification frameworks** as an interim internal reference while a local classification framework is being developed[6], taking into account a range of international guidance, including the European Union Taxonomy, Climate Bonds Taxonomy of the Climate Bond Initiative (CBI), and Green Bond Endorsed Catalogue of China. Second-party opinions are sought by some AIs on their classification frameworks to show their alignment with market principles and standards. In the case of green mortgages, AIs generally identify the eligible buildings for their programmes based on the building rating of BEAM Plus of the Hong Kong Green Building Council[7].

- Some AIs have also developed clear procedures for **incorporating green and sustainability analysis into their due diligence process for offering green and sustainable investment products manufactured by third parties**. For instance, in the case of green and sustainable bonds, some AIs task dedicated teams to review the mandates of these bonds before execution and require third-party bond issuers to provide independent green certification on their bond frameworks prior to offering the products to customers. For other green and sustainable investment products, some AIs use due diligence questionnaires that cover a range of green or sustainability attributes (e.g. the ways that sustainability factors are integrated into and managed throughout the investment process, and alignment with its broader sustainability goals) to assess whether certain products should be labelled as green and sustainable before offering to clients.

- Some AIs have also **assessed their green and sustainable product programmes** against their own climate strategies and risk appetite standards. Some AIs have further sought verification or second-party opinions from external reviewers to demonstrate the level of greenness of their product programmes.

2. Conducting comprehensive "greenness assessments" of clients and transaction due diligence for green lending

Performing comprehensive greenness and climate-related risk assessments ensures the eligibility criteria for green and sustainable products are met.

<u>Observed good practices</u>

- Some AIs conduct **detailed assessments of prospective or existing clients seeking green and sustainable facilities with respect to climate-related risks and eligibility for green products** as part of their know-your-client and credit approval

[5] Green Bond Principles: https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/

[6] Together with other financial regulators in Hong Kong, the HKMA has been working towards proposing a local green classification framework for consultation with the banking industry and other stakeholders.

[7] BEAM Plus of Hong Kong Green Building Council: https://www.hkgbc.org.hk/eng/beam-plus/introduction/index.jsp

processes. For such client-level "greenness assessments", AIs collect and review additional supporting materials from clients, including greenness certifications issued by independent third-party agencies[8] and second-party opinions on potential projects, and information about the overall green and wider sustainability strategies of clients. Questionnaires are used by some AIs to collect relevant quantitative and qualitative information for green and climate-related risk assessments. Site visits and negative news checking are also conducted by some AIs to understand the overall greenness and climate risk profile of clients and the potential reputation risks that they face.

- While the transaction approval process for conventional products is usually adopted for green and sustainable products as well, some AIs **seek additional advice and support from dedicated teams or approvers with green and sustainable expertise** during the process. Other additional measures adopted by AIs for the approval of green and sustainable transactions include:-
    - For *green loans and green trade facilities*: Borrowers are required to provide additional evidence to indicate the greenness of their projects or the proposed use of proceeds, including **third-party greenness certifications, and external verification showing alignment with GLP.** While borrowers' self-attestations are sometimes acceptable according to market practices, predefined eligibility criteria on borrowers and loans are put in place (e.g. renewal of loans for existing projects) to specify the occasions where a self-attestation can be made in lieu of a third-party certification.
    - For *sustainability-linked financing*: AIs assess the key performance indicators (KPIs) and the corresponding sustainability performance targets (SPTs) set by borrowers through in-depth discussions with them, benchmarking against key market players' performance, assessing the relevance and materiality of KPIs by making reference to Materiality Map of Sustainability Account Standards Boards (SASB)[9], and reviewing the borrowers' past performance. Second-party opinions on the appropriateness of KPIs and SPTs are also required by some AIs as a condition precedent. Some AIs assign a separate unit to conduct the assessment and benchmarking and provide appropriate advisory services to support clients to develop acceptable KPIs and SPTs as needed.
    - For *green personal loans*: Green personal loans are mainly offered by AIs for the purchase of electric vehicles (EVs) in Hong Kong. To ensure the use of the EV loan facilities is consistent with the said purpose, AIs require borrowers to provide purchase evidence including sales invoice and purchase order of an EV that is on the list of eligible EVs of the Environmental Protection Department for transaction approval or before loan drawdown.

