

# INVESTOR DUTIES AND ESG INTEGRATION IN CHINA

March 2018

# THE PROJECT

In January 2016, the Principles for Responsible Investment (PRI), UN Environment Finance Initiative (UNEP FI) and The Generation Foundation launched a three-year project – [Fiduciary Duty in the 21st Century](#) – that aims to clarify investors’ fiduciary duties at national and international levels to include environmental, social and governance (ESG) issues.

Since its launch, the project has:

- Engaged with over 400 policy makers and investors to raise awareness of the importance of ESG issues to the fiduciary duties of investors.
- Published the Global Statement on Investor Obligations and Duties, which has now been signed by 123 signatories from 22 countries.
- Published and started to implement roadmaps on the policy changes required to achieve full incorporation of ESG issues into investment processes and practices across eight countries (Australia, Brazil, Canada, Germany, Japan, South Africa, the United Kingdom and the United States).
- Extended the research into fiduciary duties – and, more broadly, investor duties – to six Asian markets: China, Hong Kong, India, Korea, Malaysia and Singapore.
- Hosted over 20 workshops and conferences with investors and regulators in 14 countries to discuss regulatory clarification and investor practice on ESG integration as part of the fiduciary duties of investors.
- Engaged with the European Commission High-Level Expert Group (HLEG) on Sustainable Finance to help formulate recommendations on EU-wide clarification of investor duties.

For more information, see: [www.fiduciaryduty21.org](http://www.fiduciaryduty21.org)

**ESG integration is defined as: “The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”.**

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# CONTENTS

Introduction	5
Detailed recommendations	7
China's long-term vision	9
The drivers of change: integrating ESG in investor duties	15
Examples of legislation and guidance to integrate ESG in investor duties	26
Interviewees and contributors	28
Glossary	29
About the project partners	30
Disclaimers	31

# INTRODUCTION

Fiduciary duties, also referred to as investor duties, exist to ensure that those who manage other people's money act in their beneficiaries' interests, rather than serving their own interests. The manner in which investor duties are defined has profound implications. Decisions made by fiduciaries cascade down the investment chain, affecting decision-making processes, ownership practices and, ultimately, the way in which companies are managed.

**The report *Fiduciary Duty in the 21st Century*, published in 2015, concluded that failing to consider long-term investment value drivers, which include material ESG issues, in investment practice is a failure of fiduciary duty.**

Fiduciary duty per se is not a well-established concept in Chinese law. However, many of the principles that underpin fiduciary duties – for example, duties of loyalty and prudence, requirements to act with care, skill and diligence, and requirements to act in good faith in the interest of beneficiaries and clients – are familiar to Chinese investors. These duties are not defined in a single body of law but have emerged from a complex interaction of regulation, soft law and market innovation. Together, they create a set of investor duties and obligations that mirror the duties and obligations expected of investors in other jurisdictions.<sup>1</sup>

Investor duties in China do not explicitly require investors to integrate consideration of material ESG issues in their investment decision-making, nor do they require investors to consider the Chinese government's long-term sustainability goal, articulated in the concept of the *Ecological Civilisation*.<sup>2</sup> However, there is a strong investment case for doing so, while such consideration is in line with the interests of clients and beneficiaries.

**The central recommendation of this report, therefore, is that investors should integrate ESG issues in their investment decision-making processes as part of fulfilling their duties towards their beneficiaries and to support the development of China's Ecological Civilisation. Investor duties should reflect and align with the Chinese government's Guidelines for Establishing a Green Financial System (GEGFS).**

Since the release of these guidelines in 2016, the promotion of green finance has become central to China's sustainable economic growth, implemented through five pilot zones and integrated in major investment projects such as the Belt and Road Initiative. The China Securities Regulatory Commission (CSRC) has announced that, by 2020, it will require listed companies to disclose key environmental information in their annual or semi-annual reports. The Shanghai and the Shenzhen Stock exchanges have joined the UN Sustainable Stock Exchanges (SSE) initiative and are committed to supporting the development of green and transparent markets in China. China is increasingly recognised by the international community for its leading role in green finance development worldwide, for taking green finance to the G20, and for enhancing inter-governmental dialogues on issues related to private sector climate disclosure.<sup>3</sup>

Meanwhile, domestic and international capital markets are expected to play a significant role in financing China's green transformation and growth. To meet the goals of its 13th Five-Year Plan, China needs a minimum of RMB3-4 trillion each year in green investments from 2015 to 2020, at least 85% of which needs to come from the private sector.<sup>4</sup> Asset owners, and specifically State pension funds, are of critical importance to this process. They sit at the top of the investment chain. Through their investment practices and through the signals they send to the wider investment market, they have the ability to cascade and drive green and sustainable capital through the investment chain. State pension funds are

1 See <https://www.fiduciaryduty21.org/investor-statement.html>

2 China State Council (2015). 中共中央 国务院印发《生态文明体制改革总体方案》

3 As in international organisations' green economy and green finance strategies, green is also inclusive, and is always considered in the perspective of social welfare and sustainable development.

4 Ma, J. (2016). *Green Finance: China and G20*.

subject to general duties of loyalty, prudence and care, and are expected to act in a way that supports the Chinese government's objective of ensuring social welfare.

The growing contribution of capital markets to the Chinese economy implies that aligning investment practice with sustainability goals will be key to establishing a green financial system. Investors can achieve this alignment by systematically integrating material, relevant ESG factors in investment decision-making. However, there are barriers to ESG integration in the investment sector in China. These include:

- The lack of formal regulatory mechanisms that require investors, and in particular asset owners, to take account of ESG factors in their investment processes;
- The lack of guidance to support investors in integrating ESG factors into their investment processes;
- Difficulties in engaging companies on ESG issues due to the lack of consistent, comparable and reliable reporting by companies;
- The lack of unified definitions aligned with international practice for green and sustainable investment products;
- The lack of knowledge of the investment case for integrating ESG factors to drive value creation, and how company performance on ESG factors might be used in investment research and decision-making processes; and the perception that ESG factors and green finance are ethical issues that compromise returns, and are separate to fundamental investment analysis.

To align investments and investor duties with the Ecological Civilisation, and the Guidelines for Establishing the Green Financial System in China, we recommend:

1. **Publishing guidance** on green and sustainable investment that articulates how institutional investors and their investment managers should implement the GEGFS;
2. **Introducing regulation for pension funds to integrate ESG issues, encourage high standards in investee companies and disclose on ESG practices and performance;**
3. **Ensuring and monitoring the effectiveness of the mandatory environmental disclosure framework** for companies, and aligning with international disclosure standards for ESG issues;
4. **Expanding a standardised offering of green and sustainable investment products and comprehensive tools to support their market uptake.** The demand from financial institutions for green investment is growing and can be further strengthened; and
5. **Supporting investor education and ESG investment research,** and building operational capacity for sustainable investment.

The recommendations made in this report are informed by our analysis, our interviews with key stakeholders in China, and by the stated priorities and objectives of the Chinese government. They acknowledge the significant progress in China over the past decade in green and sustainable finance. Our hope is that these recommendations will accelerate the rate at which China's investors align their practices with the goals of green finance and of sustainable development.

# DETAILED RECOMMENDATIONS

This report was developed through industry consultation and sets out recommendations to ensure that the modern interpretation of investor duties is reflected in the practice of Chinese institutional investors. It also sets the Chinese capital market in a broader international context, as regulators and investors respond to a rapidly changing investment environment. Our recommendations cover five categories: policy frameworks; regulations on ESG integration; ESG disclosure; sustainable and green products; and investor education.

## 1. Policy framework and sustainable investment guidance

- a. The China Securities Regulatory Commission (CSRC) and the Asset Management Association of China (AMAC) should publish sustainable investment guidance that articulates how institutional investors and investment managers should implement the Guidelines for Establishing the Green Financial System. Among other things, the guidance should recommend that investors have a process in place to implement sustainable investment, and that they disclose against it.
- b. The CSRC and the AMAC should publish a stewardship code setting out investors' stewardship responsibilities.<sup>5</sup> Such a code should include requirements for investors to monitor corporate ESG performance, to engage with companies with the aim of improving ESG performance, and to report on how they are doing so.
- c. The CSRC, the AMAC and stock exchanges should support the adoption of sustainable investment guidance and the stewardship code through publishing and disseminating examples of implementation best practices; one area of focus could be on how sustainable investment strategies and corporate policies can effectively address long-term, climate and sustainable development-related issues while also delivering satisfactory investment returns.

## 2. Regulation on ESG integration and disclosure for pension funds and their investment managers

- a. The relevant Chinese government branch is recommended to issue regulations that require pension funds and their investment managers to ensure that material ESG issues are systematically and explicitly integrated in their decision-making and engagement practices, and to report on how they implement these requirements. Such regulation would help align investors' duties with the wider policy objectives defined in the GEGFS.
- b. In addition, the government should require pension funds and their investment managers to report on how they integrate ESG issues in their investment practice and processes, and on how they engage with companies and other stakeholders. Widely recognised voluntary and specific frameworks, such as that developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), should be further promoted to encourage investors to disclose on the climate performance of their portfolios.
- c. The National Social Security Fund (NSSF) should lead by example, showcasing how ESG integration has been implemented in its investment processes and decision-making.

## 3. Disclosure requirements for companies on ESG integration and performance

- a. The government and the CSRC should continue to enhance disclosure requirements for companies on ESG integration and performance, in alignment with international standards while taking into account the present Chinese circumstances. In the process of implementing a mandatory environmental disclosure framework, the CSRC and the Ministry for Environmental Protection (MEP) should consider the following principles:
  - ESG factors should be disclosed in the annual report and the other outputs of conventional accounting practice, with clear links between ESG factors and the company's business model and risk factors;

<sup>5</sup> Stewardship codes govern the interactions between investors and investee companies, with a view to promoting long-term value creation strategies. Formalised stewardship codes are a relatively recent invention, although there has been notable growth in such codes in Asia in recent years with Hong Kong, Japan, Malaysia, Singapore and South Korea introducing them since 2014. Most stewardship codes are voluntary, although some governments promote adherence more actively than others.

