A green China – what you need to know by Ken Hu

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Going green has emerged as a key component of China's current growth plans as the country sets its sights on addressing pollution concerns and ensuring a sustainable future. Ken Hu, Chief Investment Officer, Fixed Income, Asia Pacific, published a whitepaper in October **(China green bonds: A sustainable asset class)** that examines the country's growing appetite for green finance and the emerging investment opportunities.

In this Q&A, Ken revisits the topic, answering some common questions about where green finance is heading in 2018, discussions from China's 19th Party Congress and what role sustainable development will play in the "One Belt, One Road" (OBOR) policy.

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1. What is green finance?

The term green finance generally refers to products and services that either directly provide funding for projects which improve the environment or indirectly incentivize eco-friendly best practices. Once a niche area, it now comes up during many of my conversations with investors as environmental, social and governance (ESG) considerations have become more mainstream in Asia Pacific over the past few years. Sustainable investment assets, a broader classification that includes green finance, increased five-fold in the region between 2014 and 2016 to more than US$1 trillion.[1]

Green bonds are one of the financial instruments in this area that my team and I closely monitor. They are fixed income securities that use proceeds to fund environmental projects like water management in Brazil, forest restoration in China and geothermal energy in Indonesia.

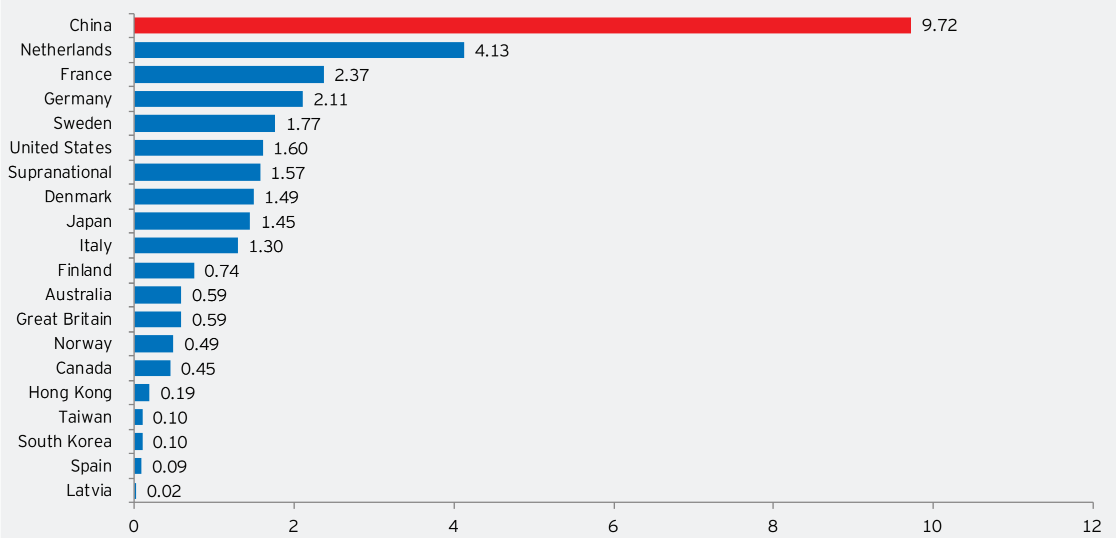
2. How does China rank globally in green bond issuance?

Despite only issuing its first green bond in 2015, China has already emerged as the world leader with more than US$60 billion in total issuance. Globally, green bonds raised more than US$130 billion in 2017 and that is in large part due to China which outpaced all other countries and supranational organizations with more than US$30 billion in issuance. To put it in perspective, that amount exceeds the past four years' worth of issuance from the United States and the total combined sum from Sweden, Canada, Spain, Japan and South Korea.[2]

The pace of green bond issuance in China has also increased recently. In the fourth quarter alone, the country accounted for about one-third of the global total, exceeding the combined amount from the next three largest issuers (Figure 1). This is a positive signal and suggests that the green bond market in China could remain robust heading into 2018.

