China Carbon Forum | 中国碳论坛

An independent platform to foster trust and cooperation among China's stakeholders for climate action

Emerging Trends in Green Finance in China

Executive Summary

On 3rd November 2016, China Carbon Forum together with Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH (GIZ), held an event on ***"Emerging Trends in Green Finance in China"***, as part of the China Low Carbon Leadership Network (LCLN), an event series jointly organized by GIZ and CCF. This event was also supported by the Global Partners for Germany / Alumniportal Deutschland program as well as the Emerging Markets Sustainability Dialogues.

The panel included distinguished experts from academia, media, an NGO. As the speakers came from both Chinese and international backgrounds, the audience were enabled to gain an insight into a mix of perspectives, especially during Q&A sessions. After the discussion, the guests were enjoyed the follow-up networking event.

Record of Discussion

The following is an edited synthesis of discussion that took place at the event among panellists (around 50 minutes) and open Q&A with participants (30 minutes). As per convention, individual's comments are not attributed.

China is currently facing serious environmental pollution problems. According to studies, **roughly two trillion RMB of investment** is required every year from the Chinese Government **in order to deal effectively with these problems**. The audience was given an introduction to GIZ's current programs focussing on green finance in China. These are conducted under the umbrella of the 'Emerging Markets Sustainability Dialogues', which is a network of NGOs and business which promotes sustainable business and finance policies.

There are two key projects relevant to China. The first is a strategic partnership with Swedish bank SEB on **Green Bond Market Development in G20 Emerging Economies**, namely China, Brazil, India and Mexico. This program started in April this year, and has so far seen a symposium held in China in April and workshop held in September. The program involves capacity building, technical assistance and individual advisory support. The target audience for this work includes policy makers, regulators, banks, issuers and investors. In China, program partners are the Green Finance Committee and the Central University of Finance and Economics.

The other project is focused on environmental stress-testing. This takes mainstream risk management tools and look at it through an environmental lens, and involves GIZ partnering with the Natural Capital Declaration. **It develops an analytical framework and model that allows for the assessment of events on their loan portfolios**. It will of course impact on the likelihood of default, with consequent impacts on credit ratings. In China, this is being put in to practice by ICBC.

The panel noted that in the past, environmental problems were strictly the domain of the Ministry for Environmental Protection. However recently, through the work of the Green Finance Committee, the **dots are being connected between air pollution and tackling the problems of both industrial over-capacity and under-capacity in clean sectors**. Investors are also beginning to react, by removing their capital from polluting industries and directing it towards more environmentally friendly ones.

The Asian Infrastructure Investment Bank (AIIB) was formally opened for business earlier this year, and was formed just a few weeks after the Paris Agreement. The projects that have been invested in are still relatively small and the number of staff is low. Nevertheless, with $100 billion in capital the vision is high. Although a sizable budget, relative to the forecasted demand the panel recognised that AIIB would not nearly be able to provide this amount itself, and so would be **hugely reliant on private investment** in the future in order to realise its goals.

According to a recent McKinsey report, the world needs $90 trillion in infrastructure investment over the next fifteen years - this is almost twice the stock of existing infrastructure. If this infrastructure is created at the same carbon intensity as the existing stock, the Paris Agreement will be unachievable. It would also create massive stranded asset risks. However, if it is done well, through sustainable energy, transport and cities, **it could lock in the path towards achieving the ambition in the agreement**.

The AIIB groups its operations under three strategic themes: green infrastructure, cross-country connectivity, and mobilisation of private capital. With trillions sitting in institutional investment funds there is a real need to bridge the gap between this and infrastructure, and so one way AIIB is keen to lower financial risk for investors in this regard is by **creating attractive asset classes** that **group similar projects accordingly**.

The panel recognised that as it stands the Paris Agreement is a *framework*, however in time it is estimated that carbon will be priced internationally, and projects that are currently being financed without considering this reality, are adding to the risk of the large investors. Criteria need to be developed so that infrastructure can qualify for a certain asset class, and then have access to capital. Multilateral banks such as AIIB have a role to play in this process, along with the G20 and many major financial institutions that are already engaged. The aim is to **make investment in sustainable infrastructure a bread and butter business option for big asset managers**.