- ESG factors should, over time, be subject to assurance in a similar manner to financial data. We suggest a phased introduction of this requirement; and
  - Companies should report using common performance metrics to allow for comparability, in particular by industry, portfolio and across time-series.
- b. The government and the CSRC should expand the mandatory environmental disclosure framework to include all material ESG issues, and ensure alignment with international standards to allow for comparability.
  - c. The government should continue to promote and enhance the adoption of forward-looking and scenario-based frameworks on climate change with companies, including the recommendations set out by the TCFD.
  - d. Stock exchanges should require companies to disclose all financially material ESG factors as part of their listing requirements, in support of the mandatory environmental disclosure framework.

#### 4. Sustainable and green finance products, labels and tools for investors

- a. Investment managers, with support from the AMAC and regulators, should develop a supply of green and sustainable investment products for institutional investors, focusing on long-term sustainability goals, and building on the development of the green bond market.
- b. Regulators should standardise taxonomies for green finance and ESG integration. The development of indicators and standards in green finance should be aligned with the current efforts underway to harmonise standards across the Chinese financial system. Other material indicators and standards on ESG information should be integrated in this process. A similar approach should be adopted when designing green and sustainable labelling for investment products.

- c. Stock exchanges should further promote and develop their green finance capabilities, alongside the Green Finance Action Plan published by the Sustainable Stock Exchanges (SSE) initiative.
- d. NGOs and service providers should develop tools to support ESG integration in investment decision-making; these tools could include, for example, environmental scenario analysis, the assessment of corporate performance on ESG issues, and ESG ratings.

#### 5. Investor education and ESG investment research

- a. The AMAC should promote the integration of ESG issues in investor education and should support the development of appropriate professional education, analytical tools and training for the investment industry.
- b. The AMAC, with support from investment managers and service providers, should promote the integration of material ESG issues in investment research and ratings. It should encourage China-specific academic research into the relationship between ESG factors and investment performance, and should support efforts to address the practical barriers to such research (such as weaknesses in corporate disclosures, and lack of disclosures from investors on how ESG issues affect their portfolios and performance).
- c. Investment managers should provide appropriate education, analytical tools and professional training on ESG issues to their investment teams and operational staff.
- d. In connection with this report, the PRI, UNEP FI and The Generation Foundation will provide complimentary access to the trustee module of the PRI Academy for selected trustees or directors at pension funds across China. This practical response to some of the training, capacity and awareness challenges identified in this report directly supports our recommendations.



# CHINA'S LONG-TERM VISION

## Sustainable development in China

China is the world's second largest economy, the largest holder of foreign exchange reserves, and the second largest destination for foreign direct investment. Between 1980 and today, China's GDP per capita (in current US dollars) has grown from US\$200 to more than US\$8,000. This rapid development has, however, come at a heavy environmental cost; China is the world's largest emitter of carbon dioxide, and suffers from air, water, and soil pollution, as well as water shortages.<sup>6</sup> Traditionally, economic growth and environmental sustainability were inversely related. This is changing, however, and China is now fundamentally transforming its development model to integrate and align economic growth and environmental sustainability in a mutually supportive way.

## National sustainable development strategies

At the 18th National Party Congress in 2012, the concept of an Ecological Civilisation was elevated as a national strategy and, in the same year, was included in China's constitution. During the

For China today, the guiding principle of sustainability is to simultaneously pursue economic growth, social development and environmental protection, both domestically and internationally. This is reflected in several high-level policy frameworks, programmes and guidelines.

opening ceremony of the 19th National Congress, President Xi Jinping used the phrase "Clear waters and green mountains are as good as mountains of gold and silver", reflecting the idea of harmony between humanity and nature as an important component of Chinese civilisation. To implement this idea in financial markets, the People's Bank of China (PBOC) along with six other government agencies jointly issued in 2016 Guidelines for Establishing the Green Financial System, which provide an essential first step for implementing the overall strategy of promoting the Ecological Civilisation.<sup>7</sup>

**Figure 1: Guidelines for Establishing the Green Financial System.**

<i>Issued by: Peoples Bank of China, Ministry of Finance, National Development and Reform Commission, Ministry of Environmental Protection, China Securities Regulatory Commission, China Insurance Regulatory Commission, China Banking Regulatory Commission.</i>	
<b>1. Develop green lending</b>	Establish a policy framework, support financial institutions in establishing a credit management system, etc.
<b>2. Enhance the role of the securities market</b>	Improve rules and regulations for green bonds, guide international investors to invest in green assets etc.
<b>3. Launch green development funds and public private partnerships</b>	Improve relevant rules and regulations on green public private partnerships, etc.
<b>4. Develop green insurance</b>	Establish a compulsory environmental pollution system in areas of high environmental risks, etc.
<b>5. Improve markets for the trading of environmental rights</b>	Develop a variety of carbon finance products, promote the establishment of markets for emissions rights, energy use rights, etc.
<b>6. Support local government initiatives</b>	Explore supportive measures such as bank re-lending, macro-prudential measures and capital market instruments, etc.
<b>7. Promote international cooperation</b>	Promote cooperation through the Belt and Road Initiative, South- South cooperation and the Asian Infrastructure Investment Bank
<b>8. Prevent financial risks</b>	Improve supervision mechanisms, rules and standards

Source: PBOC (2016). Guidelines for Establishing the Green Financial System

<sup>6</sup> Emissions per capita are still below those of other major carbon emitters worldwide.

<sup>7</sup> Peoples Bank of China, et al. (2016). Guidelines for Establishing the Green Financial System. <http://www.pbc.gov.cn/english/130721/3133045/index.html>

**The 13th Five-Year Plan of 2016-2020** also focuses on reducing inequality, recalibrating the economy for more inclusive, stable growth, and addressing urbanisation. Within this, China set itself the goal of eradicating poverty by 2020 by transforming itself into a “moderately prosperous society”.<sup>8</sup> At the same time, the national strategy aims to achieve significant progress in building a resource-efficient and environmentally friendly society. China’s ongoing supply-side structural reforms are expected to reduce excess industrial capacity in sectors such as cement, coal, construction, and steel. The transition away from heavy industries will be a disincentive for investments into key polluting sectors and offers opportunity for investment into low-carbon industries.

Risk prevention is on top of the agenda in capital markets development. The China Securities Regulatory Commission (CSRC), which has a large role in overseeing and managing risks, actively guides market participants to strengthen environmental awareness and strictly enforce environmental protection laws and regulations. In July 2016, the CSRC issued notifications stating that companies that had committed environmental violations in the previous three years would not be allowed to issue shares and would face strict requirements for all access to credit.<sup>9</sup>

### International and regional strategies

**On the international stage, a Green Finance Study Group was established as part of China’s presidency of the G20 in 2016,** to “develop options on how to enhance the ability of the financial system to mobilise private capital for green investment.”<sup>10</sup> The study group was co-chaired by China and the UK, with the support of UN Environment as secretariat. The group gathered experience from G20 member countries, key international institutions, observer nations, the private sector and a range of knowledge partners.

**In 2013, China launched the Belt and Road Initiative,** with the aim of contributing to balanced, inclusive and sustainable regional development through financing large-scale infrastructure projects in China, Asia and Africa. This is in line with President Xi’s initiatives to open China’s economy, to coordinate the role of domestic and foreign demand in stimulating growth, and to simultaneously attract foreign investment, technology and talent. To help ensure the environmental sustainability of the initiative, in 2017 the Chinese Ministry of Environmental Protection, Ministry of Foreign Affairs, National Development and Reform Commission (NDRC) and Ministry of Commerce jointly issued the “Guidance on Promoting Green Belt and Road”.

Meanwhile, the Green Finance Committee, an organisation affiliated with the PBOC and whose members account for 70% of China’s financial assets, in 2017 issued the ***Environmental Risk Management Initiative for China’s Overseas Investment*** to promote sustainable finance of Chinese organisations abroad. This document specifically promotes integration of environmental risk analysis, ESG integration, consideration of long-term goals such as the Paris Agreement and the UN Sustainable Development Goals, adherence to the PRI, and consideration of the standards of the Global Reporting Initiative (GRI) on information disclosure.<sup>11</sup>

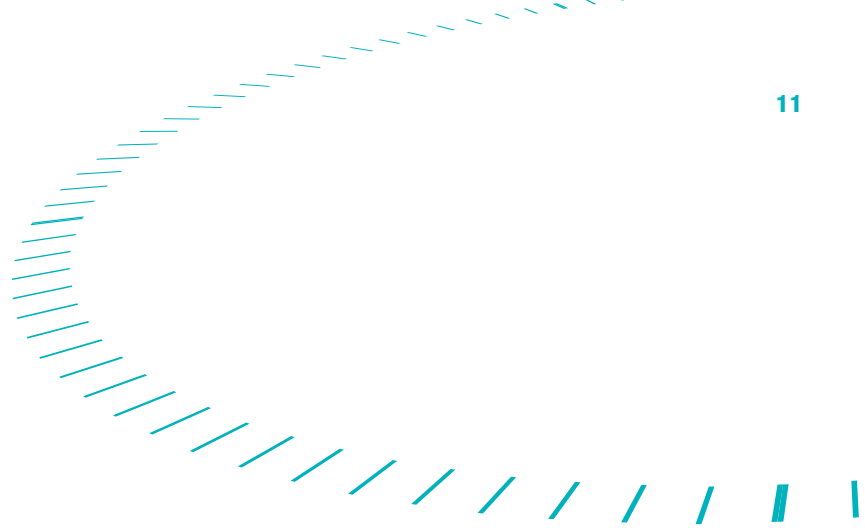
**China has put in place high-level policy frameworks, established programmes and published guidelines to achieve green and sustainable growth nationally and internationally. With the PBOC, the CSRC and the government’s commitment to sustainability, investors will need to align financial and sustainability performance, and consider ESG factors in investment. Shifting national priorities will make it riskier for investors not to consider ESG factors in investment.**

8 As another strategic policy document indicating the direction of the Chinese economy, in 2015 the Communist Party of China introduced at the Fifth Plenary Session of the 18<sup>th</sup> National Party Congress Central Committee five ‘New Development Principles’, namely innovation, coordination, greenness, openness and sharing.

