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Client Alert

Navigating the Green Bonds Markets in China

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Executive Summary

China's climate change objectives under the Paris Agreement will require it to invest a massive amount of capital into growing its domestic renewable energy generation, as well as invest in other emissions-reducing efforts. The government of China has adopted a green financing initiative that includes regulating its green bond market.

Green bond guidelines have been issued by the various regulators of the domestic (CNY) bond markets to encourage capital raising. These bond guidelines have led to RMB 34 billion of issuance in the first quarter of 2016 alone, with a required target of RMB 300 billion annually.

Although recent developments have made access to the CNY interbank bond markets easier for foreign investors (e.g. investment managers of pension funds and insurance funds), it is important to understand that there are important differences between international and Chinese green bonds.

Introduction

Under the Paris Agreement, China has committed to reduce its carbon dioxide emissions per unit of gross domestic product by 60-65 per cent by 2030 from its 2005 levels, and to increase the share of its non-fossil fuels in primary consumption to around 20 per cent. This will necessitate a massive investment into renewable and nuclear energy and away from coal-fired power generation. According to China's Financial Research Institute at the State Council's Research Center, this investment translates into RMB 2.9 trillion (US$460 billion) worth of investment annually in the next five years. The government also wants 70 per cent of that investment to come from the private sector. It is expected that potentially RMB 300 billion of this could be annually financed by green bonds.

The purpose of this paper is to guide investors on some of the issues relating to investments in green bonds in China. This paper should be read as complementary to our other paper on the global green bond markets.

Background

The State Council of China announced plans in 2013 to grow a corporate green bond market as part of meeting the objectives of the 12th Five-Year Plan to assist China's transition to a low-carbon green economy. The promotion of green finance to facilitate the development of the low-carbon green economy and the reform of China's bond market is a major focus of the 13th Five-Year Plan, which is intended to serve as the roadmap for the development of China's economy between 2016 and 2020.

This focus has led China to develop a green financial system as a market-based institutional arrangement which provides regulations relating to green securities, green credit and green insurance. Unlike other countries, where green bonds are unregulated, China has chosen to regulate its green bond market with the primary purpose of using it to facilitate a targeted approach to China's transformation of its energy economy and, therefore, to use policy as a key driver to achieving this ambition.

In 2014, China set up a green finance task force comprising 40 experts to assess and advise on the best way for China to deliver on its decarbonising ambitions. This task force produced a detailed report in April 2015[1] and that, in turn, gave birth to the Green Finance Committee of the China Society of Finance and Banking **(GFC)**. The GFC is led by China's central bank and includes an elite group from China's financial community including the top tier regulators, banks, asset managers, insurers and thought leaders[2] .

The elite status of this group demonstrates the political will behind the green finance initiative in China and is an indication of the greater likelihood of its success. Within a short time since the report of the Green Finance Task force, we have already seen the publication from the People's Bank of China **(PBoC)** of the Green Bond Guidelines, the Green Bond Endorsed Project Catalogue[3] and the publication by the National Development and Reform Commission **(NDRC)** of its guidelines on green bonds, linked to fiscal support for infrastructure investment. The NDRC guidelines include a list of 12 priority areas in energy conservation and emission reductions, climate change and green industries.

The Regulations

The regulation of the Chinese bond market has been split based on the class of bond instrument.

Class of Instrument	Market	Relevant Regulator
Treasury bonds, local government municipality bonds	Interbank Exchange[4]	Ministry of Finance
Financial bonds[5]	Interbank	PBoC
SOE enterprise bonds	Interbank Exchange	NDRC
Non-financial enterprise debt financing instruments [6]	Interbank	National Association of Financial Markets Institutional Investors(NAFMII)
Corporate bonds[7]	Exchange	China Securities Regulatory Commission (CSRC)

Not all of the above regulators have published their green bond guidelines. For example, NAFMII, which will publish guidelines to follow for non-financial enterprises wishing to issue green debt financing instruments, is not expected to publish its guidelines until the middle of 2016.

