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COP26: CHINA'S GREEN FINANCE AGENDA

— THOUGHT LEADERSHIP

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China has pledged to be carbon neutral by 2060. It's a huge ambition and will require a vast amount of domestic and international investment. Our experts examine China's green agenda, the opening up of its financial markets and what this means for international businesses and opportunities.

International sustainable finance

Sustainable finance is increasingly fashionable, but there is no single definition of what it is. In the context of the international capital market, typically, it falls within two particular sets of principles and standards, one established by the International Capital Markets Association (ICMA), known as the Green Bond Principle (GBP) and the second, the Climate Bonds Initiative, an NGO that has established the Climate Bond Taxonomy. "These are both market-driven on a voluntary basis and are regularly updated. They pretty much govern the market in terms of the process of assessing and evaluating whether a bond and its connected proceeds would be regarded as being 'green'," says David Tsai, a Hong Kong-based partner in Clifford Chance's capital markets practice.

In terms of green derivatives there are several types seen globally, from the traditional transactions PROVIDING long-term green projects such as renewables with traditional hedging involving interest rates, FX and retail price index transactions, to the newer transactions involving developing areas such as wind indices and the trading of renewable energy certificates. "We've also seen a resurgence of some of the more classic, catastrophe-related derivatives, and ESG-related credit derivatives with index trading where there's an ESG criteria and a recognition that, perhaps, good ESG companies also provide better returns and less risk. There are also exchange-traded products such as options or futures that link to ESG indices." These are all growth areas, but I would say that a new green derivatives market in light of ESG goals is still quite nascent when it comes to a real identity," says London-based, Clifford Chance Partner, Paget Dare Bryan who heads the firm's international derivatives product group.

China's green bonds, funds and derivatives

The Chinese green bond market is the second largest market outside of the US in terms of issue size and capacity. In 2015, the Chinese government announced its intention to create a green financial system and the National Development and Reform Commission (NDRC) which is responsible for China's policy direction, and the People's Bank of China (PBOC), the de facto bank of China, have both formulated respective green bond principles. The PBOC typically governs the financial sectors, whilst the NDRC typically regulates state-owned enterprises and other corporate enterprises. It was a regulatory-driven process, both in terms of the types of projects that were eligible and the methodology used to assess whether something was 'green' and was not being market-formulated as the green bonds standards promulgated by the ICMA. "There were some discrepancies between what the NDRC and the PBOC outlined as eligible. Over time, every year or so, there would be an iteration, an amendment, an update to the catalogue, and an update to the rules, so China's domestic green bond market has become fragmented and it was difficult for domestic and international investors to work out their equivalence to international standards," explains Tsai.

As a result, in 2020, the PBOC and the NDRC announced a consultation to unify the green bond principles that are applied within China. In April 2021, the PBOC, in conjunction with China's key regulators, published the Green Bond Catalogue which took effect on 1 July, and applies to all green bond products within China. "It should hopefully mean that there is less fragmentation, and is a clear step that China is ensuring that, domestically, standards are consistent. In particular, fossil fuel is no longer eligible, so China has, on that front, moved to align with international standards," Tsai says.

ESG investment in China

"China was a late starter in terms of ESG investment but the Chinese government's aim for peak carbon dioxide emissions before 2030 and to achieve carbon neutrality by 2060 means that momentum is gathering very quickly," says Ying White, a Beijing-based Partner who heads the China funds and international management group.

She says that Chinese mutual funds are very active in ESG investment – by the third quarter 2020 there was RMB420 million worth of ESG-focused index funds and actively managed funds. "It seems to be a very organised, very active and very much in contrast with the private equity sector, which is not as organised in terms of disclosure and reporting requirements. It's hard to see a clear picture in the private equity sector," says White.

China's self-regulatory organisation – the Asset Management Association of China (AMAC) – issued the first green investment guidelines for private and public funds in 2018. In 2019 it issued a notice requiring fund managers to carry out an ESG self-assessment report detailing how they are incorporating ESG into their operations. "The data gathered showed that government-guided funds are actively incorporating ESG factors into their decision-making," says White.

ESG and the derivatives market

"The ESG derivatives market is small but it is growing within Hong Kong and there are opportunities of growth within China. It's currently still very limited, pretty bespoke to the actual transaction, and quite specific to the counterparty and the financial and business environment of that counterpart[y]," says Dare Bryan. Some dealers have tied the hedging element of a transaction – FX or interest rates – to sustainability goals with their clients; so, for example, payouts are made if targets are met."

