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Financial Services Special Report: China's Green Finance Market

SUMMARY

President Xi Jinping has prioritised the development of a national green finance system as set out in the 13th Five Year Plan. China was the world's second largest green bond market in 2017, and new opportunities will emerge in green asset securitisation and covered bonds. Chinese regulators are also pursuing greater information disclosure and ESG investment, and green finance pilot zones will deliver greater innovation and growth in the market. A "green" Belt and Road is essential to meeting global climate change commitments and the UK is working with China to ensure high standards on project delivery. The newly established UK International Climate Fund – China Green Finance Programme will help ensure the UK remains China's partner of choice on green finance.

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Market and Standards

Addressing environmental pollution has been identified by Chinese President Xi Jinping as one of his 'three battles' for the next three years. Developing a national green finance system has been publicly endorsed by President Xi and the State Council, the top decision making body in the country. China's push in green finance started in 2015 with the establishment of the Green Finance Committee under the People's Bank of China (PBoC). This was consolidated when China used its G20 Presidency in 2016 to take forward green finance on the international stage, co-chairing the Green Finance Study Group with the UK. Since then China has undertaken a rapid implementation of policies and market initiatives, particularly following the publication of the Guidelines for Establishing a Green Financial System.[1]

China's green bond market has grown rapidly but is now shifting focus to 'quality over quantity'. China's green bond market grew from zero before 2015 to the largest in the world in 2016. Last year China issued $37.1bn green bond, 4.5% up on the previous record-breaking year (although falling to second place globally, behind the US). With $9.3bn worth of green bonds aligned with international green bond definitions, China represents 12% of the global market over the first half of 2018.[2] The green bond market is forecast by some to grow to $1tn annually by the early 2020s, with China anticipated to account for 40% of this.[3]

Having achieved scale, China is now focussing on streamlining domestic guidelines and aligning these with international best practice. On 27 December 2017, the PBoC and CSRC jointly released provisional *"Green Bond Assessment and Verification Guidelines"*, modelled on the Climate Bonds Standard & Certification

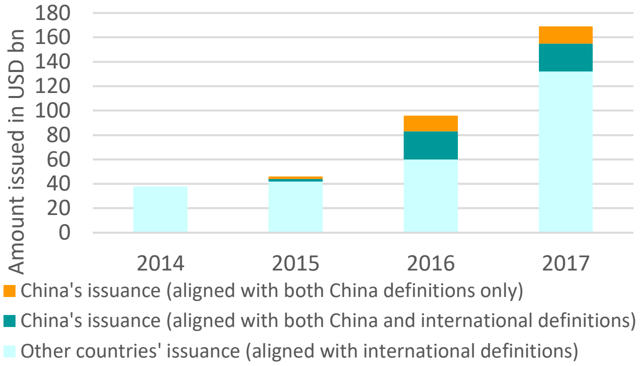
[1] In August 2016, seven Chinese ministerial agencies including the PBoC and the Ministry of Finance jointly released the *Guidelines for Establishing the Green Financial System* (http://www.pbc.gov.cn/english/130721/3133045/index.html)

[2] According to data from Climate Bonds Initiative https://www.climatebonds.net/files/files/China%202018%20H1%20Report_EN%20final%281%29.pdf

[3] Forecast by Sean Kidney, CEO, Climate Bonds Initiative, and Ma Jun, Chair, China Green Finance Committee.

Scheme.[4] These guidelines demonstrate China's ambition to improve its regulatory mechanisms to make sure the bonds are genuinely 'green', with more stringent reviews, disclosure and penalty rules in place to monitor and track verifiers' qualifications and due diligence processes. While there are still controversies around what can be called 'green' in China (notably "clean coal"), this is a major step forward and arguably the world's most comprehensive approach in terms of regulatory oversight.

China is a major player in global green bond market



Source: Climate Bonds Initiative

New Products

China's flagship Belt and Road Initiative (BRI) offers huge potential in overseas green infrastructure investment. China has become a major financier of overseas infrastructure projects. The BRI plans to invest $1-4trn across Europe, Africa and Asia. The quality of these projects and the commensurate environmental impact has been varied and not yet aligned with green finance or global climate policy goals. Ensuring these projects meet internationally recognised environmental standards will be key.

The Chinese government is increasingly aware of the risks around project delivery and the UK is working with China to ensure the application of high standards to infrastructure projects. As a leader in large-scale low carbon infrastructure project financing and related professional services (legal, accounting, insurance and consultancy), the UK is well positioned to benefit from this major overseas infrastructure development programme and also inform and shape implementation of projects. Chinese companies will also need green insurance facilities and better risk management tools for investment along the Belt and Road, to make sure they comply with global sustainability standards. The UK has a mature insurance sector with considerable climate-related risk management expertise, making it well placed to take advantage of opportunities both in China and across the Belt and Road.