Of the guidelines that have been published, the following observations may be made:

- The PBoC guidelines only relate to the inter-bank CNY bond markets. However, they also apply where overseas financial institutions wish to issue green 'panda'[8] bonds.
- In comparison to guidelines for other green bond standards outside China, the notable feature of the PBoC and NDRC's guidelines is the eligibility for clean coal equipment purchase, facility construction and operation to be funded by green bond proceeds. Outside of China, it is universally accepted that funding of fossil fuel power generation does not qualify for green bond classification. Although in the Chinese context and its vast number of coal-fired power plants (many of which are new), this makes sense, it does mean that something labelled 'green' in China, many not be 'green' outside China. This could certainly limit its appeal to international investors looking to invest in Chinese green bonds, or it will require those investors to carry out additional diligence prior to the purchase of the bonds to ensure the prospectus does not include clean coal utilisation as a category of the green industry to be funded from the proceeds of issuance.
- It is also notable that the PBoC's guidelines encourage the use of second opinions but do not mandate it. A second opinion is a document issued by third party certificating or auditing entities that certifies the 'green' nature of the bond at the point of issuance. Outside of China, the current trend is towards the requirement of second opinions, but this is not universal and is very much an investor-driven requirement. Similarly, if Chinese green bonds are to appeal to investors outside China, then they will have an opportunity to ask this of issuers during the 'marketing/roadshow' stage of the bond.
- The NDRC guidelines create the incentive for the issuance of green bonds by facilitating the ease of access, for example by (i) permitting the funds raised through the green bond issuance to account for 80% of the total investment of the project in question, (ii) provided that the issuer's debtto asset ratio is below 75%, not taking into consideration the scale of the issuer's existing debentures when reviewing its green bond issuance amount, and (iii) lifting the requirement for the green bond issuer to have a bond issuance quota (which would otherwise be required for issuance of conventional bonds).

Rapid Growth To Date

The green bond market in China is off to a rocket start. In just the first quarter since the publication of the PBoC guidelines, there have been three major issuances as summarised in the table below.

Issuer	Amount	Date of Issue	Term
Shanghai Pudong Development Bank Co	RMB 20bn (US$3.03bn)	January 2016	3-year
Industrial Bank of China	RMB 10bn (US$1.52bn)	January 2016	3-year
Bank of Qingdao	RMB 4bn (US$610m)	March 2016	3-year (Tranche 1) 5-year (Tranche 2)

(Note: Exchange rate for RMB/USD = 6.61 applied for the purpose of this table with rounding.)

According to some estimates, it is expected that China will reap RMB 1.5 trillion (US$227 billion) for renewable energy and environmental projects within the next five years.

Beside these domestic green bonds, previously a number of 'dim sum'[9] green bonds had also been issued in the London offshore RMB (i.e. CNH) markets, such as:

- The International Financial Corporation's RMB 500 million bond in 2014 on the London Stock Exchange
- PBoC's RMB 5 billion bond in October 2015
- The Agricultural Bank of China's triple-tranche dual-currency bond in October 2015

The RMB 600 (US$94.53 million) tranche had a two-year maturity, whereas the US$400 million tranche had a three-year and the US$500 million tranche had a five-year maturity respectively.[10]

Among other developments, the Shanghai Stock Exchange has issued a notice on corporate green bond issuance and listing. These rules provide for green bonds to be issued by different types of issuers with the blessing/approval of their respective bond regulators. The notice also refers to the ability to list qualified foreign green bonds. To complement this, Shanghai Clearing House has also announced that it plans to issue a green bonds index.

Furthermore, the establishment of a Green Development Fund is provided in the official 13th five-year plan.

Potential Further Growth

The publication of the PBoC's Green Bond Guidelines certainly facilitates panda green bond issuance for those interested in selling into the domestic Chinese markets. The issuance of green 'dim sum' bonds also helps with the further internationalisation of the Renminbi and adds momentum to the loosening of capital market restrictions in China.

Green bonds can also be a vehicle to channel financing into infrastructure projects in China and other Asian countries. The China-led establishment of the Asian Infrastructure Investment Bank (AIIB) is also expected to have a significant role to play in the Asian carbon finance space. For example, the AIIB's Environmental and Social Framework includes a statement in support of "investments promoting greenhouse gas emission-neutral and climateresilient infrastructure, including actions for reducing emissions, climate-proofing and promotion of renewable energy" and is expected to be a driver for standardisation of green-financing concepts in the region.

Historically, financing for infrastructure projects has been done through bank debt. With the effect of Basel III beginning to bite on regional banks, the need to finance projects via the debt capital markets is being further recognised. This is leading to recognition that it is likely to be cheaper to fund debt though the capital markets in China than in the bank markets. The ability to issue longer-term debt via bonds is also important for green projects as it reduces the maturity mismatch between project development timelines and borrowing timelines.

Recent events such as the decision to add the Renmimbi to the International Monetary Fund's Special Drawing Rights (SDR) basket as well as the PBoC announcement[11] inviting a wide range of foreign entities (including commercial banks, insurance companies, securities companies, funds, asset managers, pension funds, charity funds and endowment funds) to directly participate in the domestic interbank bond (IBB) market without any quota restrictions, could create significant opportunities for the green bond market growth in China.