9 China Securities Regulatory Commission (2016, July 1), Fulfilling Green development philosophy, identifying regulatory requirement (践行绿色发展理念 明确监管要求), retrieved from [http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201607/t20160701\\_300109.html](http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201607/t20160701_300109.html)

10 G20 (2016). *Communique – G20 Finance Ministers and Central Bank Governors Meeting*

11 Green Finance Committee (2017), *Environmental Risk Management Initiative for China’s Overseas Investment*



## National investment objectives and outlook for the capital market

It is estimated that China will require at least US\$460bn in investment each year to address its environmental problems, amounting to over 4% of GDP.<sup>12</sup> Of this financing, it is expected that government investment will only cover 15%, with the balance to come from the private sector, including institutional investors.<sup>13</sup>

### The transformation of China's capital market

To meet the goals of its 13th Five-Year Plan, China will need to turn to the domestic and international capital markets. **This marks a significant change given that, at present, China's financial system is currently predominantly bank-based.** China's outstanding social financing, i.e. the total funds in the real economy obtained from the financial system, amounts to RMB173.67trn (some US\$27.5trn). Of this, RMB loans constitute 86.2%, foreign loans 1.5%, entrusted loans 8.1%, trust loans 4.6%, undiscounted banks' acceptance bills 2.5%, bonds 10.6% and stock issuances 3.8%.<sup>14</sup>

According to the government's ambitions, **investments in fixed assets by both public and private institutional investors will remain a key pillar of economic growth.**<sup>15</sup> These include investments in clean energy, transport, communications, oil and gas, environmental protection, emerging industries and upgrading of manufacturing.<sup>16</sup> While the public sector investments grew 18.7% in 2016, investment by the private sector investments grew only 3.2%. This prompted the government to promise to improve conditions for private investing, including through the capital markets.

Increasing the sophistication and depth of its financial system are key government priorities. This includes encouraging private banking, reforming stock and bond markets, developing clear regulations and ensuring their appropriate coverage, and ensuring a larger proportion of direct financing. China has also set a target of merging 106 state-owned enterprises (SOEs) in strategic industries into 40 "world-class" corporate groups. In addition, it aims to achieve full Yuan convertibility by 2020.

### China's fast-growing asset management industry

The Chinese asset management industry is growing rapidly, expanding 51% between 2012 and 2015, and is expected to grow 13% a year to 2020.<sup>17</sup> According to the Asset Management Association of China, the total accumulated value of the industry reached RMB79.1trn in 2015 (US\$12.5trn)<sup>18</sup>.

Institutional investments account for about 40% of total assets under management, compared with a global average of 61%. Of that 40%, insurers and corporate investors (including not-for-profit institutions, finance companies and investment companies) account for approximately 17% each, with pension funds accounting for 5%.<sup>19</sup> Besides mutual funds, commercial banks and insurers, the asset management industry also includes trust companies, securities firms and fund subsidiaries, which often serve as intermediaries between financial institutions and end customers.

**Unlike other major stock markets, which are dominated by professional asset managers, retail investors account for 85% of transactions.**<sup>20</sup> Furthermore, 61% of Chinese investors trade at least once a month, compared with 37% of investors globally. Short-term speculative investments by these retail investors help explain the volatility of China's financial markets, as seen in the summer of 2015.

<sup>12</sup> International Institute for Sustainable Development (2015), *Greening China's Financial System*

<sup>13</sup> Ma, J. and Zadek, S. (2016). 'The G20 Embraces Green Finance'. Project Syndicate. Retrieved from <https://www.project-syndicate.org/commentary/g20-embraces-green-finance-by-ma-jun-and-simon-zadek-2016-09>

<sup>14</sup> PBOC (2017). 社会融资规模存量统计数据报告

<sup>15</sup> See work report of the Chinese government as laid out by Premier Li Keqiang in March 2017, retrieved from [http://english.gov.cn/premier/news/2017/03/16/content\\_281475597911192.htm](http://english.gov.cn/premier/news/2017/03/16/content_281475597911192.htm)

<sup>16</sup> State Council (2017). *Report on the Work of the Government*

<sup>17</sup> BCG (2016). Qin Xu. 'Top 400: Changing times in China'. Retrieved from: <https://www.ipe.com/reports/special-reports/top-400-asset-managers/top-400-changing-times-in-china/10013548.article>

<sup>18</sup> The AMAC (2017). *2015 China Securities Investment Fund Fact Book*.

<sup>19</sup> Ibid.

<sup>20</sup> Reuters (2015). 'China's stock market freezing up as sell-off gathers pace.' <http://www.reuters.com/article/us-china-stocks/china-stock-market-freezing-up-as-sell-off-gathers-pace-idUSKCN0PI04Q20150708>

**The Chinese asset management industry is shifting from saving to investing.** Currently, China's asset management industry is predominantly focused on bank savings and in-house portfolios. It is, however, expected that the proportion of managed assets and government-linked funds (such as the NSSF, China Investment Corporation, and State Administration of Foreign Exchange) will grow in the coming years. It is projected that about 60% of the increase through to 2020 in assets managed will come from retail investors and 40% from institutional investors. The key drivers for this trend will be the further growth of institutional investors, households' strategies evolving from saving to investing, and RMB internationalisation.<sup>21</sup>

**The need for investment into environmentally friendly and sustainable assets creates a unique opportunity for this growing investment industry. Investment managers can take advantage of that opportunity by integrating material ESG factors into their investment decision-making processes.**

## Opportunities, challenges and ambitions of pension funds

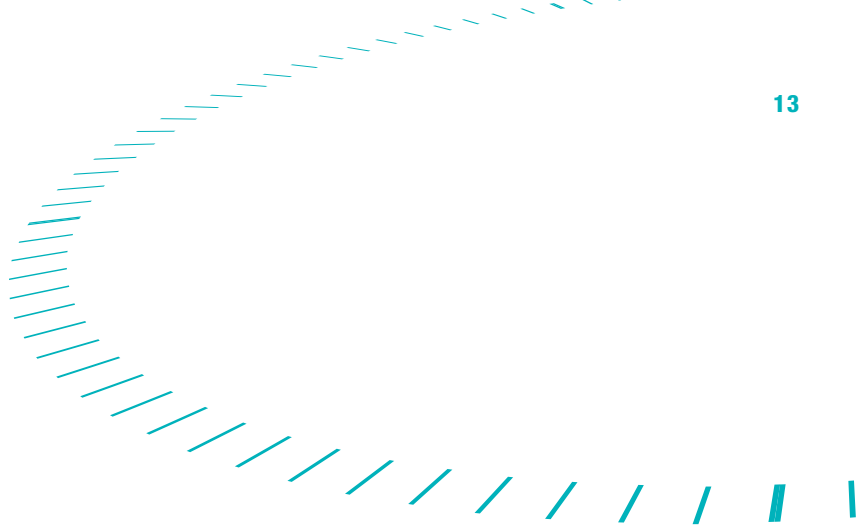
Chinese pension funds face major challenges from an ageing population and the associated need to generate sustainable long-term revenues for future pensioners. Historically funded by government budgets, pension funds now also take private and corporate contributions and are turning to private markets to invest in debt and equity. At the same time, pension funds are seeking to align themselves with the shifting economic policy focus towards environmental protection and sustainable development.

### A shift in the investment focus of pension funds

The majority of State pension funds are funded by the government, but there is a clear move towards increased funding by enterprises and by employees.<sup>22</sup> In addition, the National Social Security Fund (NSSF) was created in 2000 as a "fund of last resort" that can supplement provincial pension funds, as well as covering other social needs such as healthcare. Most of the funding for the NSSF has come from the central government, creating an additional strain on the national fiscal budget.

<sup>21</sup> Oliver Wyman (2014) Asset Management in China: The awakening of the dragon? [http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/financial-services/2014/WebsiteUpdates/Asset\\_Management\\_In\\_China\\_English\\_916.pdf](http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/insights/financial-services/2014/WebsiteUpdates/Asset_Management_In_China_English_916.pdf)

<sup>22</sup> As an example, some provinces with high concentrations of unprofitable state-owned enterprises, such as Liaoning, Jilin and Heilongjiang, rely mostly on the central government's budget.