The panel noted that the situation has changed markedly for green finance in China in recent years. It has only been within the last couple of years that **the idea of environmental risk has been tied to financial risk**. Ten years ago, a company based around sustainable finance was not viable in China. Banks did not understand the need to consider environmental and social risk. However, large companies were developing sustainability strategies. This shows that banks and institutional investors are slow to respond to the market situation. Now, there is a booming market in green finance. This is partly due to the seriousness of China's environmental challenges, such as air pollution, and a greater awareness of risk in the financial sector.

The panel observed that in the past, typical Asian investors did not generally see environmental issues as tied into financial investments, and thus tended to separate them into two distinct categories. Part of the change that has occurred is also that **'dirty' industries now often do not make money**. Huge over-capacity exists in steel, cement and coal. A correlation can be drawn between stock prices and air pollution levels. By contrast, **there is now money to be made by investing in green infrastructure**, although there is much more that needs to be done before it is sufficient.

China has developed two approaches to encouraging green finance. The first was through green lending guidelines, released in 2012. These guidelines emphasise a broad set of goals, including: environmental risk management, product innovation, and in-house environmental management. Second, the past 12 months has seen the rise of green bonds in China. Currently Chinese companies own $40-50 billion in green bonds – 40% of the global total – however this is not nearly enough to address the environmental problems sufficiently. **The next step is the development of national-level and local-level green funds**. These will focus on helping SMEs working on technology to reduce pollution.

The panel noted that, in addition to facilitating green finance, **regulatory incentives can be important for improving environmental performance**. China currently has four policy tools in this regard: daily fines, halting operations, confiscation of product, and prosecution through the court process. The first of these is often not very effective, as the level of fine imposed is not very high. The other three, however, can have a big impact, through either the cost of restarting the production line, or reputational risk with clients.

In many countries, **there is inertia to carry on the status-quo** – funding coal power which is at the surface the cheapest path. However now there are **country based** global commitments, which imply fundamental changes. The economics is also changing, with technology becoming more affordable. Environmentally-friendly technologies require large amounts of capital but very small operating costs. Currently we are living in a period of unprecedented globally low interest rates and so, with the addition of technology becoming more affordable and operating costs so low, from a financial perspective if banks could give investors access to these, the profile of sustainable projects would look very different. The panel agreed that a key component in aiding the conversion of successful capital in to sustainable projects was that more banks – and in particular Chinese banks – should try and get on board with providing easy routes for lending.

The AIIB is just one example of China's "going out" strategy, which also includes the Belt and Road Initiative, among others. Guidelines were issued last month on the promotion of a green finance system in China. The guidelines included **a requirement that overseas investment be clean and green**. The Green Finance Committee will study how to make this a reality for the State-Owned Enterprises and major banks.

The panel considered **why there are not more banks in China currently promoting green finance principles**, for example only the China Industrial Bank has signed up to the Equator Principles. The reason that the Industrial Bank has accepted the Equator Principles is due to an historical relationship with the International Finance Corporation (IFC) which contributed to internal reform. Other banks, however, are hesitant to adopt international standards due to sensitivities around international relations. For the larger banks, such as ICBC and ABC, the adoption of the

Principles would entail a very large portfolio of loans to be screened. ICBC, however, has conducted stress-testing on the power and cement sectors, which gained significant international attention. **This is a critical step for big banks with significant lending to heavy industrial sectors**, as the increasing external costs of such industries will greatly impact their risk.

Proper assessment of risk is based on evidence, so the availability of data is important. **Currently there is not enough accessible data in China**, although big data has a very important role in potentially helping to assess the market situation and risk. Now the government is encouraging public disclosure around information sharing, which is very helpful.

There is a fear that has been expressed that **emerging countries forming new banks may undermine the work of established banks**. The BRICS countries, however, are trying to send a coherent message that given they are countries are shareholders and that they also have so much riding on this agenda, they will be additional, and not take away from the work of others. Important for this to be realised in practice, is the establishment of adequate grievance mechanisms. AIIB has such a framework in place, and consultation must take place with all the affected communities. The AIIB is also very keen to engage on policy with outside stakeholders, including industry, government, and the private sector.

With all the progress that has been made, it is still small compared to the scale of capital required. **The panel concluded that there is no silver bullet**. There is not always a clear way to turn the need for infrastructure into economic demand. For this reason, strong direction from government can give investors the confidence to invest and sign contracts. The amount of capital being discussed is large, and perhaps daunting. The panel suggested three scenarios: business as usual, policy adjustments for Paris, third recognising constraints. All three require comparable amounts of investment, they are distributed differently. **Meeting the goals of the Paris Agreement, therefore, is achievable**.