China is seeking to develop green private equity and venture capital investment and seeking capacity building in green infrastructure and insurance mechanisms. Green private equity in China has grown rapidly in recent years, with nearly 500 green private equity funds established as of end Q1 2018.[5] The rise of data-driven technology and fintech means a large number of Chinese clean-tech companies and start-ups need strategic investment from commercial sources of capital. The government is also tentatively preferable tax policies to attract international private equity in the green space.

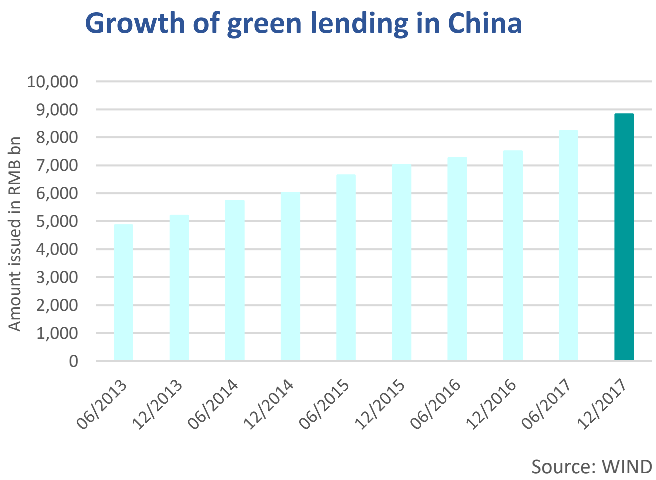
China will also use innovative monetary policy tools to incentivise green lending, potentially paving the way towards the establishment of a green securitisation and covered bond market. The central bank has already incorporated green bonds and green loans into Macro-Prudential Assessments (MPA) – i.e. analysis of the

[4] The Climate Bonds Standard and Certification Scheme is a labelling scheme for green bonds used by issuers, governments and investors to ensure they genuinely contribute to addressing climate change. Rigorous scientific criteria ensure consistency with the Paris Agreement.

[5] Green private equity funds supply venture capital to companies that focus on sustainability. Source: China Securities Investment Fund Association

indicators contributing to financial stability risk – in February, and in June announced an expansion of the Medium-term Lending Facility to include green loans and green bonds.

Since Green Finance Pilot Zones started last year, local banks in pilot zones have placed a greater emphasis on green lending. In June the PBoC published the total balance of green loans issued in the five pilot zones, which totalled RMB 260bn as of March 2018. This is up 13% compared to the year before the pilot was introduced. On 27 July the PBoC announced the *''Green Credit Performance Evaluation Scheme for Deposit-taking Financial Institutions'',* which was included as part of the MPA to further incentivise green lending.



The rapid development of green lending brings opportunity for green asset securitisation (bundling green loans into securities) or a green covered bond market (where green loans are used as collateral). This could unlock additional capital currently tied up in loans to finance the transition to a low carbon and climate-resilient economy, and further expand the supply of green lending. While the UK could share advanced practices on green lending evaluation practices with China (e.g. Green Investment Group's green impact assessment and reporting methodologies), there is also space for UK market players including investors, underwriters and industry associations (e.g. Loan Market Association), to step in and work with Chinese counterparts to scale up the market for green debt financing. As international investors become more familiar with the onshore market through London-Shanghai Stock Connect, Bond Connect and inclusion of Chinese securities in global indices, there will, in time, be further opportunities to introduce international capital to China's green securitisation market.

China's green finance pilot zones will also lead to new innovation. The pilot zones programmes located in Guangdong, Guizhou, Jiangxi, Zhejiang and Xinjiang will include preferable green finance monetary policies including bank re-lending, capital market instruments, green guarantee programmes, green funds, and project databases.

Disclosure and Performance

The CSRC is pushing for mandatory environmental information disclosure by Chinese listed companies by 2020. Opacity and lack of access to environmental data in China has always been the biggest barrier for investors with a green preference. In December 2017 the CSRC issued "*Guidelines for the Disclosure of Contents and Formats of Listed Companies"*, requiring mandatory disclosure of environmental information from major polluting listed companies,[6] and encourage other listed companies to disclose on a 'comply or explain' basis. In March the PBoC issued a circular on "*Strengthening the Supervision and Administration of the Duration of Green Bonds" and "Disclosure Requirements on Green Bonds*", which require quarterly disclosure of both green benefits and environmental violations.