[8] Some AIs have put up a list of pre-approved service providers by making reference to the Recognised External Reviewer List of the Hong Kong SAR Government's Green and Sustainable Finance Grant Scheme to facilitate assessment by their staff.

[9] SASB's Material Map is a tool that helps identify likely material sustainability issues on an industry-by-industry basis (https://www.sasb.org/standards/materiality-map/).

- Some AIs also **perform additional due diligence on clients of climate risk sensitive and high carbon-emitting sectors according to their own sectoral policies**. Clients are asked to provide extra proof and information (e.g. via completing sector-specific climate risk questionnaires and submitting transition plans) to show that their business strategies and activities are in line with the AIs' strategies, policies and risk appetites. The clients' carbon emissions reduction targets are compared against the industry transition pathway.

3. Performing post-offering monitoring and controls to ensure the proper management of green and sustainable products

Performing post-offering monitoring and controls helps to ensure that green and sustainable products remain green and sustainable throughout their lifecycle, thereby mitigating the potential risk of climate-related greenwashing.

<u>Observed good practices</u>

- After the launch and offering of green and sustainable products, some AIs **conduct regular reviews on product portfolios.** The greenness performance of their products and the allocation of proceeds of their green liabilities are also monitored on an on-going basis to facilitate early detection of potential misuse of proceeds and the associated climate-related risks. Additional reviews and assessments are also undertaken on the terms set for individual green and sustainable credit products during annual credit reviews and on an as-needed basis. For instance:-
    - For *green liabilities products such as green deposits and green bonds*: AIs have put in place measures to ensure fund proceeds of these products are exclusively used in green projects or referenced to eligible green assets approved under their green product framework. Some AIs maintain a certain buffer (usually around 10%-20% of their total green assets) to ensure the amount of green liabilities will not exceed that of green assets and to allow for some movements and re-classification in the asset base. Some AIs also apply specific green product codes to facilitate their daily monitoring process. Regular reviews focusing on businesses of climate risk sensitive sectors and activities are conducted.
    - For *green loan and green trade facilities*: During annual credit reviews, AIs adopt extra controls in line with the GLP for reviewing and assessing clients' use of fund proceeds. Clients are required to provide evidence to show that the funds are used in the pre-agreed manner, for example by providing an annual attestation of the use of proceeds and greenness of projects, reporting on the allocation and green impact of relevant loan proceeds, and making relevant public disclosure. Some AIs also take an extra step beyond GLP, requiring clients to submit independent external verification on the use of green loan and trade facility proceeds.
    - For *sustainability-linked financing*: In line with the SLLP recommendations, AIs require clients to submit independent external verification of their

performance against each SPT for the KPIs for the annual credit reviews. Clients' KPI performance is also entered into the AIs' credit monitoring systems to facilitate on-going tracking and monitoring.

  - For *green and sustainable investment products*: Where practicable, some AIs periodically evaluate the performance of third-party manufactured sustainable funds against the respective fund managers' ESG investment objectives and strategies. Such products will only be kept on the offering list of green and sustainable products if their performance is consistent with the AIs' long term strategic goals towards a low-carbon economy.

- Some AIs have **put in place policies and procedures to handle the failure to adhere to the terms and conditions of green and sustainable product transactions**. Specifically, they have established a mechanism to "declassify" transactions that fail to adhere to the green terms set in the facility agreement from "green and sustainable" to "non-green". The AIs will re-assess the identified transactions and seek approval for declassification from dedicated committees or teams, and restrict such declassified transactions from being presented as green or sustainable by themselves and their clients. The declassification mechanism helps prevent overstating the volume of the AIs' green and sustainable business and ensure the green and sustainable products and transactions are managed in the appropriate manner.

4. Enhancing transparency and accountability in respect of green and sustainable products

Enhancing transparency by disclosing more information about AIs' green and sustainable business including their green initiatives, the projects being funded, and the allocation of relevant green proceeds is conducive to mitigating the risk of perceived greenwashing.

