中国人民银行
THE PEOPLE'S BANK OF CHINA
Research Bureau of People's Bank of China

UNEP

Inquiry: Design of a Sustainable Financial System

ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 3: Green the Development Banks

Detailed Recommendations 3: Green the Development Banks

Over the years, multilateral financial institutions have played an important role in the infrastructure construction and economic development of many countries and especially developing countries. However, their investments are insufficient compared to the massive investment demand in these countries. More investment entities and innovative investment models are required to ensure the sustained and healthy development of the world economy, particularly those developing economies at large. In response to emerging requirements of regional economic development, BRICS countries and developing countries in Asia including China have initiated the BRICS Development Bank, the AIIB and the Silk Road Fund. However, these initiatives have aroused misunderstandings and doubts regarding their ability to manage environmental and social risks arising from their investments by international rules. This paper presents a brief description of the necessity for creating a project environmental management system with high standards and proposes certain recommendations on the outbound green investments of the BRICS Development Bank, the AIIB and the Silk Road Fund.

(I) The case for green investments by the BRICS Development Bank, the AIIB and the Silk Road Fund

Investment projects supported by multilateral financial institutions should promote the development of an industry or region, but the mistakes of investment directions and risk management practices may also cause negative environmental impacts that impede sustainable regional development. Hence, multilateral investments should address not only the short-term demands of certain local communities but also a region's long-term development needs. This requires investors to refrain from those projects that only benefit certain groups of people or address short-term needs at the sacrifice of public resources such as local ecological environment.

Green investment instruments include: first, green finance instruments such as green finance (interest rate discounts, guarantee, tax deductions, price subsidies and government procurement), green credit, green fund, green bond and share, as well as green insurance, which steer private capital to invest in green industry sectors such as clean energy, energy conservation and emission abatement, environment protection, green building and green transport. Another type of instruments is environmental and social risk management tools including standards, guidelines and operating procedures for environment, health and safety formulated by international organizations, governments and private sector, which help financial institutions to effectively identify, measure, monitor and control environmental and social risks of investment and financing activities.

Apparently, great gaps exist in the infrastructure investments of developing countries. According to a report of the World Economic Forum, there will be an annual demand for infrastructure investments worth at least US$5 trillion prior to 2020 in such areas as agriculture, water conservancy, electric power, communications, transport, buildings, industrial facilities and forestry (WEF, 2013). According to the World Bank estimates, annual investment demand of low-carbon infrastructures in Asia Pacific Region stands at US$80 billion (World Bank, 2012). However, existing regional multilateral financial institutions cannot meet such demands. Lack of financing has hampered the economic and social development of these countries. Therefore, creation of the BRICS Development Bank, the AIIB and the Silk Road Fund will address certain investment gaps of infrastructure investments in developing countries.

As preparations for the BRICS Development Bank, the AIIB and the Silk Road Fund accelerate, some countries have developed misunderstandings and doubts on the policy directions for governance and other matters. For instance, there are concerns that the BRICS Development Bank, the AIIB and the Silk Road Fund will not implement rigorous environmental protection and social justice policies in their future procurement and investment decisions. In response to these misunderstandings and concerns, President Xi Jinping, while attending the MOU signing ceremony for the establishment of AIIB, stated to representatives from other countries that the AIIB will study and draw upon the experiences and rules of other multilateral development agencies, such as the World Bank and the Asian Development Bank. After the MOU signing ceremony, the Chinese finance minister Lou Jiwei expressed to reporters that China will support existing multilateral development banks and work closely with existing multilateral development banks for the sustained, stable and healthy development of Asian economy. We have reasons to believe that the BRICS Development Bank, the AIIB and the Silk Road Fund will strive to implement international environmental, social and governance standards (ESG) in their future investment decisions and attach great importance to environmental and social risk management.

