BSR

Sustainable Investment in China 2009

Overview

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In August 2009, during the writing of this report, the Shanghai Stock Exchange and China Securities Index launched China's first sustainability index, the Social Responsibility Index (SSE-SRI), using China-adapted methodologies to select strong environmental, social, governance (ESG) performance stocks. The stated objectives of the SSE-SRI are to encourage listed companies to actively manage their social and environmental risks and opportunities, to provide investors with a new investment benchmark, and to popularize the concept of socially responsible investment.[1] BSR believes that with the right support from government and mainstream investors, these goals can be achieved, making China's investment community a leader in sustainable investment.

Sustainable Investment in China 2009 is the third in a series of reports which investigates and provides recommendations for the development of sustainable investment (SI) in emerging economies.

Over the past three months, BSR conducted a research study commissioned by the International Finance Corporation (IFC) to analyze the state of sustainable investment markets in China and provide recommendations for further market development. This paper is an abridged version of the full report, *Sustainable Investment in China 2009*. Readers are advised to refer to the full report for details and references.

Introduction

PROJECT OBJECTIVES AND METHODOLOGIES

Sustainable Investment in China 2009 is the third in a series of reports which investigates and provides recommendations for the development of sustainable investment (SI) in emerging economies. This report has been commissioned by the International Finance Corporation (IFC) and prepared by BSR. As with the previous reports, this report focuses on 'sustainable investment,' defined as investment using strategies that take environment, social, and governance (ESG) factors into consideration.

Stocks included	Stocks not included
A Shares	B Shares
ADRs	H Shares
	Other Chinese stock listings

To better acknowledge the current state and future potential of SI in China, BSR undertook a detailed review of the latest public research and partnered with Mr. Liang Meng, a senior researcher at the People's Bank of China (the Central Bank) to analyze China's financial markets, regulatory framework, and SI market infrastructure. BSR also conducted approximately 100 interviews with government agencies, institutional investors, asset managers, equity research, and academics.

The report's focus is on China's A-share market, which consists of CNY-denominated shares listed on the Shanghai or Shenzhen stock exchanges or through ADRs. B shares (listed on the Shanghai and Shenzhen stock exchanges with trading in foreign currencies), H shares (listed on the Hong Kong Stock Exchange) and shares of Chinese companies listed on Nasdaq, NYSE or other overseas exchanges are not included. The report also briefly covers sustainable investment activity by private equity investors.

A SNAPSHOT IN TIME

This report must be seen in the context of the global financial crisis that unfolded during 2008 and 2009 following the emergence of problems in the US sub-prime mortgage market in 2007.

The authors have done their best to present an accurate and balanced 'snapshot' of China's sustainable investment market in this fast-changing and turbulent environment and to frame conclusions and recommendations that will be

[1] Shanghai Stock Exchange Press Release, August 5, 2009

accurate for the next 1-3 years. BSR has sought to use the most up-to-date data available, but we acknowledge that some of the information and corresponding analysis contained in this report may have an unavoidably short shelf-life in these exceptional circumstances.

China and Sustainable Investment

Sustainable Investment is the practice of incorporate environmental, social and governance (ESG) factors into investment decisions.

SI is the practice of incorporating environmental, social and governance (ESG) factors into investment decisions. EuroSIF estimated the global market for SI at US$7 trillion,[2] and SI has now been adopted by investors in nearly all segments of the investment market, from listed equity investment and private equity to infrastructure investment and fixed income investment. The reasons for adoption of course vary. Some investors do so to manage risks with the aim of better financial performance; others want to seize business opportunities in fast-changing environmental and social landscapes; while others inform their investment practices in line with particular ethical values. The methodologies of these investors are also diversified, including negative screening, positive screening, best-in-class, shareholder activism, and integrated approaches such as engagement and non-financial risk auditing/analysis.