<u>Observed good practices</u>

- In addition to their climate-related commitments and goals, some AIs have published their climate-related strategies and policies including those governing product classification frameworks. Second-party opinions of their green and sustainable product programmes are also published.

- Some AIs publish product-specific portfolio-level impact reports on their sustainable finance activities, covering items such as the amount of green and sustainable finance disbursed and the associated positive environmental impacts (e.g. carbon emissions avoided) induced through the use of proceeds of green deposits offered and green bonds issued by the AIs.

- Some AIs issue regular utilisation or allocation reports to their green deposits and green bonds clients to keep them informed of the types of green projects being funded by the relevant green products at the portfolio level.

- Some AIs make TCFD-aligned climate-related disclosures to enhance their overall transparency and accountability. When disclosing information about their green and sustainable business, some AIs adopt a conservative approach by not including sustainability-linked products under green and sustainable categories for meeting their sustainable finance targets, on the consideration that the proceeds of these sustainability-linked products are not solely restricted to green projects and activities. Other AIs, on the other hand, clearly define the types and disclose the detailed breakdown of all green and sustainable finance transactions when sustainability-linked products are counted towards their sustainable finance targets.

5. Building appropriate expertise in product development and comprehensive due diligence processes

Dedicating sufficient resources to building appropriate expertise is essential to ensure AIs' green and sustainable product due diligence and assessment of the associated risks are duly conducted.

<u>Observed good practices</u>

- Most AIs have provided green and climate-related training and developed internal guidance notes for their staff. Tailored training on ESG and climate-related issues is provided to staff at different levels of seniority at institutions (from the board and senior management level to working level) and to staff of various functions (e.g. frontline, risk management, compliance and legal, internal audit, and treasury). Climate-related risks, including greenwashing risks, are covered in these training sessions to raise staff awareness and strengthen their capabilities to assess the relevant risks during the due diligence processes. Some AIs have set up a single resource platform to house all the internal guidelines and policies, international and industry guidelines, and relevant documents relating to green and sustainable products to facilitate consistent deployment of policies and accessibility of useful information by staff.

Glossary

- *Green loans / green trade facilities* refer to credit / trade finance facilities made available exclusively to finance or refinance new and/or existing eligible green projects and activities[10]. The fundamental determinant of green loans and green trade facilities is the utilisation of the proceeds for eligible green projects / activities.

- *Green mortgages* refer to mortgage loans granted with respect to eligible residential properties that have received BEAM Plus Platinum or Gold rating issued by the Hong Kong Green Building Council (or equivalent)[11].

- *Green personal loans* refer to personal loans granted for specific uses which have positive environmental impacts. In Hong Kong, the main type of green personal loans offered by AIs are electric vehicle loans.

- *Green deposits* refer to deposits where funds are allocated to finance eligible green assets as verified under the bank's green product framework.

- *Sustainability-linked financing* (including sustainability-linked loans or sustainability-linked trade facilities) refer to credit facilities which incentivise the borrowers' achievement of ambitious, predetermined sustainability performance objectives[12]. The financing terms of these products are usually linked to the borrowers' green and sustainability performance measured using predefined sustainability performance targets (SPTs) for the pre-agreed key performance indicators (KPIs). The use of proceeds is not a determinant of sustainability-linked products, as the relevant loan proceeds can be used for general corporate purposes.

- *Green and sustainable investment products* refer to investments of which the investing process has taken into account environmental factors as their key investment focus, alongside financial factors. Green and sustainable investment products reviewed in this round of thematic examinations include green bonds, sustainable funds and green structured products.

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10 Green Loan Principles of LMA, APLMA and LSTA.

11 BEAM Plus of the Hong Kong Green Building Council is an initiative to offer independent assessment of building sustainability performance in Hong Kong. The assessment of building performance comprises seven aspects, including energy use, health and wellbeing, integrated design and construction management, sustainable sites, materials and waste, water use and innovations and additions. There are four ratings under this assessment: Platinum (highest rating), Gold, Silver, and Bronze. (https://www.hkgbc.org.hk/eng/beam-plus/introduction/index.jsp)

12 Sustainability-linked Loan Principles of LMA, APLMA and LSTA.