The BRICS Development Bank, the AIIB and the Silk Road Fund will focus their investments on the developing countries of Asia and other parts of the world. Unsophisticated legal systems, weak law enforcement and inadequate external supervision of private organizations and the media in these countries present great environmental and social risks for the BRICS Development Bank, the AIIB and the Silk Road Fund. According to our experience, negligence on environmental and social risk management will not only bring environmental disasters to the region, but will also hurt banks themselves or lead to direct financial and reputational losses. In a working paper titled *Managing Environmental Impact: International Experience and Lessons in Risk Management for Overseas Investments*, the World Resources Institute investigated some case studies of damages caused to local communities, financing institutions and banks themselves as a result of negligence of environmental and social risk management (WRI, 2013). For instance, the insolvency and bankruptcy of the Asia Pulp & Paper Co., Ltd. due to environmental protection requirements caused losses to Chinese state-owned commercial banks worth US$1.8 billion. Many companies have caused damages to the national reputation as a result of their bad environmental practices in overseas investments. For instance, Petro China was fined US$1.2 billion (actually paid US$400 million) for secretly discharging crude oil into a mine pit in Chad, which greatly damaged China's international reputation. Shougang Group also received extensive attention from the international community for labour disputes and environmental pollution in Peru.

(II) Good international practices in promoting green investment

In the *Working Papers of the People's Bank of China* (Ma et al, 2014), Chief Economist of the PBoC's Research Bureau Ma Jun recommended a series of good international practices for green finance, believing that green investments can be carried out through the following methods: first, financial institutions offer financial products such as green credit, green bond and green insurance to the market; second, the government acts as an initiator of private green investments through fiscal means such as interest rate discounts and guarantee of green loans, tax exemptions for green bond, establishment of green banks and encouragement of green funds by the private sector, etc.; third, the government steers green investments through financial systems by taking such measures as stipulating the legal liabilities through legislation concerning the investments of financial institutions in polluting projects, requiring listed companies and bond issuers to comply with green social responsibilities and creating systems for measurement and evaluation of project environmental costs.

Regarding environmental and social risk management, some departments of the United Nations have developed various standards, rules and instruments in cooperation with the financial community. Multilateral development banks, including the World Bank and the Asian Development Bank, have also summarized advanced experiences and good practices and formed a series of standards and policy requirements regarding governance structure, environmental impact assessment policies, safeguard clauses, procurement policies, fiscal sustainability evaluation for borrowing countries, and project management for infrastructure investments.

Given the focus on green investments of the BRICS Development Bank, the AIIB and the Silk Road Fund, this report will discuss the experiences of multilateral regional financial institutions in promoting international green investments.

1. Promotion of the Equator Principles

The Equator Principles (EPs) are a set of standards to be observed by financial institutions on a voluntary basis in their identification, evaluation and management of social and environmental risks in project financing and regarded as the 'golden rules' for the development of sustainable project financing by financial industry. These principles are based on the World Bank Group Environmental, Health and Safety (EHS) Guidelines and the IFC Performance Standards on Environmental and Social Sustainability and aim to provide a common benchmark and framework to assist financial institutions in managing environmental and social risks related to project financing. These principles were sponsored by the ABN AMRO Bank, Barclays Bank, WestLB AG and Citibank in 2002. By 2013, these principles were already adopted by 78 financial institutions from 35 countries or regions and China Industrial Bank (CIB) became a signatory of the Equator Principles in 2008. These banks have covered more than 70 percent of project financing volume in emerging markets.

2. Formulate guidelines on managing environmental and social risks

The World Bank Group has formulated the Environmental, Health and Safety (EHS) Guidelines and the IFC has also issued the IFC Performance Standards on Environmental and Social Sustainability. The World Bank guidelines consist of general guidelines and industry-specific guidelines involving such areas as environmental protection, occupational health and safety, community health and safety, construction and demolition. The IFC Performance Standards cover the following eight areas: evaluation and management of environmental and social risks and impacts, labour and working conditions, resource efficiency and pollution prevention and treatment, community health and safety, as well as public security, land acquisition and involuntary resettlement, biodiversity protection and sustainable management of biological and natural resources, indigenous peoples and cultural relics.

