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Inquiry: Design of a Sustainable Financial System

ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 9: Create a Green Index

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Detailed recommendation 9: Create a Green Stock Index

The Third Plenum of the 18th CPC Congress has called for vigorous efforts to propel the development of an ecological civilization, build a resource efficient and environmentally friendly society and improve the level of the ecological civilization, which requires capital markets to steer more resources towards green industries through innovative methods. Capital markets are an important venue of resource allocation while stock indices represent a key weather wane that steers capital allocation in the stock market. As shown by international experience, development of green stock indices can effectively steer more private capital to be invested in green industries.

Energy intensive and heavy industry enterprises account for a significant share in the composition of China's major stock indices, while many fund and institutional investors have naturally invested their capital in polluting industries by the same proportion in making passive investments (investments consistent with the composition of stock indices). As a result, China's stock index system has enhanced the pollution-intensive investment and industry structure to some extent. We believe that China's green stock index system (stock indices with a significant share of green enterprises) should be created and promoted to serve as an important driver for institutional investors to make green investments.

(I) The case for developing green stock indices and green investments

1. Overseas experience of green indices and green investments

As shown by overseas experience, an important driver of sustainable investment and corporate sustainable development is the development and application of green indices. Overseas markets represented by Europe and North America have already developed sophisticated experiences of green (sustainability) index and green (sustainable) investments.

Representative overseas sustainability indices include the Dow Jones Sustainability Index (DJSI), the FTSE Good World Social Index, the MSCI ESG (economy, environment and governance) index series, the NASDAQ Clean and Green Energy Index, and the Standard and Poor's Global Clean Energy Index. Among them, the Dow Jones Sustainability Index (DJSI) is the earliest of its kind with an extensive influence. The MSCI ESG index series can be further divided into the sustainability index, responsible investment index and environmental index. In addition, some other indices have been dedicated to clear energy and clean technologies, including Wilderhill Clean Energy Index (ECO) and the US Clean Technology Index (CTIUS).

With the development of sustainability indices in various securities markets and attention of major investment funds to corporate sustainability, sustainable development has become an important industry for financial investments. According to a survey of the US SIF in 2012, assets for sustainable investments in US have amounted to US$3.74 trillion, which represents an increase of

22 percent compared with 2010 and accounts for about 1/9 of total assets under professional investment management. According to statistics of the SIF Europe, investment assets of such themes as sustainability and ethics reached €6.7 trillion in Europe by 2011.

2. Green indices and green investments are highly relevant for making an economic transition, reducing investment risks and enhancing corporate sustainability

Green indices and green investment are consistent with international development tendencies and China's growth transformation. From the perspective of securities market, the significance of green indices and green investments can be explained as follows:

First, green enterprises represent a higher share in the green indices compared with traditional indices. Guided by the green indices, investment institutions will increase the proportion of their asset allocation to green industries. More capital directed towards listed green enterprises will increase the P/E ratio of these companies, reduce their cost of financing from the stock market, promote green industries, and incentivize more unlisted companies to join the rank of this type of green enterprise.

Second, green indices provide integrated information that has been screened and verified concerning the environmental impacts and performance of companies, which helps reduce the environmental risks of investments and increase the risk and return ratio. Accordingly, green investments can help investors evaluate the economic, social and environmental performance and sustainability potentials of invested companies and reduce investment risks arising from the negligence of sustainable development for short-term return.

Third, green indices and green investments provide more open, extensive and transparent opportunities for publicity for listed companies with superior environmental and governance performance and bring about a series of positive effects recognized by investors and customers alike. Once companies are excluded from the influential green indices, their management teams will face negative pressure. Green indices and green investments will incentivize and restrain corporate business conduct and push businesses to improve their environmental performance.

3. China's green indices and green investments have taken the preliminary steps and boast great potentials

Green indices have taken preliminary steps in China's capital markets and currently include TEDA EP Index jointly formulated by Shenzhen Securities Information Co., Ltd. and TEDA Investment Holding Co., Ltd., the SZSE CSR Price Index, the CNInfo-CBN-CIB Fund CSR Index, CNInfo-NFMedia-Low Carbon 50 Indices, the SSE CSR Index, the CSI-ECPI-ESG Sustainability 40 Indices, as well as the CSI-CT ESG 100 Index. On the whole, China's green and sustainability indices are still relatively few and indices related to CSR, environmental protection and low carbon are less than 20, whose market influence remains rather limited.