He adds, as an example of a sustainability-linked derivative in Asia, that in Hong Kong, BNPP and Hysan, a property investment, management and development company, developed a 15-year cross-currency HK/US$ swap which provided that Hysan would make contributions to charity if certain sustainable goals were not met. These goals required Hysan to remain in the top 20% of Hong Kong companies in the Hang Seng Corporate Sustainability Index.

Of particular note, the recent opening of the Guangzhou Futures Exchange – in which the Hong Kong Exchange has a 7% stake – is expected to provide further opportunities in China, the GBA and Hong Kong for developing green financial products.

China and emissions trading

China's statement that it will be carbon neutral by 2060 will require an estimated US$21 trillion in investment, according to research from Tsinghua University in Beijing. "China's financial services will clearly play a critical role in mobilising these investments, but China can't do it on its own. International co-operation is needed and Beijing has highlighted its willingness to work with the international community to advance global environmental governance," says Maggie Zhao, a London-based Partner in Clifford Chance's Global Financial Markets group.

Emissions trading is already well-established in the EU. As Dare Bryan says: "It has become auction-led and we've seen recently quite a high increase in the price of carbon futures. There is interest in growth and trading of them, both on futures and options. We have also for many years had an OTC derivatives market that uses specific annexes produced by ISDA that allow parties to access the contracts; and we've seen the development of bank note issuances that are linked to carbon pricing. We have even seen developing a repackaging carbon market too, so it's an asset class not just not just for emitters, but also for investors."

China's market was established just three years ago, but has boomed since February 2021, when the Ministry of Ecology and Environment produced rules around trading. "China is suddenly the largest emissions trading systems (ETS) market in the world, priced somewhere around about US$800 million for this year but worth up US$25 billion by the end of the decade. So we are going to see potentially quite a market opportunity," he says. China is taking a rates-based approach rather than focusing on cap-and-trade, which means that it is looking at how emitters produce their power and is trying to produce some elements of restraint. The developing expectation is that "Those who produce electricity below the benchmark that has been set will be able to sell their excess, thus supporting the efficient producers, and that's a good business model," he says.

There is also an offset market in China that looks set to grow. "China is very good at looking at other countries, seeing what they have done and what has not worked so well. In the past 15 years or so, the EU scheme has raised a number of questions around volatility, documentation, observance by emitters and penalties. Although we can clearly expect some developmental issues in China, they've been very good at bringing in better technology and, perhaps, better monitoring," he says.

Future opportunities

Local governments in China are actively using the Qualified Foreign Limited Partner (QFLP) programme to incentivise and attract global fund managers ¬ – mostly in private equity – to set up in their jurisdictions and make investments, while at the same time applying local ESG goals. A recent example is a London-based climate fund which set up joint venture funds with a local Chinese state-owned company to make climate change investments.

Global fund players are bringing into this market the methodology to incorporate ESG factors, such as consistent disclosure and reporting measurements into the decision-making process, and Chinese regulators are starting to incorporate international standards in the bond and securities market. As David Tsai explains: "It's seeking to align its securities market in terms of disclosure towards what international investors would expect in terms of ESG." The China Securities Regulatory Commission (CSRC) (the SEC-equivalent regulator in China) is expected to announce this year that it will impose mandatory ESG reporting requirements on bond issuers and listed corporates.

Further areas of development are the current China futures law, which will be helpful to the international financial community, and opportunities in derivatives. "If we end up with a real piece of netting legislation that gives a clear opinion on netting, that would reduce concerns around the current Chinese bankruptcy law and issues around bank resolution, and that would allow a lot more bank involvement in the derivatives market," says Dare Bryan.

What's next?

Ying White says that within the next five years the Chinese market is likely to see the development of ESG measurement, guidelines and a disclosure system. "Industry associations, professional associations and regulators are currently talking about the lack of a unified or consistent system. The question is whether it should be from the CSRC, from industry associations or self-regulatory organisations, such as AMAC, or from the stock exchange? I think this is going to be a high priority for China."

And David Tsai adds: "I think the Chinese securities market, not just in terms of ESG or green issues, but overall, was previously quite restricted to international investors. Over time it has opened more channels such as Stock Connect and Bond Connect, and hopefully China will open up further still to support its transition to a low carbon economy." He adds that in terms of COP26, whilst China is generally aligned with international standards, there remains some divergence still. "Discussions at COP26, either formally or informally, may trigger further revisions, so that's something to watch out for."

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