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Sustainable Investment in China

ISSUE BRIEF

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International Finance Corporation
World Bank Group

Introduction

To support the growth of sustainable capital flows, IFC's advisory services seek to influence, support and enable capital market stakeholders to better integrate environmental, social and governance factors (ESG) into capital allocation and portfolio management processes, using IFC's own investment practices as a model. IFC is playing its part to support the growth of the market by funding the development of enhanced stock market indices, financial instruments, and through targeted market research.

Compiling data on the state of development of the sustainable investment (SI) industry is important for global investors and investment managers to understand the scale and location of opportunities in the market for sustainable investment products. While a number of organizations provide this information in developed economies such data is scarcely available in emerging markets.

IFC thus decided to launch a series of Sustainable Investment Country Reports initially covering the largest emerging capital markets attracting global portfolio investors – Brazil, India and China. Further regional reports will be added to the series covering Sub-Saharan Africa and the Middle East.

This summary version of the report Sustainable Investment in China 2009, which may be downloaded in full from IFC's website, provides a snapshot of the Chinese market. While there has been an increase in sustainable-related research and investable products, for example the Shanghai Stock Exchange and China Securities Index launched China's first sustainability index, the Social Responsibility Index (SSE-SRI) in August 2009, challenges lie ahead for the growth of sustainable investments in China.

In our own investments and through our interactions with clients and other stakeholders, IFC will continue to play a role in promoting sustainable investment in China.

EXECUTIVE SUMMARY

To better acknowledge the current state and future potential of SI in China, IFC engaged Business for Social Responsibility's Beijing office (BSR) to undertake a review of the SI industry and enabling market conditions in China. BSR partnered with the People's Bank of China (the Central Bank) to analyze China's financial markets, regulatory framework, and SI market infrastructure. BSR also conducted approximately 100 interviews with government agencies, institutional investors, asset managers, equity research, and academics.

China is the world's third largest economy. The Shanghai and Shenzhen stock exchanges list more than 1,500 companies with a combined market capitalization of US $2,658.2 billion as of November 2008, rivaling the Hong Kong Stock Exchange (US $2,121.8bn) as Asia's second-largest stock market. However, unlike the Hong Kong Stock Exchange, both the Shanghai and Shenzhen stock exchanges are not entirely open to foreign investment due to tight capital account controls exercised by Chinese authorities – investors are restricted to investing through a Qualified Foreign Institutional Investor (QFII) – the government-mandated quota is currently set at 85 QFIIs, with managed assets of only US $13 billion. However it is noted that China's fast growing capital market, backed by more than US $1 trillion in gross domestic savings creates a huge potential for the development of sustainable investment.

Chart 1. Estimated Stock of Sustainable Investment in China

Market Participant		Total AUM (US$ B)	Estimated Stock of Investment in Chinese Equities (US$ B)	Estimated stock of SI (US$ B)	SI Investments % of Total Investment	Potential for SI market dev. short to med term
Domestic: Mutual funds		**294.73**	**294.73**	**3.32**	**0.011%**	**High**
Domestic: Pension funds	**NSSF**	**82.29**	**33**	**0.33**	**1%**	**Medium /High**
	Enterprise Annuity	**27.96**	**8.4**	**0.08**	**1%**	**Medium /High**
Domestic: Insurance		**518**	**26.9**	**0.26**	**1%**	**Medium**
International: QFII		**13**	**13**	**0.13**	**1%**	**Medium**
International: ADR		**n.a.**	**n.a.**	**0**	**0%**	**Low**
TOTAL		**971.83**	**411.63**	**4.12**	**1%**	

Source – BSR estimates

A Nascent SI Market

Though certain conditions signal a promising future for the SI market in China, the market currently remains underdeveloped. Mainstream investors have limited awareness and capacity related to ESG issues. Most domestic market participants have not yet moved from the 'what' and 'why' to the 'how.' Also, confusion over terminologies obscures the differences between sustainable investment and environmental thematic investment, and there is lingering skepticism about the business case for ESG integration and statistical evidence on SI financial returns. A lack of qualified personnel—analysts and researchers trained to perform both ESG and financial evaluation— further limit the ability of institutional investors to successfully execute sustainability-oriented investment.