Green investments in China are also in an inception stage. Take securities investment funds for instance. According to the Wind statistics, by August 2014, there were a total of more than 2,300 securities investment funds in China, of which 960 are stock-type funds,[1] but only more than 10 funds are related to environmental protection, low carbon and CSR.

China's A-share market capitalization is among the highest of the major countries in the world, with growing influence. China's green indices and green investments lag behind developed countries with great potentials to be explored.

(II) Recommendations on the development of green indices and green investments

1. Draw upon international experiences and promote the development and innovation of green indices

Green investments developed early in Europe and North America, where a series of sophisticated evaluation systems and indicator formulation methods have been put into place. Chinese institutions may draw upon these experiences to offer more green and sustainability stock indices that facilitate market development of relevant investment products. Stock exchanges and index companies may provide platforms for the release of green indices and relevant information. Chinese index institutions may utilize research outcomes through cooperation with sophisticated overseas index institutions to expedite the development of domestic green indices. For instance, Shenzhen Securities Information Co., Ltd. partnered with the FTSE to develop an index series of environment and technology. In addition, efforts should be made to encourage the research and development of green indices by wealth management institutions and intermediaries such as the research on sustainability indices and low carbon indices by NOAH.

2. Improve the CSR information disclosure mechanism and enhance the representation of green indices

Limited influence of Chinese green industries is related to the insufficient information disclosure of listed companies and the lack of targeted index formulation methods.[2] Overseas index institutions have employed extensive sources of data including corporate information disclosures, questionnaire surveys, public information and direct communication with companies. In some instances, third party auditing has been introduced. For Chinese green indices, therefore, greater efforts must be made to further improve the disclosure of environmental information and sustainability information by listed companies; encourage non-profit research institutions and third-party institutions to conduct disclosure and rating of the sustainability performance of companies as candidates to be screened in the development of green indices and green investment products.

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[1] Refer to partial blend fund, balanced blend fund, normal shares fund and index-type fund, excluding bond fund, bond-oriented fund, currency fund and international fund.

[2] For instance, due to the unavailability of key information such as corporate energy consumption, the classification of "low carbon companies" in the "low carbon" index can only be determined according to the industry, business operation concepts and development strategies of companies.

3. Promote the application of green indices among institutional investors

Development of green investment products requires the participation of institutional investors. Judging by overseas markets, pension management institutions are important participants for this type of products. Chinese domestic large institutional investors including social security funds and insurance assets management institutions still follow large-cap stock indices such as Shanghai and Shenzhen 300 Indices as performance benchmark or investment targets. Large institutional investors should be encouraged to employ green indices, foster green investment concepts in the market and promote the development of green investment products.

4. Encourage asset management institutions to develop more targeted and diversified green and sustainability investment products

Asset management institutions should develop more theme funds including green funds, sustainability funds and ethical funds with reference to green indices. In addition to public placement funds, great efforts can be made to develop various forms of green investment products including collective wealth management and separately managed account (SMA) wealth management. In particular, SMA wealth management can be customized to offer products that are more consistent with customer values. Asset management institutions should explore new methods of green investments,[3] identify their respective advantages and possible problems and barriers[4] and develop diversified green investment products based on index research, customer resources, investment duration and data availability.

Aside from listed companies, continued efforts should be made to encourage venture investment institutions to inject capital into green enterprises with potential through equity investments in such areas as environmental protection, renewable energy, new resources, integrated utilization of resources, ecological agriculture, sustainable transport and clean production.

[3] Such as green index, the coming investment, exclusion of fossil fuel energy, focus on clean technology and adjustment of investment portfolio according to carbon footprint.

[4] Potential challenges including poor short-term performance of green investments, great errors in stock index duplication, inconsistency with the principle of scattered investments and high data cost.

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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