Though the SI market is quite substantial in most developed countries (for example, in the US approximately one of every nine dollars under management is in SI assets), it is still new to many emerging economies. This study investigates the status and prospects of sustainable investment in China. To understand the full context, we first review some relevant trends in the country's economic, social and environmental development. The key points with implications for SI are:

» ***Imbalance between economic and social/environmental development:*** China has experienced an average 9 percent annual growth in GDP over the past three decades, but its rapid industrialization has also created significant environmental and social challenges. The Ministry of Environmental Protection (MEP) has estimated that environmental problems cost China US$200 billion every year, equivalent to approximately 10% of GDP.

» ***Increased investment by Chinese multinationals in strategic CSR issues:*** There are more and more Chinese companies beginning to address CSR strategically and report on their progress, especially those that are expanding overseas. Some have even joined the first tier of global companies in CSR leadership, such as China Mobile which successfully joined the 2008 Dow Jones Sustainability Indexes (DJSI).

» ***Fast-growing household incomes and capital markets:*** Along with economic development and the rise of gross domestic savings, China's capital markets have experienced explosive growth. All segments of the financial market have shown significant year-on-year increases, especially stock markets. The Shanghai Stock Exchange has now overtaken Hong Kong in terms of market capitalization to become the 6th-largest exchange globally.

Understanding the process of China's development provides important context for SI. Without a prosperous economy, without the need to address environmental and social challenges, without corporate ESG responsibility efforts, without sophisticated capital markets and adequate increases in household income, there would be no foundation for the development of SI markets. The fact that China currently shares all of these characteristics bodes well for the potential growth of sustainable investment.

[2] EuroSIF. *"SRI Study 2008."*

Due to severe imbalances between economic growth and social/environmental development, both the government and the general public have been urged to tackle social and environmental challenges. With demand from the public for solutions, SI could be a powerful lever for influencing corporate behavior. As SI investors emphasize ESG factors in investment valuation and award companies with strong ESG performance through investment, they create motivation for companies to improve their ESG standards.

Meanwhile, the existence of a prosperous economy, more strategic business management of CSR, and increased transparency of Chinese multinational companies gives SI investors the data they need to make investment decisions, and suitable targets for those investments.

Finally, China's fast growing capital market, backed by more than US$1 trillion in gross domestic savings creates a huge potential for the development of SI, and the addition of SI financial products can fill specialized gaps in the market.

A Nascent SI Market

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

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

In the mutual fund sector, AEGON-Industrial Fund Management Co. Ltd, an SI pioneer in China, has offered the first and only socially responsible investment retail fund since May 2008. The fund, which had attracted US$375 million as of March 2009, has adopted a positive screening approach and developed a set of criteria to assess corporate sustainability and environmental compliance. The fund has done well thus far, outperforming the market benchmark by 47% from its inception in May 2008 through June 2009.

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

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

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

SI with Chinese Characteristics

Sustainable investment in the international context is commonly understood to utilize three core strategies: screening of investments based on ESG criteria, shareholder advocacy on ESG issues, and community investment programs. SI activity in China has so far been focused almost exclusively on ESG screening criteria.

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

The government continues to implement reforms to encourage sustainable development and has enacted leading policies such as the Green Securities Policy

The Fund's ESG approach primarily focuses on corporate governance and compliance, which is consistent with other CSR and ESG philosophies BSR has observed in China. The Fund also has specific ESG criteria that are particular to the Chinese market—special emphasis is placed on a company's compliance with the law, tax payment, and cooperation with government.

Further Growth in ESG

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

Case Study

In August 2008, six well-known Chinese NGOs raised objections to Gold East's IPO during the 10-day public evaluation period. In light of evidence they provided, the local environmental protection bureau repeated the environmental audit, held further consultation and only approved the company's request to list ten months later.

