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Inquiry: Design of a Sustainable Financial System

ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 5: Promote the Issuance of Green Bonds

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Green bonds not only provide a low-cost source of funding for green credits and investments, but also reduce the risk of maturity mismatch. We recommend that China commence the pilot issuance of green bonds at the earliest possible date to support the green lending business of banks. China should also hasten its pace in formulating policies that permit and encourage companies (or enterprises) and local government to issue green bonds. This paper will focus on the discussion of green bonds, while green bonds issuance by relevant companies and local governments will be discussed in another paper.

Green bonds refer to the negotiable securities issued by financial institutions incorporated within the territories of the People's Republic of China in the national interbank bond market based on the commitments of principal and interest payments. Most of green bonds are issued by policy banks, commercial banks, financial companies of corporate conglomerates, and other financial institutions.

Over a long period of time, the issuance of financial bonds has been dominated by policy banks, which are responsible to raise capital for projects supported by national industrial policy in such areas as key projects, agriculture and import and export. In accordance with the *Opinions of the State Council on Further Promoting the Development of Small and Medium-Sized Enterprises* (SMEs), in 2009, the CBRC expressed its encouragement of the special financial bonds to support SMEs issued by commercial banks. By the end of September 2013, Chinese commercial banks issued a cumulative amount of 292 billion yuan (US$47 billion) in financial bonds of small and micro businesses, which vigorously supported the credit issuance by SMEs. On July 1, 2013, the CBRC promulgated Notice on Relevant Matters Concerning the Issuance of Special Financial Bonds Relating to Agriculture, Farmers and the Countryside by Commercial Banks. Without doubt, the launch of special financial bonds for the second time reaffirms the effectiveness of special financial bonds.

The World Bank issued the first green bond in 2008. Merely six years later, the total green bonds issued globally in 2014 stood at US$40 billion. Currently, the IFC, the Asian Development Bank, the European Investment Bank, along with a number of sovereign states such as the UK, India, Canada and Iceland, have all issued their versions of green bonds. Internationally, green bonds have already become a very mature green financial product. Their long maturity and low financing cost are well suited to the needs of the green investment projects, and thus are welcomed by both investors and project owners.

(I) The case for issuance of green bonds by Chinese financial institutions

Since the inauguration of the 12th Five-Year Plan period (2011-2015), economic restructuring and sustainable development have become the dominant themes of China's domestic economic development, and energy conservation and environmental protection industries have gradually become new drivers of China's economic growth in the process of economic transition. After rounds of phase-out and consolidation, China's energy conservation and environmental protection industries have already demonstrated a robust momentum of rapid and stable development and emerging technologies and products require extensive financial support. Meanwhile, China's domestic financial system is experiencing the acceleration of interest rate liberalization and the swift emergence of Internet finance, which have posed challenges to the intrinsic business models of banks and created pressures on credit issuance including capital restrictions, deposit drains and cost increases. Green bonds enjoy a strong market demand with great potential to promote China's economic restructuring and become an important business of financial innovation. Given these characteristics, the development of green bonds is a timely initiative.

1. Consistent with the needs to develop energy conservation and environmental protection industries

In the *Opinions on Accelerating the Development of Energy Conservation and Environmental Industries* (the State Council [2013] No.30 Document) promulgated in 2013, the State Council identified an objective to maintain an annual growth rate of energy conservation and environmental protection industries above 15 percent to reach an aggregate output value of 4.5 trillion yuan (US$730 billion) by 2015 to become a new leading industry of the economy. According to statistics, China's environmental investment programs require total investments worth 5 trillion yuan by 2020 (US$800 billion) (including 1.7 trillion yuan of air pollution treatment and 2 trillion yuan of water pollution treatment), which represents a massive financing demand. However, due to complicated technologies and long investment cycles, energy conservation and environmental protection projects have extensively encountered the problems of difficult and costly access to financing and traditional financing instruments may no longer satisfy a tremendous financing demand. In this context, the development of innovative financial investment and financing models must be carried out to address the financial needs of energy conservation and environmental protection industries.