In a recent report, the World Resources Institute (WRI) evaluated the compliance with sustainability and governance policies by the World Bank in the process of project implementation (WRI, 2014). According to its evaluation of 60 projects approved between January 2012 and June 2013, the WRI found that 82 percent of projects took environmental and social risks into consideration. However, 75 percent of projects did not consider climate change risks while 88 percent of projects did not consider greenhouse gas emissions. Although the World Bank has already implemented systematic environmental and social risk management policies, these policies are incomplete and still have great room for improvement. Nevertheless, these guidelines and standards have greatly enhanced environmental and social risk management through application in investment projects.

3. Identify environmental sustainability as a core business objective

In *its* Strategic Framework for 2008-2020, the Asian Development Bank has identified environmental sustainability as one of the priorities of strategic agenda and environment (including climate change) as one of its five core business areas (ADB, 2008). The Asian Development Bank believes that infrastructure investment is crucial for achieving sustainable growth, regional integration and poverty alleviation and made the following commitments: assist the expansion of energy supply; help suppliers and consumers to increase energy efficiency; support clean energy; assist the revision of policies, systems, regulations, technologies and laws that impede efficient energy utilization.

Regarding environmental and social risk management, the Asian Development Bank has, through its Safeguard Policy Statement, described in detail the following safeguard policy statements including *Involuntary Resettlement Policy*, *Policy on Indigenous Peoples* and *Environment Policy*. According to the type, location, size and potential environmental impacts, individual projects can be divided into four categories and safeguard policies are designed for each of them.[1]

[1] http://www.adb.org/site/safeguards

4. Issue green bonds

Green projects have positive externalities and polluting projects have negative externalities while existing policy and pricing systems fail to internalize these externalities into project return. In addition, many green projects have such problems as significant early-stage capital investments and long investment cycle, which have increased financing difficulties for green projects. In order to address financing shortages of green projects, multilateral financial institutions have launched green bonds and products over recent years and steered private investments toward green investment sectors through bond issuance. By the end of 2013, the World Bank Group and the IFC as its affiliate have financed approximately US$7.5 billion by distributing climate bonds. These investments have been made in such areas renewable energy, energy efficiency and environmental protection to support projects in developing countries like India, China, Turkey, Indonesia and Armenia. According to the Climate Bonds Initiative, in 2013, about US$346 billion worth of bonds were related to climate change solutions and some US$159 billion worth of green bonds or climate bonds were offered, many of which were issued by the development banks of various countries (Kidney and Oliver, 2014).

(III) Recommendations on promoting green investments by the BRICS Development Bank, the AIIB and the Silk Road Fund

We would like to propose the following recommendations on maximizing the contributions of the BRICS Development Bank, the AIIB and the Silk Road Fund to energy conservation, environmental protection and sustainable development:

1. Accede to or reference the Equator Principles and establish a system for project environmental and social risk evaluation with high standards

The Equator Principles are the gold standard for managing environmental and social risks; they have been adopted by more than 80 financial institutions, commercial banks and credit export agencies around the global. The BRICS Development Bank, AIIB and the Silk Road Fund should adopt the Equator Principles or operate in accordance with the Equator Principles from the outset, and proactively integrate environmental and social risk management into the project management life cycle. In addition, the BRICS Development Bank, the AIIB and the Silk Road Fund should try to establish an environmental and social risk management system with higher standards within three to five years and become a model and global leader in the management of environmental and social risks.

2. Consideration must be given to the sustainable development of output capacity exporters and recipients in overseas investments

The establishment of BRICS Development Bank, AIIB, the Silk Road Fund and the proposal for ‘Belt and Road’ are encouraging news for China’s industries and widely believed to provide new outlets for China’s excess production capacity. Undoubtedly, these new mechanisms will facilitate Chinese companies in going global, contribute to domestic economic growth and employment, and enhance China’s long-term development potentials. However, these mechanisms cannot become channels for Chinese companies to offload outdated and polluting industrial capacities to other developing countries. While investing in and exporting to foreign countries and regions, Chinese companies must keep China's national image and the welfare and long-term development of the local populace at heart, so that they can help maintain and develop China's relationship with these regions.