**Figure 2: Organisation of China’s Pension System<sup>23</sup>.**

	Pillars		Chinese terminology	Funded status	Contributions	Asset allocation	Asset management
Municipal Pension Funds (Five pillars)	State	0	Zero: Minimum guarantee (Di Bao)	From government	n/a	n/a	n/a
		I	Ia: Mandatory Social Pool Old Age Pension	Pay As You Go	Employer: 20% of salaries	100% in government bonds / deposits	100 % domestic
		II	Ib: Mandatory individual account pension	Should be funded	Employee: 8% of salary	<100% in government bonds / deposits <30% in equities (since 2016)	
	Private	III	II: Voluntary Enterprise Annuity (set up by eligible employers)	Funded	Employer and employees	<30% in equities, <50% in financial bonds >20% in government bonds / Deposits	
			III: Other voluntary pensions, e.g. Group Pension Insurance Plans	Funded	Employer and employees	<25% in equities, <20% in financial bonds <100% government bonds	
Private & State	IV	IV: Family support; subsidised healthcare and housing	From government or family	n/a	n/a	n/a	
National Reserve Fund	State	n/a	National Social Security Fund	Central government budget, capital and equity assets derived from SOE IPO sales, investment returns etc.		<b>Domestic</b> >= 50% government bonds/ deposits =< 40% equities =< 10% fixed income =< 10% private equity funds.  <b>International</b> =< 20% equities and fixed income	Domestic and international - depending on onshore and offshore investments

Source: Society of Actuaries, Sterling Finance Research, NSSF. See also <http://www.cncaprc.gov.cn/contents/16/10608.html>

23 Pillar I is the State pension system; Pillar II is the corporate pension system (which includes the Enterprise Annuity system) and occupational pensions; Pillar III comprises individual top-up pension plans. The Enterprise Annuity system was created in 2004, as a voluntary occupational pension system established by enterprises and their employees, to supplement the basic old-age pension. Mutual funds are also growing very rapidly, and bring opportunities for smaller investors to pool money for investment in stocks, bonds and securities.

The fundamental issue for Chinese pension funds is the ageing of the population and therefore the increasing proportion of pensioners. China's population is rapidly ageing, thanks to improvements in healthcare and as a consequence of the implementation of the one child policy between 1979 and 2015. In 2015, the worldwide old-age dependency ratio was around 12-13%. In China, this ratio is expected to surge to 33% by 2040, while the world average will rise only to 19%.<sup>24</sup> This poses a major challenge to the financial sustainability of the endowment of insurance systems and pension funds.

Traditionally, State pension funds have been restricted to investing only in high security, low-yielding assets such as government bonds and bank deposits. In 2015, the State Council issued guidelines to

loosen investment rules on pension funds, stating that up to 30% of Pillar 1b assets could be invested in domestically listed shares.<sup>25</sup> This measure is expected to benefit capital markets by increasing the number of institutional investors, and benefit pension funds by increasing their returns and diversifying their investments.

**Most pillars of the pension system in China now have access to the equity market to increase revenue generation. As long-term investors, pension funds will also be expected to take into account the governments' Ecological Civilisation policy goal and the GEGFS. Their role in combining their financial objectives with the Ecological Civilisation will be increasingly important.**

**Box 1: The National Social Security Fund**

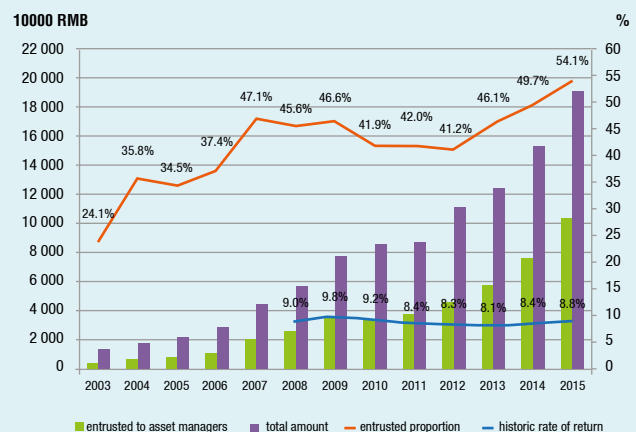
The National Social Security Fund (NSSF) is China's largest pension fund, with total assets of RMB 1,914bn in 2015. It was established as a strategic reserve fund by the Chinese government in 2000 to mitigate the effects of China's ageing population and to help provide financial protection for the country's pensioners. The NSSF is managed by the National Council for the Social Security Fund (NCSSF) in accordance with regulations issued by the State Council, the Ministry of Finance and the Ministry of Human Resources and Social Security (MOHRSS). The pension assets overseen by NSSF are made up of two components – the locally managed pension fund and the supplementary Social Security Fund. By the beginning of November 2017, NCSSF had signed investment contracts worth a total of 430 billion Yuan (US\$65bn) with nine provincial governments, of which 180 billion Yuan was already invested.

The NSSF has more flexibility on asset allocation than any other Chinese pension fund. Since 2012, it has taken steps to improve returns from its vast locally managed assets, which have traditionally been held by banks or used to purchase government bonds.

The fund not only has the potential to help stabilise China's volatile investment markets through long-term investments, but it could

also encourage ESG integration into investments from other asset owners. "Long-term" and "responsible investment" are listed as core philosophies underpinning its investment decision-making.

**NSSF investment and historical returns.**



Source: NSSF Council.

24 Source: data.un.org. The old-age dependency ratio is the ratio of the population aged 65 years or over to the population aged 15-64, presented as number of dependents per 100 persons of working age (15-64).

25 Ministry of Finance (8 September, 2016) *Measures for the management of occupational pension funds* (Chinese) retrieved from: [http://www.mof.gov.cn/zhengwuxinxi/zhengcefabu/201610/t20161013\\_2434596.htm](http://www.mof.gov.cn/zhengwuxinxi/zhengcefabu/201610/t20161013_2434596.htm), and The State Council (2015) *China's Pension Fund seeks investment in stock market*, retrieved from: [http://english.gov.cn/news/top\\_news/2015/06/29/content\\_281475137042132.htm](http://english.gov.cn/news/top_news/2015/06/29/content_281475137042132.htm). Furthermore, in 2017 the Ministry of Human Resources and Social Security stated that it is studying the possibility of investing urban and rural residents' social endowment insurance funds in higher-yield financial products (see Xinhua (28 July, 2017) 'More pension funds entrusted for investment: official.' Retrieved from: [http://news.xinhuanet.com/english/2017-07/28/c\\_136481046.htm](http://news.xinhuanet.com/english/2017-07/28/c_136481046.htm))

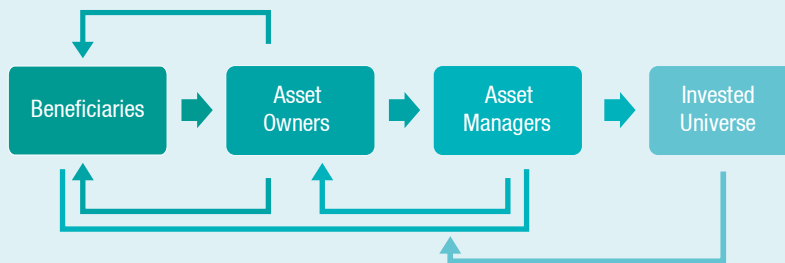
# THE DRIVERS OF CHANGE: INTEGRATING ESG IN INVESTOR DUTIES

## Investor responsibilities, obligations and duties in China

### Box 2: The modern interpretation of fiduciary duty

Fiduciary duty is a common law concept referring to investment decisions made by trustees on behalf of beneficiaries. In its original definition, it has no legal application in China. Therefore, we refer in this report to the broader concept of investor duties and obligations.

Common law definition of fiduciary duty: the duty of asset owners to their beneficiaries



Broader understanding: the duty of investors to manage the capital they are entrusted with, prudence, loyalty and care

Investor duties are defined to ensure that those who manage other people’s money act in the interests of beneficiaries. Among the most important investor duties are:

- Loyalty: acting in good faith in the interests of beneficiaries
- Prudence: acting with due care, skill and diligence, investing as an ‘ordinary prudent person’

The modern interpretation of prudence is that decision-makers need to take account of all financially material factors, including material ESG factors, to better manage risk and generate sustainable returns. Failing to consider long-term investment value drivers, which include material ESG issues, in investment practice is a failure of fiduciary duty.

### Legal and regulatory oversight and framework

The investment value chain is characterised by multi-sector regulatory oversight (see Figure 3). Four financial regulators, the People's Bank of China (PBOC), the China Securities Regulatory Commission (CSRC), the China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC) focus on different parts of the capital markets and therefore place different requirements on investors under their oversight.

Standalone asset managers are supervised by the CSRC, whereas the CBRC supervises the asset management arms of banks, and the CIRC supervises the asset management arms of insurance companies. Under the Chinese government reforms of March 2018, the CBRC and CIRC will be merged. Pension funds and the NSSF fall under the oversight of the Ministry of Human Resources and Social Security (MOHRSS) and the Ministry of Finance (MOF), whereas the CIRC supervises the assets of insurance companies, and the State Council and PBOC supervise sovereign wealth funds. Industry associations, such as the Asset Management Association of China (AMAC), contribute to the work of regulators, by focusing on specific industries (asset management, insurance or banking).

Investors may be legally qualified as financial institutions or not; this can result in different levels of regulatory oversight (as an example, some asset managers are not qualified as financial institutions and therefore not regulated as such). Similarly, the relationship between an asset manager and an investor may be governed by different laws. In some situations, it is a financial relationship, where the investor will entrust the manager to make decisions; in others it is a trust relationship. The manager's responsibilities are also subject to the relevant requirements as stipulated in the contract law.