2. Promising experimental field for exploring financial innovations

Existing investment and financing models should be modified to explore innovative business development patterns for bank credit lending as a major new source of financing for energy conservation and environmental protection industries. According to the *Development Plan for Energy Conservation and Environmental Industries during the 12th Five-Year Plan Period* (2011-2015), banking institutions shall be encouraged to engage in financial innovation and increase the intensity of their support to energy conservation and environmental protection industries on the condition of meeting regulatory requirements. Relevant documents including the *Opinions on the*

Development of Energy Conservation and Environmental Industries have also identified specific requirements on the financial support to green industries, including efforts to steer financial institutions towards increase credit issuance, conduct innovation of financial products and services, adopt new methods of guarantee, introduce guarantee institutions, encourage environmental companies to issue debt financing instruments, and encourage and steer private and foreign investments. Energy conservation and environmental protection represent an emerging market segment of China brimming with inestimable investment opportunities. Issuance of green bonds and increased financial support to green finance represent an innovative pathway to support financing services. The concept of green credit and financial innovation can be further integrated to bring about opportunities for further development of green credit services.

3. Promote economic restructuring and targeted stimulation

Since the proposition of the concept of green credit in 2011, the CBRC has been expediting the inclusion of environmental and social risk management into the credit system of financial institutions and steering financial institutions to adjust their credit structure and increase credit issuance in sectors of energy conservation and environmental protection. In 2009 and 2013, the CBRC encouraged the issuance of special financial bonds respectively for SMEs and agriculture by commercial banks, which had a favourable impact on guidance. Trickle-down and targeted guidance as the intrinsic product characteristics of special financial bonds can be brought into full play as effective means for the accurate industry promotion of green credit.

4. Increase the mid-and long-term credit issuance capabilities of financial institutions

As an emerging strategic industry, energy conservation and environmental protection industries remain in the inception stage of development and the large number of technologies and services are being applied in the areas with favourable market prospects, while technology upgrade, new technology application and product innovation all require the implementation of construction, expansion and renovation projects. Therefore, demand for green finance also demonstrates the characteristics of significant volume, long duration and high overhead costs. A significant number of energy conservation and environmental protection projects require mid-and long-term credit support. Most Chinese commercial banks have adopted the structural mismatch of asset and liability maturities to offset the pressure of increasing interest rates. Inadequate proactive liability instruments of financial institutions and weak asset and liability management capabilities have considerably restrained the business initiative and risk tolerance of financial institutions in the area of green credit dominated by mid-and long-term project financing. According to international experience, financial bonds can serve as a long-term and reliable funding source and when matched with mid-and long-term financing projects of green credit, effectively address the structural mismatch of asset and liability maturities and become a proactive debt instrument to change the current situation of passive liabilities where the deposits of commercial banks account for the absolute majority and mitigate financial risks.

(II) Recommendations on promoting the issuance of green bonds

As a new type of financial bonds, green bonds can be offered by financial institutions on the basis of applications and approvals, and with reference to the experience of financial bonds for SMEs. Early stage experiments and pilot programs can use the definitions and categories for green investment under CBRC's green credit statistical system. Specific cash volumes of pilot programs can be individually determined in light of the financing scale and business volumes of commercial banks themselves under the control of overall volume by the CBRC.

1. Identify the boundary of green bond issuers and encourage individualized design

On July 4, 2013, the CBRC promulgated the *Notice of the CBRC General Office on the Submission of Green Credit Statistical Forms* (CBRC Office [2013] No. 185), which identified and defined 12 project categories for the collection of statistics on green loans. This is the most authoritative Chinese standard for the division of green credit areas. The statistical scope of green credit can be considered to serve as the boundary for the use of funds raised from green bonds. It is suggested that the PBoC and the CBRC jointly promulgate a document to clarify the definition, issuing procedures and fund use of green bonds.

At the same time, we recommend that in determining the investment target and issuance duration of the green bonds, considerations be given to the industry distribution and characteristics of the maturity structure of green credit issuance by various financial institutions, and, within the boundary set by the green credit statistical system, permitting financial institutions to submit specific plans for green bonds financing in light of such factors as their respective development status and industry focus. Efforts can be made to fully leverage the professional capabilities of financial institutions that have already made in-depth exploration in specific areas of green credit.