1. "Global Sustainable Investment Review 2016." Global Sustainable Investment Alliance, retrieved 15 November 2017.
2. Bloomberg, data in USD as at 23 November 2017.

Figure 1: Amount of green bonds issued in Q417 (USD billions)



Source: Bloomberg, Invesco. Issuances in all currencies from 1 October 2017 to 17 December 2017 are included.

3. Do green bonds in China adhere to global standards?

As I speak with global investors about China's rise in green bond issuance, they also want to know whether the investments are truly ESG-compatible and would raise funds to generate meaningful environmental benefits. Research shows that what constitutes a green bond in China is broadly aligned with global standards. In H12017, more than 75% of a total US$11.5 billion in Chinese green bond issuance met international definitions, according to the Climate Bonds Initiative.[3]

The main point of differentiation is that investment in "clean coal," which reduces the emissions and harmful pollutants from the fossil fuel, is considered an acceptable sector for green financing in China but not in most other countries. With most of its energy currently coming from coal, China sees "clean coal" as a bridge to a diversified power mix that includes increasing contributions from renewable sources. Aside from "clean coal," China green bond proceeds are mostly earmarked for areas more in line with global expectations like mass transit, watershed management, wind power and desertification control.

4. What is driving the appetite for green finance in China?

There has been overwhelming support for sustainable development initiatives in China recently as the government looks to address rising pollution. Years of robust economic growth on the back of resource-heavy industries like manufacturing, petrochemicals and mining pose both health and environmental risks. President Xi Jinping emphasized the country's commitment to sustainable development in May this year, saying that China must safeguard the environment "like one protects one's eyes" and regard it "as one treats one's life."[4] It's also worth mentioning that China remains a vocal supporter of the Paris Agreement, in contrast to the US which announced its intention to withdraw from the landmark environmental accord.

In order to provide the funding needed for China's sustainable development, green finance must continue to expand in depth and breadth. I expect foreign investors will look to step in and add exposure to this asset class now that access to China's onshore bond markets has been simplified through new schemes like the Bond Connect program.

3. "China Green Bond Market Mid Year Report 2017." Climate Bonds Initiative, retrieved 30 September 2017.
4. "Xi stresses green development." Xinhua 27 May 2017.

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5. How was green finance discussed during China's 19th Communist Party Congress?

Green finance was a major topic of discussion during the twice-a-decade Communist Party Congress held in October. President Xi took his commitment to sustainable development one step further and codified it as a point of emphasis within the constitution. Under the "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era," which was included as a constitutional amendment, one of 14 listed principles to uphold is "ensuring harmony between human and nature."[5] This guarantees that sustainable development will remain a focal point for future policies and initiatives.

Meanwhile, the pace of growth in China's green finance market also looks set to increase. Yang Weimin, deputy head of the Office of the Central Leading Group on Finance and Economic Affairs, spoke about the scale of future development. He was quoted in local reports, saying "In terms of the green market growth, the current development is not sufficient, meaning huge potential in the future."[6]

6. What role will green finance play in China's "One Belt, One Road" (OBOR) policy?

The OBOR policy could significantly scale up the China green bond market. For one thing, there is an increasing need for fixed investment financing as China develops state-of-the-art, far-reaching infrastructure links with the rest of the world. On top of that, President Xi has repeatedly emphasized the government's preference for sustainable development. Signaling the start of a potential trend, a major Chinese issuer recently launched a green bond that pledged to use proceeds specifically for OBOR projects in areas like wastewater management and renewable energy.

China has also partnered with the United Kingdom to form a green finance task force and map out how to "green the Belt and Road." In a report released this year, the group set a goal of increasing private investment in green financial instruments linked to OBOR projects and made several recommendations like creating an investor alliance and improving asset transparency.[7]

7. What is the investment performance of green bonds?

While green bonds have been in the market for only a decade, early evidence suggests that they are a viable asset class for ESG-driven and non-ESG-driven investors alike. For green bonds issued globally during the five quarters through March 2017, spreads generally tightened after new deals were announced and post-issuance performance also exceeded that of the corresponding secondary market.[8] In China, benchmark green bond indices have outperformed both central government bonds and the aggregate overall bond market (Figure 2).