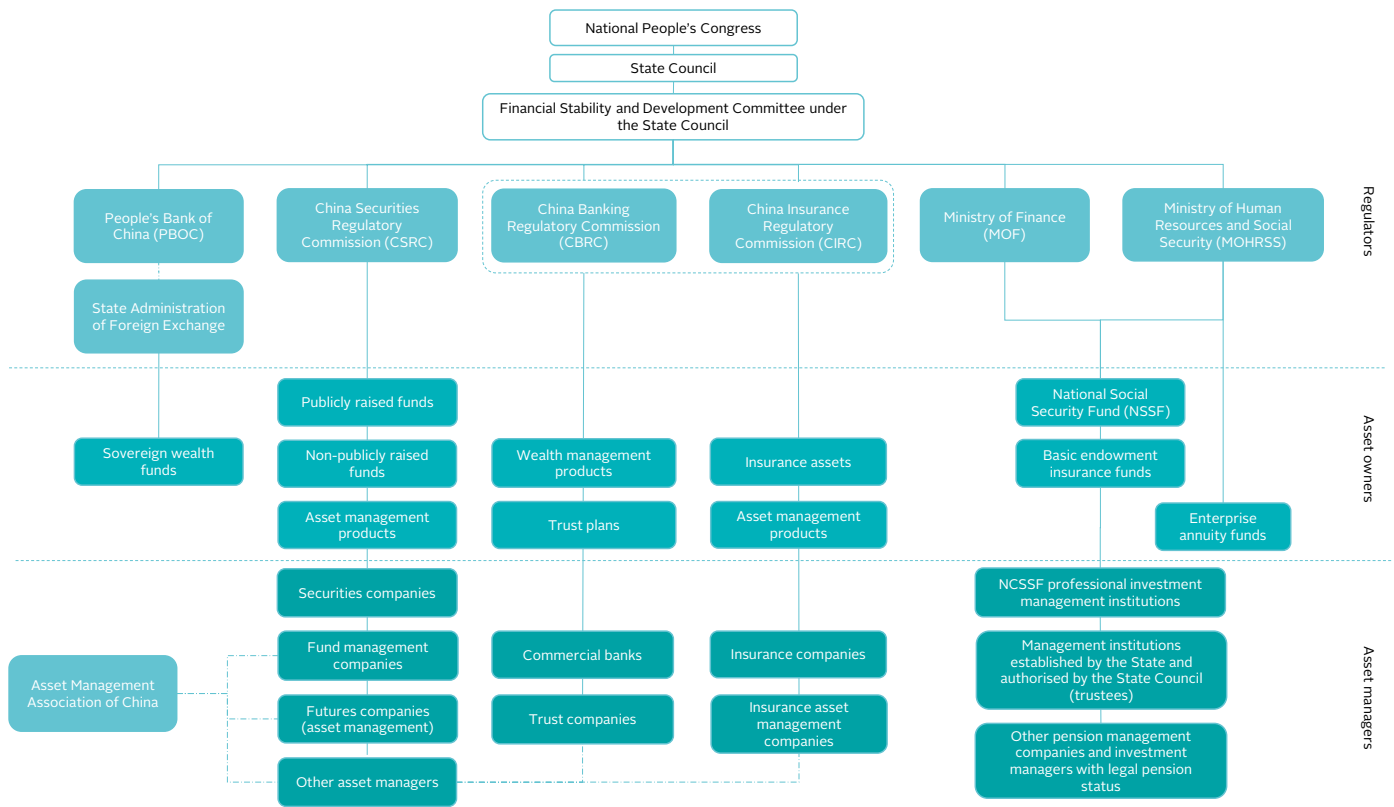
Investors are expected to play a major role in providing financing for the country's sustainable long-term growth. Markets will also be key to finance pension funds and ensure sustainable revenues for an ageing population. However, the current legal, regulatory and normative frameworks guiding investment decision-making in China only connect investors with long-term national goals at a very high level. They do not require investors to explicitly integrate material ESG issues or long-term goals into their investment practices and processes, and they do not clarify their duties towards promoting the Ecological Civilisation.

The legal framework for investor duties is defined by a complex set of laws and regulations. These laws contain the general rules of loyalty, care and good faith, safeguarding the legitimate rights and interests of beneficiaries, providing full risk disclosure to protect the lawful rights and interests of the clients and refraining from prejudicing national interests and public interests (see Figure 4).

However, **this framework does not explicitly connect investor duties with long-term government policy goals such as the Ecological Civilisation. There is no legal or regulatory clarification of investors' duties or of investors' obligations that directly and/or explicitly refer to implementing the GEGFS.** The legal framework does not explicitly link long-term issues with investment industry agendas; one specific issue is that investors have investment time horizons that tend to be much shorter than those for the Ecological Civilisation or for infrastructure projects underway as part of the Belt and Road Initiative.



**Figure 3: Regulatory oversight of the investment value chain.**



Source: Zhong Lun research, UNEP FI / PRI

**Figure 4: The legal framework for investors in China.**

Main investors	Major laws and regulations	Main aspects of investors' duties
<b>Basic Endowment Insurance Funds (Pillars Ia and Ib)</b>	Social Insurance Law of the People's Republic of China / Circular of the State Council on Issuing the Administrative Measures for Investment with Basic Endowment Insurance Funds	<p>The overarching requirement for these funds is to keep assets safe and to protect nominal value. Within this, these funds' Management Institutions (as trustees), along with Investment Management Institutions entrusted by Management Institutions, are subject to general rules about loyalty and care.<sup>26</sup> They are expected to ensure that there is no embezzlement, no taking of improper benefits, no insider trading etc. Investment Management Institutions are also expected to treat beneficiaries fairly i.e. subject to the pension rules.</p> <p>As with the NSSF, Basic Endowment Insurance Funds shall satisfy the requirements relating to investment proportions as stipulated in Article 37 of the Administrative Measures for Investment with Basic Endowment Insurance Funds. In order to cover losses arising from investments, Investment Management Institutions are required to hold 20% of the management fees collected in the current period as risk reserves. The risk reserves shall be invested and operated together with the principal, with separate accounting, and belong to the trustors.</p> <p>The annual fees collected by Investment Management Institutions shall not be higher than 0.05%.</p>
<b>The NSSF</b>	Regulations on National Social Security Fund / Interim Measures on the Control of the National Social Security Fund Investment	<p>The NSSF must meet similar requirements as the Basic Endowment Insurance Funds. The National Council of Social Security Fund (SSF, the management and operational organisation of the NSSF) is expected to keep assets safe and to increase the value of these assets. The SSF is also subject to general rules about loyalty and care. The SSF can review, select and entrust professional investment institutions that meet strict requirements as investment managers. These professional investment managers are required to ensure that there is no embezzlement, no taking of improper benefits, no unfair treatment of the assets of NSSF, no making of investments that may result in unlimited liability, no credit trading using NSSF assets and no insider trading. The investments made by or on behalf of NSSF shall meet the following conditions (1) at least 50% of assets should be invested in bank deposits or national debt instruments, with no more than 10% invested in bank deposits; (2) at least 10% of assets should be invested in enterprise bonds and financial bonds; and (3) no more than 40% of asset shall be invested in securities investment funds and stock investments.</p> <p>The SSF and investment managers shall disclose information regularly or temporarily as required by law, and the NSSF is subject to auditing at least once a year.</p> <p>To avoiding conflicts of interest, an investment manager must be approved by the SSF if it invests the Social Security Fund assets in the fund managed by itself.<sup>27</sup></p>
<b>Enterprise Annuity Funds (Pillars II and III)</b>	Order of the Ministry of Human Resources and Social Security on Issuing the Trial Measures for Enterprise Annuities / Measures for the Administration of Enterprise Annuity Funds (Revised in 2015)	<p>An employer providing an Enterprise Annuity Plan must appoint a trustee to oversee the management of the assets by a third party. Irrespective of the approach chosen, investment management companies entrusted by trustees, as investment managers, are expected to act honestly and in good faith, not commingle assets or funds, not embezzle assets, and treat investors fairly.</p> <p>Other obligations of trustees and investment managers are similar to those for Basic Endowment Insurance Funds.<sup>28</sup> Trust law (which has similar fiduciary duties to trust law in common law jurisdictions) also applies; that is, trustees are subject to best interest, due diligence and good faith requirements.</p>

26 In terms of Basic Endowment Insurance Funds, provincial governments are trustors and management institutions of the endowment funds established by the State and authorised by the State Council take the place of trustees.

27 It is stipulated in Article 29 of Interim Measures on the Control of the National Social Security Fund Investment that the Investment Managers need approval when they invest the Social Security Funds in other funds managed by them (since the Investment Managers are professional asset management institutions, they manage multiple funds, including the Social Security Funds, at the same time).

28 Basic Endowment Insurance Funds, the NSSF and Enterprise Annuity Funds have similar regulatory structures as to duty of care, or trustee/investment manager obligations.

Main investors	Major laws and regulations	Main aspects of investors' duties
<b>Publicly-raised funds and non-publicly-raised funds</b>	Law of the People's Republic of China on Securities Investment Funds / Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds	<p>The fund manager of a (non) publicly-raised fund (including its directors, supervisors and senior managers) is required to perform its duties diligently and dutiously, to follow the principles of voluntariness, fairness, honesty and good faith, to safeguard the legitimate rights and interests of investors, and to refrain from prejudicing national interests and public interests.</p> <p>These managers are required to set up efficient mechanisms dealing with conflicts of interest. They are forbidden to mix their proprietary assets or the assets of others with fund assets, treat the assets of different funds under management in an unfair manner, embezzle fund assets, divulge undisclosed information obtained by virtue of their positions, or engage in insider trading.</p>
<b>Trust plans</b>	Trust Law / Administrative Measures for Trust Companies / Administrative Measures for Collective Investment Trust Schemes of Trust Companies	<p>Where trust companies manage and use or dispose of trust property, they must be diligent, meet the duties of honesty, creditworthiness, prudence and effective management, and protect the interests of the beneficiary.</p> <p>Trust companies must avoid conflicts of interest in handling trust affairs. If it is not possible, they must make due information available to the trustor and the beneficiary or they must refuse to engage in such business.</p> <p>Like fund managers, trust companies shall not seek illegitimate benefits by taking advantage of their trustee status, by diverting trust property for non-trust purposes, or by promising no losses or guaranteed minimum returns.</p>
<b>Wealth management products and plans</b>	Interim Measures for the Administration of Personal Wealth Management Business of Commercial Banks	<p>Commercial banks shall exercise prudence and due diligence when undertaking personal wealth management business in line with their clients' interests and risk tolerance.</p> <p>Commercial banks shall follow the principles of integrity, diligence and honest disclosure when selling wealth management products, and shall provide full risk disclosure in a fair, open and impartial manner to protect the lawful rights and interests of the clients.</p>
<b>Asset management products and plans</b>	Administrative Measures for Client Asset Management Business of Securities Companies / Regulations on the management of subsidiary companies of fund management companies / Measures for Pilot Asset Management Services Provided by Futures Companies / Circular of China Insurance Regulatory Commission on Issues Concerning Pilot Business of Asset Management Product to Be Carried out by Insurance Asset Management Companies	<p>The asset manager of an asset management plan shall comply with relevant laws, administrative regulations and provisions, follow the principles of fairness and impartiality, protect the legitimate rights and interests of clients, and uphold the principles of honesty, trustworthiness, diligence, and dutiousness, so as to avoid conflicts of interest.</p> <p>They shall have a sufficient understanding of their clients, and shall recommend suitable products or services for these clients by following the principle of matching risks with returns.</p> <p>They shall build efficient mechanisms to prevent potential risks, to manage conflicts of interest, and to prevent transfers of interests. They are prohibited from misleading clients into purchasing products or services incompatible with their risk tolerance, from making commitments to a client that the principal of its assets will not suffer losses or that a minimum yield will be obtained, from comingling the asset management business with their other business, and from insider trading.</p>
<b>Insurance assets</b>	Insurance Law of the People's Republic of China / Order of the China Insurance Regulatory Commission Regarding the Release of the Tentative Provisions on the Administration of Insurance Assets Management Companies	<p>Insurance assets shall be invested safely and only in certain vehicles approved by the State Council, such as bank deposits, government bonds and bonds issued by financial institutions.</p> <p>The asset management businesses of insurance companies shall observe the Insurance Law and relevant provisions of the CIRC, conduct business on a voluntary, fair, and good-faith basis, apply the principle of good faith, and perform diligence. The asset management businesses of insurance companies shall not harm the interests of the State or the common interests of society.</p>