2. Create incentives for green bonds issuance

Regulatory authorities used to provide issuing banks with significant policy preferences in such areas as the loan-deposit ratio, risk weight and tolerance of non-performing loan (NPL) ratio of special financial bonds for SMEs and agriculture. In particular, loans in these areas are not included in the numerator for calculating loan-deposit ratio and are not subject to the policy of reducing the weight of risky assets. In this manner, financial institutions no longer worry about the allowance of risky assets and the restriction of loan-deposit ratio in issuing loans, which has effectively motivated the enthusiasm of commercial banks for credit issuance to SMEs and areas relating to agriculture, farmers and the countryside.

Areas for the issuance of green bonds are consistent with those identified by the *Opinions of the State Council General Office on the Financial Support of Economic Restructuring, Transformation and Upgrade*. Different from special bonds for SMEs, green bonds are characterized by the high proportion of project loans, long investment recovery cycles and low project return, thus uncompetitive compared with other types of credit issuance by banks. In order to safeguard the success of green bonds, it is suggested to consider adopting the following policy incentives:

- Allow **commercial banks** to exclude loans backed by green bonds from the calculation of its loan-deposit ratio (as long as they show that they keep accurate account of risks, have sufficient capital, and run a successful green financing business).
- Allow **financial institutions** that meet the required capital to risk asset ratio and are capable of providing sufficient capital, to have access to 75% preferential risk weighting and preferential capital regulation requirement per the relevant provisions of the *Administrative Measures on the Capital of Commercial Banks (Trial Implementation)*.
- **Banks that invest in green bonds**, should be permitted to apply a 50 percent multiplier for the portion of risk asset corresponding to the green bonds they hold when calculating their capital to risk asset ratio;
- **Institutional investors** that have subscribed to green bonds should be entitled to the same tax exemption policy as for treasury bonds. For corporate investors of green bonds, for instance, interest revenues received by investors from issuers should be fully exempted from corporate income tax.
- For **enterprises that receive the capital raised through green bonds**, encourage their local government to allocate a portion of its budget to provide discounted interest rate for part or all of the loans the enterprises have taken out.

3. Create a follow-up evaluation system to quantify the environmental effects of green bonds

Regulators should identify specific requirements on the use of proceeds raised from green bonds. For instance, specialized institutions or departments (such as eco-finance divisions) should be responsible for fund use and management, and create dedicated accounts for fund operation. That is, the use of funds raised from green bonds should be limited within the statistical scope of green credit identified by the CBRC and an evaluation system should be put into place after the issuance of bonds and loans. This system should not only evaluate the present use of funds by financial institutions, but also assess and evaluate on the environmental protection and energy conservation effects of the funds, so as to realize the supervision, management and evaluation of green bonds over their entire life cycles.

4. Gradually streamline review and approval procedures and increase bond issuance efficiency

Given that the proceeds raised from issuance of green bonds will be allocated to energy conservation and environmental protection industries that are supported by current policies, we recommend that the review and procedures for the issuance of green bond be streamlined by consolidating the serial approval process involving CBRC and the PBoC into a parallel one, which will shorten the approval time, enable financial institutions to take advantage of the optimal time to issue bonds, increase the flexibility of interest rate inquiry, and enhance market efficiency.

THE GREEN FINANCE TASK FORCE

The Green Finance Task Force was initiated by People's Bank of China (PBC) Research Bureau and the UNEP Inquiry into the Design of a Sustainable Financial System in 2014. The Task Force brought together leading Chinese financial policy and regulation experts together with experts from the private sector, academia and think tanks, as well as international experts.

A number of organizations have lent great support to this Task Force, chief among them are Chongyang Institute for Financial Studies of Renmin University, the Ecological Finance Research Center at the Renmin University of China, the Eco Forum Global, the International Institute for Sustainable Development, the Green Credit Special Committee of China Banking Association, and China Finance 40 Forum.

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