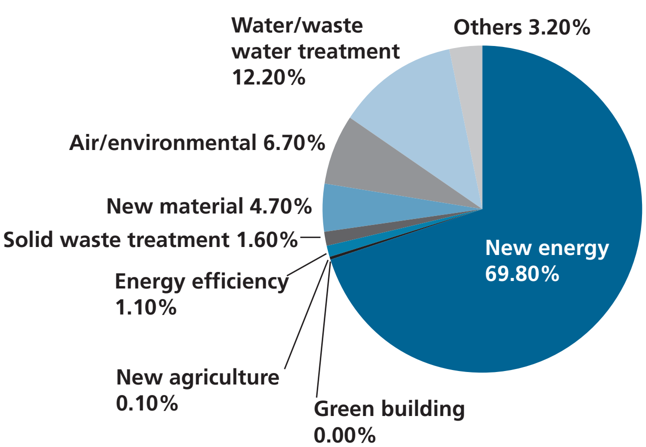
There are some encouraging cases in which a small number of market pioneers and innovators in different segments of the market have started to explore ways to integrate ESG factors into their investments, but these efforts are generally in the very early stages and often are limited to a broad public commitment to social responsibility rather than a rigorous process of evaluation and screening.

In the mutual fund sector, AEGON-Industrial Fund Management Co. Ltd, an SI pioneer in China, has offered the first socially responsible investment retail fund since May 2008. The fund, which had attracted US $375 million as of March 2009, has done well thus far, outperforming the market benchmark by 47% from its inception in May 2008 through June 2009.

While most pension funds in China show only limited interest in SI, the National Social Security Fund of China (NSSF), the country's largest pension fund with total assets of US $82 billion, lists "responsible investment" as one of its four core investment principles.

In the private equity arena, Tsing Capital, a leading Chinese private equity firm focused on clean technology, spent 8 years developing its own core competence through integrating ESG factors into the entire investment process, from due diligence to monitoring and engagement. Three-digit financial returns and significant reported social and environmental impacts demonstrate the potential viability of the SI model in China.

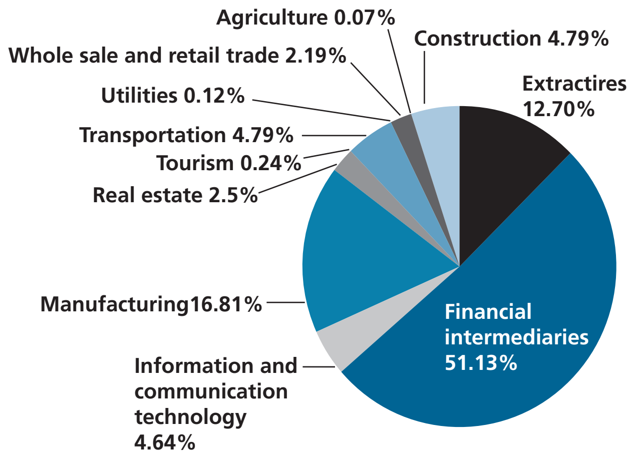
Figure 1. Investment in Clean Tech Enterprises by Sector



Source: Source Zero 2IPO, China Clean Tech Report, 2009

The SSE-SRI index launched in July 2009 is comprised of 100 SSE-listed stocks with good ESG performance based on SSE's rating system. The SSE claims that social contribution value is one of the key rating criteria, and the index's average social contribution value per share of RMB 2.42 and average earnings per share of RMB 0.69 in 2008 were both higher than the overall average of SSE-listed stocks.

Figure 2: Shanghai Stock Exchange Social Responsibility Index (SSE-SRI) – Sector Breakdown



Source: China Securities Index, Ltd.