### The role of normative frameworks and non-legal expectations

A normative framework, comprised of social norms and expectations, and soft law, can also have a strong influence on investment practice and on the level of compliance with or uptake of existing regulations. These rules and policies may result from regulators' values and beliefs, from government and regulators' reactions to certain recent market developments, and from the goals or issues that the government is concerned with. They may be expressed through official notices, in senior regulatory officials' speeches, or in the results of regulatory action. Examples of how these norms and policies are signalled include faster approval for green bonds (as these are aligned with government goals), or signals from government that investors should exercise caution in investing in high-polluting industries.

For institutional investors, the relationship between regulatory and normative frameworks lies in the interpretation of investors' duties as inherently moral, as well as legal.<sup>29</sup> It is considered that the role of the financial sector is to protect capital, support the real economy and not harm society. Beyond their explicit legal duties, investors are expected to bear a responsibility towards their beneficiaries. While this responsibility is not clearly defined in current law, it is present in the unwritten, normative framework. However, despite these normative expectations, many investors continue to focus on short-term gains and near-term financial performance.<sup>30</sup>

### The interaction between regulators and the market

The legal framework for investors in China is built on a complex interaction between top-down policies, norms and market innovation. When regulators set out the basic conditions for the market or influence its structure, the market reacts with financial innovations and strategies to create new space for revenues. The

outcomes of such strategies may or may not be aligned with the expected results or with long-term government policies. This leads to the next phase of regulatory experimentation and evolution (starting with soft policies and guidance), followed by updates to the legal framework, aiming to address a changed market context and balance the system.

The investment industry has developed significantly over the past decade. After a first phase of policy experimentation, our research suggests that we may be witnessing a new phase of market top-down redesign. The work by financial regulators on the stability committee also aims to address overlaps and overregulation, and unify existing frameworks.<sup>31</sup> The work on the Ecological Civilisation and the GEGFS may contribute to redesigns of the existing legal framework and to the transfer of norms and expectations into law.

### The emergence of green and sustainable investing

The transition to a green economy in China, formalised by the government's concept of the Ecological Civilisation and the GEGFS, has attracted investors' attention. However, progress towards green and sustainable investment has been stalled by:

- A lack of regulations and guidance aimed specifically at investors;
- Misconceptions that sustainable investing is risky or financially underperforming;
- The difficulty in translating high-level policies into business strategies and products; and
- Insufficient data on ESG performance.

29 This refers to the Chinese traditional interpretation of individual duties, heavily based on the moral nature of people. See "The Chinese legal tradition" in *Foreign Investment in China*. F.Li, 1999, p.156-157

30 <http://knowledge.wharton.upenn.edu/article/whats-behind-chinas-stock-market-gamble/>

31 The PBOC, CBRC, the CSRC, the CIRC and the State Administration of Foreign Exchange published in November 2017 a guiding opinion about asset management business carried out by financial institutions. Although it is only a draft for public comments (with no legal enforcement), it has signalled that regulators plan to conduct supervision according to the type of asset management products instead of the type of financial institutions, and apply the same regulatory standards to the same type of products. One of the aims of this guiding opinion is to reduce regulatory vacuums and regulatory interest arbitrage.

### The influence on investors of the Guidelines for Establishing a Green Financial System

The GEGFS have helped China become the world's largest green bond market, with 10% of all credit being green, and home to more than 50 local green funds.<sup>32</sup> However, unlike banks, investors have not been required to directly align with the GEGFS. The guidelines “encourage” investors but do not require them to integrate its principles. Also, the work of the CSRC in recent years has been focused on listed companies and less on investors. The small historical size of the institutional compared with the retail market, and relatively young capital markets in China help explain why the uptake in sustainable investing has been limited.<sup>33</sup>

Although not mandatory for investors, the GEGFS have provided policy signals promoting green and sustainable investment.<sup>34</sup> They aim to create a system change: greening the economy implies that all sectors consider their contribution to the Ecological Civilisation. However, green investment, green lending or green bonds are all still project-based, and comprise a very small share of overall financial activity in China.<sup>35</sup> As the policy framework is still shaping up, devising solutions that create systemic behavioural change will be important, especially within the emerging parts of the financial sector (such as private pension or insurance for example). Developing the GEGFS for investors will help align investment practices with the Ecological Civilisation.

### Misconceptions around sustainable investing

Despite the international growth of ESG integration in investment practices, progress in China so far has been limited. Some widely held misconceptions about sustainable investment are partly responsible for this situation. In Figure 5, we set out the most prominent we have identified in our research on the Chinese market, and explain why we do not consider them valid.

#### Box 3: The case for sustainable investing

Responsible or sustainable investment is an approach to investing that aims to incorporate ESG factors into investment decisions, with the aim of better managing risk and generating sustainable, long-term returns. Global growth in sustainable investment has been driven by:

- Recognition in the financial community that ESG factors play a material role in determining risk and return, following multiple examples of how issues such as climate change, working conditions, corruption and aggressive tax strategies can affect corporate and investment performance;
- Understanding that incorporating ESG factors is part of investors' fiduciary duty to their clients and beneficiaries;
- Concern about the impact of short-termism on company performance, investment returns and market behaviour;
- Legal requirements in many jurisdictions that require investors to protect the long-term interests of their beneficiaries and to support efforts to ensure the stability of the wider financial system;
- Market pressure resulting from competitors seeking to differentiate themselves by offering responsible investment services as a competitive advantage; and
- Beneficiaries becoming increasingly active and demanding transparency about where and how their money is being invested.

32 IIGF & UN Environment (2017). *Establishing China's Green Financial System: Progress Report 2017*

33 As of February 2018, only seven of 1,900 PRI signatories are based in China.

34 In addition to the GEGFS, other government policies have sought to address sustainability issues – for example, social welfare, local development and job creation are important goals for SOEs.

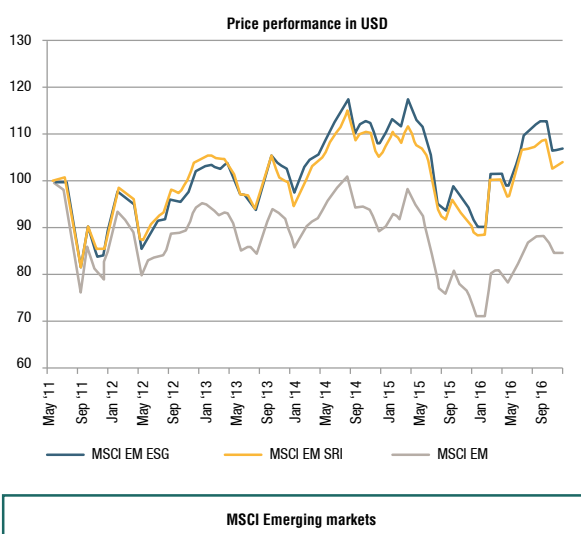
35 While green bonds have been a huge success (with China being the largest issuer), they remain a small part of the total bond market, at 2% in China and even less globally.

**Figure 5: Misconceptions on sustainable investment in China.**

Commonly held view	Fact
Sustainable investing is philanthropy or an ethical preference, separate from fundamental financial analysis. Furthermore, sustainable investing compromises investment returns.	<b>Market data demonstrates that integration of material ESG factors into investment research and decision-making processes can deliver better financial performance.</b> In Figure 6 we illustrate the example of the MSCI emerging market index and its ESG counterpart. We also note that research by Industrial and Commercial Bank of China of 180 companies listed on the Shanghai Stock Exchange came to similar conclusions. <sup>36</sup>
Sustainability issues may affect financial performance in the long term but do not affect short-term performance.	<b>Unmanaged ESG issues can affect performance in the short term.</b> There are many company-specific examples of how sustainability issues affect corporate performance. For example, high pollution stocks are negatively impacted, while electric vehicle companies see their stock price increase much faster.
Green investing is too risky because it focuses on innovative industries and projects with a high degree of uncertainty.	<b>Integrating material ESG factors in investment analysis implies taking account of additional risks that may affect performance.</b> Sustainable investing enables better investment risk management. Green and sustainable investing does not focus on emerging technologies, but represents a systematic integration of ESG risks and opportunities within investment practice in general.
There are no regulatory requirements on Chinese investors to consider ESG or sustainability issues.	<b>The regulatory framework is changing: the CSRC and the AMAC are working to further promote the GEGFS.</b> A regulation on mandatory environmental reporting is being prepared for 2018, to cover all listed companies from 2020.