3. Establish a highly transparent environmental disclosure mechanism and identify the minimum proportion of environmental projects in total loans and investments

Information disclosure is an effective means to increase financial institutions' and enterprises' sense of social responsibilities, discourage polluting investments and bolster green investments. The BRICS Development Bank, the AIIB and the Silk Road Fund should adopt high standards for information disclosure and not only require the disclosure of environmental and social risks of projects and risk mitigation measures by loan applicants, but also prescribe a minimum value for the percentage of loans to environmental projects and disclose such information in their annual reports.

4. Issue green bonds and put private capital under the service of green transformation

As a low-cost, highly liquid and relatively low-risk investment instrument, green bonds can effectively enhance the ease of financing green projects, reduce their financing costs and provide channels for institutional investors and other private capital to invest in the green industry. According to the practices of green bond issuance by multilateral financial institutions, governments and enterprises in recent years, green bonds enjoy tremendous development potentials. The BRICS Development Bank, the AIIB and the Silk Road Fund may draw upon the experiences of the World Bank, the IFC and the Asian Development Bank and provide a portion of the investments needed by the green infrastructure by issuing green bonds.

5. Promote green investments in the private sector through such means as the PPP model

The strength of the PPP model is that the government can partner with private sectors to raise funds for green infrastructure projects, while sharing the investment risks and benefits. In other words, the PPP model provides financing for green infrastructure projects in the form of private capital through the leverage effect of limited public funding. In both China and other countries, many green infrastructure projects have been successfully funded via the PPP model. The BRICS Development Bank, the AIIB and the Silk Road Fund should draw upon these experiences to expand the use of the PPP model.

6. Give sufficient consideration to energy conservation and emission abatement in the process of procurement and investment decision-making

The BRICS Development Bank, the AIIB and the Silk Road Fund should require environmentally friendly procurement, design and construction management by invested enterprises and projects. First, infrastructure and other projects invested by the BRICS Development Bank, the AIIB and the Silk Road Fund should follow the principle of 'green procurement' by giving priority to the procurement of raw materials, products (such as energy efficient buildings) and services (including engineering services) with relatively limited negative environmental impacts, bring about improved environmental performance of suppliers, and thus promote green investment and consumerism. Considering the significant size of projects invested by the BRICS Development Bank, the AIIB and the Silk Road Fund, their green procurement is likely to support a series of green products and technologies and foster new economic growth drivers. Secondly, low carbon requirements must be embedded in the upfront design of infrastructure projects, given the long service life of projects. Otherwise, it would be very difficult to change the poor environmental performance after project completion. Third, green construction practices must be followed to conserve resources and reduce construction activities with negative environmental impacts to the maximum extent, abate floating dust and noise, and conserve water and energy.

References:

ADB (2008). Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008-2020.
Equator Principles (2014). Members and Reporting. Available at: http://www.equator-principles.com/index.php/members-reporting
Equator Principles Association (2013). Equator Principles III. London: Equator Principles Association.
Ma, J. Shi Y., Yao B.. (2014). Green Finance Policies and Their Application in China. Working Paper of the PBoC No.7, 2014 Working Papers of the People's Bank of China (No.2014-07).
WEF (2013). The Green Investment Report: the ways and means to unlock private finance for green growth. Geneva: WEF.
WRI (2013). Managing Environmental Impact: International Experience and Lessons in Risk Management for Overseas Investments, working paper. Washington: World Resources Institute.
WRI (2014). Designed for the future? Assessing principles of sustainable development and governance in the World Bank's project plants. Washington, DC: World Resources Institute.

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.

Advisor: Pan Gongsheng, Deputy Governor, People's Bank of China
Domestic Convener: Ma Jun, Chief Economist, Research Bureau, People's Bank of China
International Convener: Simon Zadek, Co-Director, United Nations Environment Programme Inquiry into the Design of a Sustainable Financial System