This will open up the world's third largest bond market to a much wider pool of overseas investors. In the past, only a limited group of RMB qualified foreign institutional investors (RQFIIs)[12] could participate in the IBB markets and, even then, with a quota limitation. It is notable that it is demand from asset managers that has led the growth in green bonds outside China. Therefore, increasing the ease of access to the IBB market for pension funds, investment banks and asset managers without any quota restrictions can only be a boon to green bond investors. After all, the RMB remains the highest yielding currency in the SDR basket of currencies at present and therefore, investment into the domestic bond market is no longer just an f/x play but also a yield play. With the cheaper cost of funding offshore no longer available as the driver for CNH bond issuances, the likelihood is that fewer issuances will occur in the overseas market, at least for now.

What To Watch Out For?

It is very easy to be lured by the size and scale of the green bond issuances in China. It is worth bearing in mind that many of the traditional bond issuers in China are state-owned entities or corporate entities with very close ties to the state. This raises concern about the size of China's domestic debt market and the increased recent awareness of its default rate.

In the past there has been an expectation on an implicit state guarantee for the debt obligations of many of the Chinese bond issuers. However, with at least seven companies reneging on bond obligations in just the first quarter of 2016, investors wishing to hold green bonds should not just look at the yield on the bond but also consider the issuer and its likely ability to service the debt. Although the PBoC's green bond rules require the proceeds of the issuance to be held separately for specific green investment use, they also allow for the funds to be invested in other money market instruments and other green bonds pending the fund proceeds being put to their prescribed use. Therefore, in a default of the issuer, the undisbursed proceeds may also be lost to other creditors of the issuer.

In terms of the various green bond guidance issued by the various regulators, not only are the standards different from international standards but there are also subtle differences in the standards of those that have been published by one Chinese bond market regulator to another. This will impact on the additional due diligence required by investors into Chinese green bonds.

Finally, although reporting on the use of proceeds is a feature of PBoC's Green Bond Guidelines, it is too early to tell whether the reporting will be sufficiently robust or if the information received following annual audits will lead to action by the relevant regulator. If active supervision does not come hand in hand with regulation of the green bonds market, it will give the impression that raising the funds is more important than ensuring their prescribed use in the context of China's green reforms.

Notes/ References

1 Establishing China's Green Financial System, April 2015 co-sponsored by the research bureau of the People's Bank of China and the United Nations Environmental Programme inquiry into the design of a sustainable financial system.

2 The committee's members include the Industrial and Commerce Bank of China, Agricultural Bank of China, China Construction Bank, China Development Bank, the People's Insurance Group of China, China Investment Corporation and China Galaxy Securities, along with 25 other financial institutions and organisations and another 54 non-executive members. In addition, the GFC also includes six international expert organisations: the International Finance Corporation, World Bank, UN Environment Programme, Principles of Responsible Investment, International Institute for Sustainable Development and Trucost.

3 Announcement No.39 of 2015 of the People's Bank of China.

4 These include the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

5 These include bonds issued by financial institutions that are development banks, policy banks, commercial banks, financial companies of enterprise groups and other financial institutions established under law.

6 These include super and short-term commercial paper, commercial paper, medium term notes, small and medium size enterprise (SME) collective notes, private placement notes, etc.

7 These include bonds issued by all companies (including SMEs) to the general public and qualified investors through public offerings or specific investors though private placements. Depending on the issuance methods and the type of investors, company bond issuance is subject to the approval by the CSCS or filing with the Securities Associate of China or the relevant exchange.

8 CNY bonds issued by non-Chinese issuers for sale into China.

9 CNH bonds issued outside China

10 In addition, Xinjiang Goldwind Science & Technology, a Chinese joint stock company, issued a US$300m green bond in April 2015.

11 PBoC Announcement No. 3 of 2016 concerning foreign institutional investors' investment into the interbank bond market, was issued and effective as of 17 February 2016.

12 And to a lesser extent, the qualified foreign institutional investor (QFII), which has historically been more equity focuse

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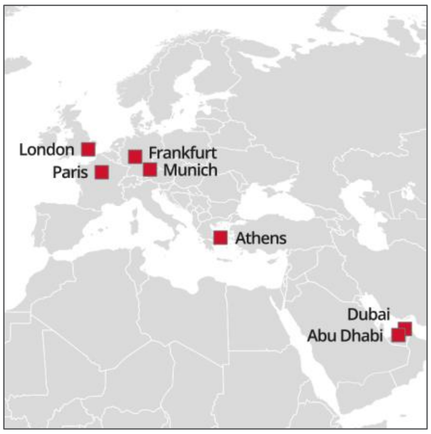

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