Source: UNEP FI and PRI

**Figure 6: Case-study: The outperformance using ESG integration in emerging markets.**



Source: MSCI<sup>37</sup>

The MSCI ACWI ESG Leaders Index is a capitalisation-weighted index that provides exposure to companies with high ESG performance relative to their sector peers.

The index consists of large and mid-cap companies across 23 developed and emerging markets. It is designed for investors seeking a broad, diversified sustainability benchmark with relatively low tracking error to the underlying equity market. The index is a member of the MSCI ESG Leaders Index series. Constituent selection is based on data from MSCI ESG Research.

MSCI also offers an SRI version of the index, which excludes certain industry sectors on ethical grounds.

As the graph shows, both the Emerging Markets ESG Leaders Index and the Emerging Markets SRI Index substantially outperformed the MSCI Emerging Market Index between May 2011 and October 2016.

36 <http://cufs.org.cn/upload/1/57310e26-2790-4f40-a7e5-0dfa13e8c704.pdf>

37 Further data is available from: <https://www.msci.com/documents/10199/c341baf6-e515-4015-af5e-c1d864cae53e>

### The contribution of ESG integration to green finance

The use of various terms to define responsible, sustainable and green investment has been a source of debate and confusion for market participants. In European and North American markets, for example, practitioners still argue about what defines and distinguishes impact, socially responsible and sustainable investing. During our interviews and exchanges with contributors, many switched between “green”, “responsible” and “sustainable”. Some interviewees noted that they were used to hearing mostly about green finance; others, that all these concepts are interchangeable.

- **The focus on green finance and green business by China’s government reflects the need to reduce the environmental impact of past industrial and energy practice.** Aligning environmental and economic performance is the government’s priority. While the language focuses on “green”, this does not mean that the scope is limited solely to environmental technology. In the terminology of UN Environment, the PRI and the OECD, green is also inclusive; green jobs are decent jobs; and green is always considered within the context of sustainable development.<sup>38</sup> In China, **green doesn’t only mean environmental, it is also about social welfare, which is a key priority of the Ecological Civilisation.**
- **How investors think about ESG issues, at the asset level, should be guided by considerations of materiality.**<sup>39</sup> For example, what is material for oil companies (e.g. health and safety, and carbon emissions) might not be material for the tourism industry (where energy management and customer welfare etc. would be more important).<sup>40</sup>

Many contributors argued that translating high-level government policies across to investment practice may be challenging. **ESG integration helps to resolve this challenge as it involves aligning investors’ interests with policy goals.** Beyond assessing how their investment practices and decisions compare to and

support national policy goals, there are strong reasons for investors to explicitly assess the financial significance (or materiality) of ESG issues as an integral part of their investment research and decision-making processes:

- ESG integration enables investors to identify those issues that create downside risks or upside opportunities for their investment processes, and to make decisions on the actions they can take (e.g. to invest elsewhere, or to engage with company management) to manage these risks and opportunities.
- ESG integration will reinforce investor interest in green finance as it is likely to lead to them invest more in those areas where the investment case is reinforced or underpinned by government policy.

Green and sustainable national development can be reinforced if investors systematically and consistently integrate material ESG issues in their consideration of each type of asset and industry sector in which they are investing. In turn, this will help deliver the Chinese government’s overall vision of investors as global citizens who, by seeking to create long-term value, support local and global sustainability.

ESG integration is, arguably, particularly important for large asset owners, such as pension funds, who tend to be “universal owners”, meaning they invest across the entire economy and therefore carry most sustainability risks in their portfolios. Such investors should seek to directly incorporate both the green finance government goals and all material ESG factors in their decision-making processes. Such an approach will also help them realise the overall vision of long-term value investors as global citizens, supporting local and global sustainability.

38 See <http://www.oecd.org/greengrowth/> and <https://www.unenvironment.org/explore-topics/green-economy>

39 The investor materiality focus can be determined depending on the investor’s risk profile, values and asset class focus. What matters is that there is a process that is systematic and consistent for all investment decisions.

40 Key environmental issues such as hazardous waste, or water withdrawal, might not be material for every listed company. See for example the Sustainability Accounting Standards Board materiality map, designed for investors in the US market. <https://www.sasb.org/materiality/sasb-materiality-map/>

### The changing ESG disclosure landscape

In 2016, 763 companies issuing A shares on China's Shanghai and Shenzhen markets published sustainability information.<sup>41</sup> This represents a step forward, as 10 years ago, few Chinese companies knew what ESG data referred to. This trend has been boosted by revisions to the guidelines for information disclosure by listed companies, and guidelines from domestic stock exchanges, such as the Shenzhen Stock Exchange's Social Responsibility Instructions to Listed Companies and the Shanghai Stock Exchange's Guide on Environmental Information Disclosure. In addition, more than 800 Chinese firms fall under the Hong Kong Stock Exchange's ESG disclosure requirement, introduced in 2016, which is partly aligned with standards published by the Global Reporting Initiative.

The launch of ESG indexes by the Shenzhen Stock Exchange and the Shanghai Stock Exchange (who both joined the SSE initiative in 2017<sup>42</sup>), and by the China Securities Index Company (CSI), has also incentivised some companies to better manage and report on their ESG performance. The Shanghai Stock Exchange's launch of a labeled green bond market has served to standardise reporting requirements for issuers. Green Chinese securities are also increasingly available abroad, through, for example, the CSI 300 Green Leading Stock Index and the 'CUFE-CNI Green Bond Index Series', both of which were launched on the Luxembourg Stock Exchange in cooperation with the International Institute of Green Finance.

ESG data, provided through voluntary and market-based initiatives, has improved both in quality and quantity. However, it is usually self-reported, unstandardised, non-assured and often incomparable. There is also a lack of an integrated approach to understanding E, S and G factors as contributing to corporate performance and risk management.

Corporate engagement on ESG data is improving. For example, MSCI reports strong growth in the percentage of companies responding to the data verification process it undertakes when it produces its ESG rating reports. As markets become more open, international investors use such reports to engage companies.

Such market-led initiatives form an important framework for disclosing ESG information, and will be key to future market uptake of sustainable and green finance policies. However, **voluntary disclosure frameworks alone, and corporate social responsibility (CSR) information not connected to business performance, do not ensure effective ESG integration in the investment process. Partial coverage, lack of third-party assurance and differing standards make it difficult for investors to compare ESG performance across industry, portfolios and time series.**

#### Box 4: The current understanding of E, S and G in China

The Chinese government's focus on the **environment** is mirrored in most of the disclosure efforts underway, which focus primarily on environmental data. Pollution and climate change are identified as major risks, and as offering significant investment opportunities.

While investors have paid most attention to environmental issues, **governance** issues have also received some attention. Interviewees for our research identified these as "easy to understand", "aligned with shareholder value" and potentially, important to generating higher returns. These interviewees also noted that, even in the absence of formal governance indicators, they still pay significant attention to corporate governance issues.

**Social issues** were described by interviewees as being the most difficult to measure, sometimes involving judgement, and not easily linked to performance. Interestingly, while interviewees saw these issues as receiving much less attention from investors, they noted that many Chinese companies already have proactive programmes in place on topics such as labour issues and community engagement.

41 These mostly take the form of a CSR report. Just over half (54%) of these companies are non-central SOEs, 34% are private-owned enterprises, 8% are controlled by central SOEs, and 4% are joint ventures. Taking into account the current number of A-share listed companies in China at more than 3,300, the number of companies issuing CSR reports is still a minority. Source: SynTao / China SIF

42 <http://www.sseinitiative.org/greenfinance/>



The Chinese authorities are taking action on disclosure, with a mandatory environmental reporting project under development by the CSRC and China's Ministry of Environmental Protection. This project will require that from 2018 listed companies disclose environmental information, or explain why they don't, which is expected to result in a 90% disclosure rate. By 2020, disclosure will be mandatory for all listed companies.

Another project underway by the City of London Green Finance Initiative, the China Green Finance Committee and the PRI aims

to share expertise on global good practice regarding climate change and disclosure. A working group of UK and Chinese financial institutions will, from 2018, pilot reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosure.<sup>43</sup>

Improving comparability of material corporate performance information across industry, portfolio and time series will enhance the ability of investors to manage risks and implement sustainable investing strategies.

#### **Box 5: The role of investor education**

For most investors in China, ESG integration is a new concept. Some investors have begun building their own internal ESG risk management processes. For the majority, however, education, training and best practice examples are necessary to build awareness and capacity. Investor education should focus on, but not be limited to, the following topics:

- How ESG integration contributes to managing long-term risks;
- How good ESG management can drive good management;
- How green finance and ESG integration can be translated into products;
- Examples of ESG integration methodologies, including systemic ESG due diligence processes; and
- The contribution of ESG integration to financial returns.

Promoting best practice and encouraging role models in sustainable investing will also help influence retail investors whose actions will be key to mainstreaming green finance. While retail investors are not the focus of this report, additional research on positively influencing such investors to buy green financial products and those that integrate ESG factors will be very important for the Chinese market.

While many decision makers or sustainability officers are aware of green finance policies and sustainable finance developments in China and overseas, operational staff are not always adequately informed or trained to implement them in practice.

ESG integration is also absent from investment research. Including information on how ESG factors affect performance will be key to influence investment decision-making. Incorporation by investment analysts of ESG issues in their ratings would give an important push to sustainable investing.