[6] Refer to those on the list of major polluting companies defined/published by China Ministry of Ecological Environment

Building on this work, the UK and China formed a pilot working group on Task Force on Climate-related Financial Disclosures (TCFD) at last year's Economic and Financial Dialogue (EFD).[7] The working group has had three formal meetings with productive output on Chinese institutions' disclosure frameworks, methodologies and detailed plans largely learnt from UK experience. At the Green Finance Pilot Zones Forum held in June, 35 Chinese financial institutions (mostly banks) signed up for a national Environmental Information Disclosure Initiative, symbolising a step towards a more transparent national financial system.

Source: Nikkei Asian Review

This, however, is only the first step. China still needs to bring in more asset management and insurance companies within the disclosure framework. In this regard the UK has a lot to share on its well-established methodologies, metrics and target-setting for disclosure. The facilitation of better information disclosure will further incentivise international investors to enter China's markets and provide a level playing field for UK business.

Empirical evidence suggests 'green outperforms' and Chinese investors are starting to embrace ESG principles. ESG is well established in developed markets but is only starting to gain attention in China. Mainland Chinese investors are increasingly aware of sustainable investing, helped by a push from government and industry organisations. An empirical analysis of the CSI 300 index by the Central University of Finance and Economics shows that environmental and climate risk factors impact the return on assets and bring increased returns for green stocks, and reduced returns for brown ones.

In a ranking of ESG performance of 6,500 global companies compiled by Thomson Reuters, PetroChina, ICBC and CITIC Bank were top Chinese performers[8] although none were in the top 100. However, a large number of institutional investors in China still lag behind in awareness and action. Most Chinese companies are slow to embrace ESG principles, mainly due to a lack of understanding of its benefits. As a leader in responsible investment the UK has for years led the debate on the need to factor ESG issues into fiduciary obligations and is well placed to encourage the incorporation of ESG into investment decision-making.[9]

UK-China Collaboration

The depth and scale of the UK's financial markets, clear track record in innovation and global leadership in green finance mean London is perfectly placed to make the most of the opportunities presented by China.[10] The UK has already played a pivotal role in the development of China's green finance market. London hosted the first ever green bond issued by a Chinese bank (Agricultural Bank of China in 2015) and the first green

[7] The pilot working group consists of 4 UK (HSBC, Aviva, Hermes, Brunel) and 6 Chinese (ICBC, Industrial Bank, Jiangsu Bank, Huzhou Bank, E-funds, China Asset Management Co.) financial institutions.

[8] Diageo PLC ranks 1st in all UK companies and 5th globally. More details here: https://www.thomsonreuters.com/en/press-releases/2017/october/thomson-reuters-di-index-reveals-2017-top-100-most-diverse-inclusive-organizations-globally.html

[9] Researchers from Deutsche Bank's wealth management unit and Hamburg University found 65% of ESG compliant investments had a positive effect on corporate financial performance in emerging markets, versus 38% for developed markets. High levels of ESG factors are already built into the system in developed markets, leaving limited marginal benefit from additional efforts. ESG standards imposed in emerging markets are generally lower and hence individual companies are able to make more difference.

[10] https://www.greenfinanceindex.net/GGFI1/Report/

covered bond (Bank of China in 2016). Most recently, in June 2018 ICBC and Bank of China issued $1.58bn and $1bn of green bonds respectively on the London market.[11] Multiple financial centres including Luxembourg, Hong Kong and Singapore, however, are looking to tap into this huge market. At the 9th EFD the UK and China recognised each other as their primary partner in green finance for capital raising, product innovation and thought leadership, and will continue to work in areas of green bond, green securitisation, greening the Belt and Road, information disclosure and ESG. The UK's Green Finance Institute will also enhance two-way knowledge and expertise transfer and promote innovation collaboration in both countries.

The newly-established International Climate Fund – China Green Finance Programme will support further cooperation and policy development in all areas outlined above, injecting new impetus into the already strong UK-China relationship. The BEIS International Climate Finance (ICF) China Green Finance Programme aims to support and incentivise China's transition to a more environmentally sustainable growth model through green finance, and develop a more commercially-driven and sustainable market for green finance that is over and above policy-led demand. The programme has allocated up to £2m for green finance technical assistance projects in China over the year 2018-19, through an open, competitive Call for Proposals. More details about the ICF China Green Finance Programme and update on the current call for proposals can be found here.

China's green finance development will also bring commercial opportunities in areas which the UK excels. Opportunities are far beyond green bonds, with professional services in large-scale low carbon infrastructure project finance; risk management, including environmental and climate risk insurance; and increasingly in developing new technologies, including green private equity and FinTech.

[11] The $1.58bn issuance by ICBC is the largest ever green bond on the London Stock Exchange.