5. "CPC rolls out Thought on Socialism with Chinese Characteristics for a New Era as guideline." China Daily 18 October 2017
6. "Reforms will boost role of green finance, official says." China Daily 23 October 2017.
7. "Greening the Belt and Road." Green Finance Initiative and Green Finance Committee, retrieved 15 November 2017.
8. "Green bond pricing in the primary market: January 2016 – March 2017." Climate Bonds Initiative and the International Finance Corporation, retrieved 30 September 2017.

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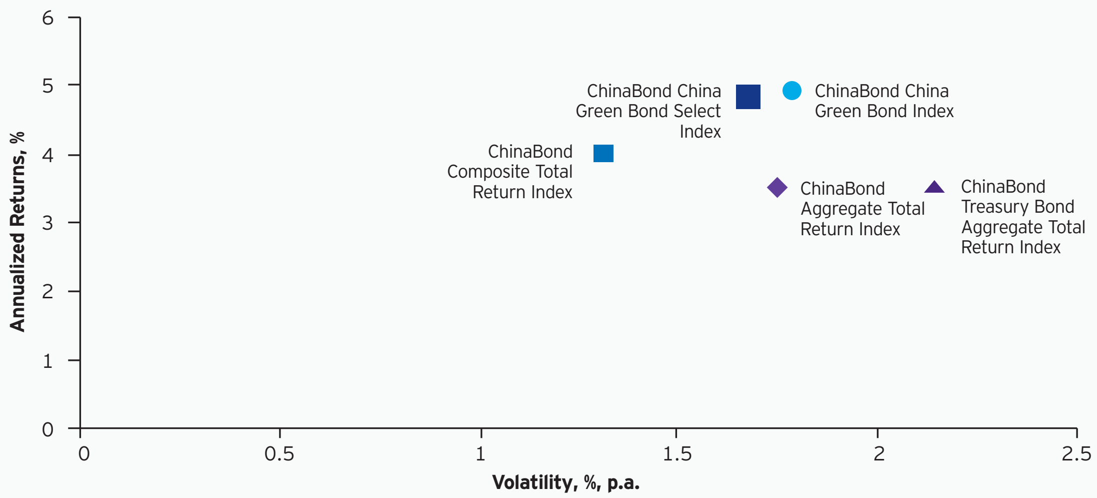
Investors in China green bonds may also have more confidence doing due diligence ahead of a potential investment, knowing that issuers face additional layers of oversight since government authorities require transparency around the use of proceeds. Another distinctive factor is that the majority of China's green bonds are considered investment-grade by onshore ratings agencies.

Figure 2: ChinaBond index return vs volatility



Source: ChinaBond, Bloomberg, Invesco, data from 31 December 2009 to 30 September 2017.

8. What is your approach to responsible investing?

There are many different ways to approach responsible investing. From an organizational level, we at Invesco are committed to adopting and implementing responsible investment principles in a manner that is consistent with our fiduciary responsibilities to clients. Within our fixed income group, we believe the first step is understanding each client's beliefs and values related to either ESG issues or impact-investing. The next step is using a detailed analysis to customize the widest possible range of investable securities that meet both the ESG mandate and the client's investment objectives. From there, the final step is formulating an ESG-tailored investment strategy with appropriate governance and risk parameters.

We believe that "active ownership" is the most effective mechanism to ensure responsible outcomes from our investments. In fixed income, active ownership means actively engaging in the bonds that we own. This requires purposeful engagement with corporates and sovereign entities to ensure they are taking steps to achieve ESG-oriented goals. Our research at Invesco suggests ESG initiatives may be particularly impactful among institutions in developing countries.

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