SI with Chinese Characteristics

SI activity in China has so far been focused almost exclusively on ESG screening criteria.

The limited number of existing SI products, with few details available on specific screening methodologies, makes it difficult to draw conclusions on what a uniquely Chinese approach to ESG investing may look like. The AEGON Industrial Fund's ESG screening methodology provides some clues: AEGON employs a positive screening process which rates listed Chinese companies from four perspectives—economic responsibility, sustainability responsibility, compliance responsibility and business ethics—and then selects the companies with the highest comprehensive score to be part of their core stock pool. The Fund's Investment Committee selects stocks from this pool to build its portfolio.

Further Growth in ESG

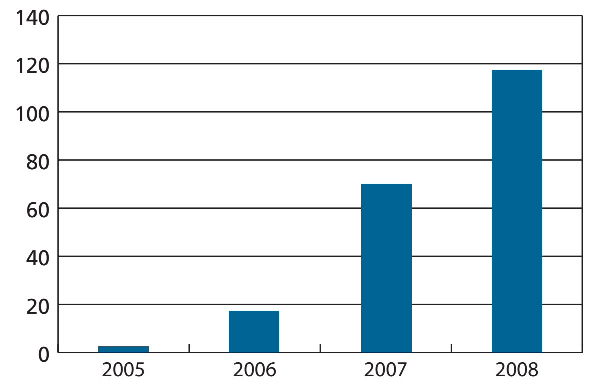
The central question is whether these developments are merely a flash in the pan or rather the early signs of a growing market in ESG investment. The increase in strategic management of CSR by Chinese companies reinforces the latter view. Taken together, the two trends are a strong sign that we will see significant growth in both CSR and ESG investment activities in China in the coming years. A number of additional developments suggest fertile ground for continued growth in ESG investment in China:

- **Evolving ESG Regulatory Landscape:** The government recognizes that China's environmental challenges threaten to constrain future economic growth and therefore social development. Environmental legislation is increasingly stringent and comprehensive, with new regulations continually being developed even as authorities struggle to enforce existing laws and standards. The government is leading the way in linking environmental and financial policies with two examples in particular: the Green Credit Policy requires Chinese banks to integrate environmental information into their lending processes and criteria, and the Green Securities Policy requires companies in certain sectors to pass an environmental audit from the Ministry of Environmental Protection (MEP) before being allowed to apply for a public listing. In 2008 the MEP inspected 73 companies going public, and of 38 completed inspections, only 18 enterprises passed.

- **Growing Awareness of the Need for Risk Management:** Increasing numbers of high-profile business ethics cases have caused investors to consider ESG factors more seriously when evaluating potential investments. As a result, a growing number of domestic institutional investors are actively screening for governance and compliance issues, while asset managers increasingly hold the belief that ESG risk management improves a company's market value in the long term.

- **Very limited but increasing third party information:** Chinese media is beginning to become more critical of business, and environmental NGOs in particular are becoming more vocal, with two organizations already providing regular information to financial institutions through newsletters. In terms of professional research providers, there are only a couple of independent ESG research organizations active in China, and even those face a limited demand for their services at the current time.

Figure 3. Number of Sustainability Reports by Enterprises in China



Source: SynTao, A Journey to Discover Values, 2008

- **Increasing attention from international SI initiatives:** Though international investors play a relatively limited role in the market due to QFII quota mentioned previously, China does attract a handful of international SI investors. Robeco and Sumitomo Trust & Banking (STB) are the first two companies to launch Chinese SI products.

Challenges and Opportunities

Despite these encouraging trends, China has to overcome a number of challenges to effectively channel the growing interest in SI into a mainstream ESG investment market. Some of them can be overcome in the relatively short term, but others, like changing investors' corporate attitudes to ESG and market infrastructure, will take several years.

The challenges and solutions identified, as well as recommended strategies are discussed in more detail in the report.
Sustainable Investment in China 2009, full report: http://www.ifc.org/sustainableinvesting

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