TASK FORCE MEMBERS

An Guojun	Research Associate, Institute of Finance and Banking, Chinese Academy of Social Sciences
Chen Zheng	Research Associate, Shenzhen Stock Exchange
Chen Yaqin	Head of Marketing Division, Environment Finance Department, Industrial Bank
Guo Peiyuan	General Manager, SynTao (expert on corporate social responsibility)
Guo Sanye	Deputy Secretary General of China Banking Association
He Qiaonv	Chairman, Beijing Orient Landscape Industry Group
Huang Chaoni	Head of Business Development – Asia, Trucost
Huang Jianhui	President, Research Institute, China Minsheng Bank
Jiang Peixing	CEO, Zhong De Securities
Jin Hainian	Chief Research Officer, Noah Private Wealth Management
Lan Hong	Deputy Director, Ecological Finance Research Center, Renmin University of China
Li Donghui	Director and SVP, Beijing Orient Landscape Industry Group
Li Jianqiang	Research Associate, Research Bureau, People's Bank of China
Liang Pingrui	General Manager, Environment Finance Department, Industrial Bank
Lu Hanwen	Deputy Director-General, Project Appraisal Department II, China Development Bank
Qi Liang	CEO, China Securities
Sheng Hetai	Vice President, People's Insurance Company (Group) of China
Sang Qiang	Senior Manager, Strategic Planning Department, People's Insurance Company (Group) of China
Su Ting	International Sustainability Development Research Institute
Wang Guijuan	Research Associate, Research Institute for Fiscal Science, Ministry of Finance
Wang Lu	Deputy Director General, Credit Reference Center, People's Bank of China

Wang Wen	Executive Dean, Chongyang Institute for Financial Studies, Renmin University of China
Wang Yao	Director, Research Center for Climate and Energy Finance, Central University of Finance and Economics
Xie Hongxing	Secretary-General, Clean Air Alliance of China
Xin Benjian	Senior Research Associate, Chongyang Institute for Financial Studies, Renmin University of China
Xu Wen	Research Associate, Research Institute for Fiscal Science, Ministry of Finance
Yang Shuying	Research Associate, Policy Research Centre for Environment and Economy, Ministry of Environmental Protection
Yao Bin	Research Associate, Research Bureau, People's Bank of China
Ye Yanfei	Deputy Director-General, Statistics Department, China Banking Regulatory Commission
Yin Hong	Deputy Director, Urban Finance Research Institute, Industrial and Commercial Bank of China
Yin Lihai	Director, Tax Policy Department, Ministry of Finance
Yu Xiaowen	Director, IISD China Office
Yu Zhenli	Research Associate, Research Institute for Fiscal Science, Ministry of Finance
Zhao Lijian	Program Director, Environmental Management, Energy Foundation China
Zhang Hai	Director of the Secretariat, Eco Forum Global
Zhang Jialin	Chairman, Aron Capital Management
Zhang Yong	Executive Director, Eco Forum Global
Zheng Tingying	Executive Deputy Director, Ecological Finance Research Center, Renmin University of China
Zhou Yacheng	Partner, Zhong Lun Law Firm
Zhou Yueqiu	Director, Urban Finance Research Institute, Industrial and Commercial Bank of China
Zhu Shouqing	Senior Associate, Sustainable Finance Program, World Resources Institute

INTERNATIONAL EXPERTS

Mark Halle	Vice-President, International Institute for Sustainable Development
Sean Kidney	CEO, Climate Bonds Initiative
Alexander Barkawi	Founder and Director, Council on Economic Policies
Stanislas Dupré	Founder and Director, 2° Investing Initiative
Butch Bacani	Programme Leader, UNEP FI Principles for Sustainable Insurance Initiative
Sony Kapoor	Managing Director, Re-Define
Susan Burns	CEO and Co-founder, Global Footprint Network
Romulo Sampaio	Professor of Law and the Director of the Research and Policy Center for Law and the Environment (CDMA) at Getulio Vargas Foundation (FGV) School of Law in Rio de Janeiro.

中国人民银行
THE PEOPLE'S BANK OF CHINA
Research Bureau of People's Bank of China

The People's Bank of China

No.32 Chengfang street,
Xi Cheng district, 100800
Beijing, China
webbox@pbc.gov.cn
86-010-66194114
www.pbc.gov.cn/

Inquiry: Design of a Sustainable Financial System

Inquiry: Design of a Sustainable Financial System

United Nations Environment Programme International
Environment House
Chemin des Anémones 11-13
Geneva, Switzerland
inquiry@unep.org
+41 (0) 229178995
www.unep.org/inquiry