The development of local networks such as the Green Finance Development Committee of Shanghai Lujiazui Financial City Council can help raise investor awareness, bring high-level policies closer to market practitioners, and promote best practices and examples for investors to adopt. Such initiatives can also facilitate the market uptake of regulatory reforms, for instance helping companies and investors comply with and utilise the upcoming mandatory disclosure framework from the CSRC.

<sup>43</sup> The group comprises ten financial institutions including several PRI signatories: Aviva, HSBC Hermes, Brunel, E-Funds, HuaXia (China Asset Management), as well as ICBC and Industrial Bank. The People's Bank of China and the Bank of England will provide input to the group.

# EXAMPLES OF LEGISLATION AND GUIDANCE TO INTEGRATE ESG IN INVESTOR DUTIES

To support investors and policy makers understand international trends towards ESG requirements, below we present selected examples of regulations and policy guidelines that integrate ESG considerations in investment decision making. A larger database is available in the PRI *Global Guide to Responsible Investment Regulation*.<sup>44</sup> It identifies almost 300 policy instruments that support investors in considering long-term value drivers, including ESG factors. More than half of these have been created since 2013, demonstrating how responsible investment regulation is rising up the agenda for policy makers, investors and civil society worldwide.

## Pension fund regulation: Ontario Pensions Benefits Act

In 2014, the Government of Ontario updated the Canadian province's Pension Benefits Act to require Ontario-registered pension funds to disclose in their Statement of Investment Policies and Practice "information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."<sup>45</sup>

While a relatively modest change, it has had important knock on effects:

- It has resulted in pension fund administrators – both within Ontario and elsewhere in Canada – having explicit conversations about ESG issues, and seeking advice from their consultants and legal advisers on modern interpretations of fiduciary duty;

- It has created pressure on other states and on the federal government to adopt similar measures;<sup>46</sup> and
- It has led to the Financial Services Commission of Ontario publishing additional guidance (Investment Guidance Notes: *IGN-004: Environmental Social and Governance Factors*<sup>47</sup>) to help pension plan administrators meet the new requirement.

## A law for institutional investors: Article 173 of the French Energy and Environmental Transition Law<sup>48</sup>

The French Energy Transition for Green Growth Law (or Energy Transition Law), adopted in August 2015, sets out a roadmap to mitigate climate change and diversify the country's energy mix.<sup>49</sup> It includes ambitious targets for reducing greenhouse gas emissions and overall energy consumption, reducing the share of fossil fuels and nuclear power in favour of renewable energy, and increasing the price of carbon.

Article 173 of the French Energy Transition Law came into force on 1 January 2016. It requires institutional investors to disclose, in their annual reports, information on how ESG criteria are considered in their investment decisions and how their policies align with the national strategy for energy and ecological transition. It also places disclosure requirements on listed companies, banks and credit providers.

44 See <https://www.unpri.org/about/pri-teams/policy/responsible-investment-regulation>

45 See <https://www.fiduciaryduty21.org/canada.html>

46 UNEP Finance Initiative, Principles for Responsible Investment, SHARE and The Generation Foundation (2017), *Canadian Pension Regulation Analysis: Alberta*. <https://www.unpri.org/download?ac=1422>

47 See [https://www.fSCO.gov.on.ca/en/pensions/fSCO\\_consultations/Documents/IGN004.pdf](https://www.fSCO.gov.on.ca/en/pensions/fSCO_consultations/Documents/IGN004.pdf)

48 See PRI, Mirova, UNEP Finance Initiative, Investor Group on Climate Change (IGCC) and Institutional Investors Group on Climate Change (2016), *French Energy Transition Law: Global Investor Briefing*. [https://www.unpri.org/download\\_report/14573](https://www.unpri.org/download_report/14573)

49 See <https://www.legifrance.gouv.fr/eli/loi/2015/8/17/DEVX1413992L/jo#JORFARTI000031045547>

Article 173 explicitly links responsible investment, finance and climate and energy policy. Responsible investment is seen as an integral part of wider climate policy efforts. An innovative feature is that monitoring and review is an explicit feature of the legislation. The French government has committed to publishing a review of the implementation decree before the end of December 2018. This approach involves passing pioneering legislation and then using an implementation stage to understand its full implications and impact, while remaining open to amending the legislation, if necessary, in the light of experience.

Many collaborative and supporting initiatives have emerged since the law's inception. These include working groups set up by the Ministry of Finance and Ministry of Ecology with investors, issuers, NGOs and service providers to develop best practice guidance, as well as similar groups set up by professional associations (for example associations for institutional investors and asset managers) to develop methodologies and more detailed frameworks to help implement the provisions of the Energy Transition Law.

### A regional policy framework: the European Union's Capital Markets Union programme

The European Commission has taken unprecedented steps in recent years to bring sustainability into the heart of Europe's capital markets. As part of the mid-term review of the flagship Capital Markets Union programme, the Commission committed to a "deep re-engineering of the financial system" to promote sustainable economic, social and environmental development. The Capital Markets Union aims to promote deeper, more integrated capital markets across Europe and in doing so, channel capital to companies and infrastructure projects.

In December 2017, at the One Planet climate summit hosted by the President of France, Emmanuel Macron, the European Commission committed to a comprehensive action plan to stimulate the market for sustainable financial products.

Its provisions include:

- Integrating sustainability considerations into the duties that asset managers and institutional investors have towards those whose money they manage, to clarify the requirement to take into account risks related to ESG factors;
- Exploring the modalities of a "green supporting factor" in prudential rules, to boost environmentally friendly investments. Lower capital charges would create incentives for investors to favour low-carbon investments or loans; and
- Incorporating ESG factors into the mandates of supervisory authorities, to enable them to monitor how financial institutions identify, report, and address ESG risks.

The High-Level Expert Group on Sustainable Finance (HLEG), comprised of 20 experts from the finance sector, civil society and academia, and tasked with advising the European Commission on a strategy to fully integrate sustainability into Europe's system of financial regulation, published its final report on this topic in January 2018. It provided detailed recommendations on the policy actions needed to integrate sustainability in the functioning of Europe's capital markets. Its priority recommendations are to:

1. Establish and maintain a common sustainability taxonomy at the EU level;
2. Clarify investor duties to better embrace long-term horizons and sustainability preferences;
3. Upgrade disclosure rules to make sustainability risks fully transparent, starting with climate change;
4. Develop a retail strategy on sustainable finance, covering investment advice, ecolabels and minimum standards;
5. Develop and implement official European sustainability standards and labels, starting with green bonds;
6. Establish 'Sustainable Infrastructure Europe' to channel finance into sustainable projects;
7. Strengthen governance and leadership; and
8. Include sustainability in the supervisory mandate of Europe's supervisory agencies and extend the horizon of risk monitoring.

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Roundtables were held in Beijing and Shanghai to discuss investor duties in China on 11 and 13 October 2017. Participants included:

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# GLOSSARY

AMAC	The Asset Management Association of China
CBRC	The China Banking Regulatory Commission
CIRC	The China Insurance Regulatory Commission
CSRC	The China Securities Regulatory Commission
GEGFS	Guidelines for Establishing a Green Financial System
HLEG	High-Level Expert Group on Sustainable Finance
IIGF	The International Institute of Green Finance
MEP	The Ministry for Environmental Protection
MOF	The Ministry of Finance
NDRC	The National Development and Reform Commission
NCSSF	National Council for the Social Security Fund
NSSF	The National Social Security Fund
PBOC	The People's Bank of China
PRI	The Principles for Responsible Investment
SAFE	The State Administration of Foreign Exchange
SSE	The Sustainable Stock Exchanges initiative
TCFD	Task Force on Climate-related Financial Disclosures
UNEP FI	UN Environment Finance Initiative

# ABOUT THE PROJECT PARTNERS

## About the PRI

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions. The six Principles were developed by investors and are supported by the UN. They have more than 1,900 signatories from over 50 countries representing US\$70 trillion of assets. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system. For more information, see [www.unpri.org](http://www.unpri.org)

## About The Generation Foundation

The Generation Foundation (the 'Foundation') was part of the original vision of Generation Investment Management LLP ('Generation') since the firm was founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for Sustainable Capitalism. Our strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism. In our effort to accelerate the transition to a more sustainable form of capitalism, we primarily use a partnership model to collaborate with individuals, organisations and institutions across sectors and geographies and provide catalytic capital when appropriate. In addition, the Foundation publishes in-house research, gives select grants related to the field of Sustainable Capitalism, engages with our local communities and supports a gift matching programme for the employees of Generation. All of the activities of the Foundation, a not-for-profit entity, are funded by an annual distribution from Generation. For more information, see [www.genfound.org](http://www.genfound.org)

## About UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector founded in 1992. UNEP FI works closely with over 200 financial institutions who have signed the UNEP FI Statements as well as a range of partner organizations to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations. For more information, see [www.unepfi.org](http://www.unepfi.org)

## About the International Institute of Green Finance, Central University of Finance and Economics

The International Institute of Green Finance (IIGF) of the Central University of Finance and Economics (CUFE), is an independent and non-profit think tank in China whose goal is to promote the development of green finance. The IIGF grew out of the Research Centre for Climate and Energy Finance (RCCEF), which was founded in September 2011, and is partly financed by donations from Tianfeng Securities. IIGF specialises in green finance as well as climate finance and energy finance. It conducts research within a range of areas such as credit, bonds, insurance, carbon trading, information disclosure and risk assessment at a national and local level and additionally conducts research internationally. IIGF is one of the executive member institutions of the Green Finance Committee of the China Society of Finance and Banking and has also built an academic relationship with the Ministry of Finance. The IIGF aims to spread the word of green finance and solidify its status as one of the world's leading financial think tanks. For more information, see [www.iigf.cufe.edu.cn](http://www.iigf.cufe.edu.cn)

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