» **Evolving ESG Regulatory Landscape:** The government recognizes that China's environmental challenges threaten to constrain future economic growth and therefore social development. Environmental legislation is increasingly stringent and comprehensive, with new regulations continually being developed even as authorities struggle to enforce existing laws and standards. The government is leading the way in linking environmental and financial policies with two examples in particular: the Green Credit Policy requires Chinese banks to integrate environmental information into their lending processes and criteria, and the Green Securities Policy requires companies in certain sectors to pass an environmental audit from the Ministry of Environmental Protection (MEP) before being allowed to apply for a public listing. In 2008 the MEP inspected 73 companies going public, and of 38 completed inspections, only 18 enterprises passed.[3]

[3] Greenlaw, "Green Securities policy presses forward in China," March 3, 2009, http://www.greenlaw.org.cn/enblog/?p=726#more-726

Case Study

In 2008, the Japan Research Institute (JRI) collaborated with Sumitomo Trust & Banking (STB) to screen Chinese listed companies based on their ESG performance. 18.5% (294) of listed companies in mainland China returned their questionnaire, though the Chinese researcher partners had to call each company on average 4 times to persuade companies to fill out the forms.

- **Growing Awareness of the Need for Risk Management:** Increasing numbers of high-profile business ethics cases have caused investors to consider ESG factors more seriously when evaluating potential investments. As a result, a growing number of domestic institutional investors are actively screening for governance and compliance issues, while asset managers increasingly hold the belief that ESG risk management improves a company's market value in the long term.
- **Very limited but increasing third party information:** Chinese media is beginning to become more critical of business, and environmental NGOs in particular are becoming more vocal, with two organizations already providing regular information to financial institutions through newsletters. In terms of professional research providers, there are only a couple of independent ESG research organizations active in China, and even those face a limited demand for their services at the current time.
- **Increasing attention from international SI initiatives:** Though international investors play a relatively limited role in the market, as they are restricted to investing through a Qualified Foreign Institutional Investor (QFII; the government-mandated quota is set at 85 QFII, with managed assets of only US$13 billion), China does attract a handful of international SI investors. Robeco and Sumitomo Trust & Banking (STB) are the first two companies to announce a launch of China SI products.

Challenges Remain

Despite these encouraging trends, China has to overcome a number of challenges to effectively channel the growing interest in SI into a mainstream ESG investment market. Based on interviews with market participants in different segments of the investment market and stakeholders in government, academia, and industry associations, BSR identified the following key challenges:

CHALLENGE #1: CONFUSION OVER TERMINOLOGY

"Without a clear definition, people would tend to ask what SI is and why it is important; and the government would be skeptical to promote it in China."

The first barrier for promoting SI in China is the question of nomenclature. Terms such as Socially Responsible Investment (SRI), Responsible Investment (RI), Sustainable Investment (SI), and Green Investment (GI) are all used by the Chinese investment community. However, people tend to use these terms as if they are synonymous, or interpret them freely depending on the occasion or audiences. This is closely linked to a limited understanding of the terms themselves and a lack of consensus on definitions.

This confusion over terminology limits common understanding about SI and its link with corporate change. A government official pointed out in an IFC-BSR SI stakeholder roundtable meeting that "Without a clear definition, people would tend to ask what SI is and why it is important; and the government would be skeptical to promote it in China." A lack of consensus on terminology and lack of widely accepted Chinese nomenclature slows uptake.

CHALLENGE #2: SHORT-TERMISM

A fund manager stated that "Long-term means overnight for so many investors in China."

One common area of agreement among interviewees was that the mentality of investors in China is still dominated by an emphasis on short-term results, which works against ESG integration. One investment professional commented, "With less than three month holding period, why should asset managers spend time to investigate ESG risks? One or two months is a common investment horizon in mainland China."

Short-termism is linked to the mindset that financial returns are prioritized over all other considerations. A clean-tech investment manager admitted during an interview with BSR that “this is profit-driven. We do this not because we love clean-tech.” Though there are exceptions, ethics and social impact are normally considered as lower priorities compared with financial return.

When BSR interviewed domestic investors, many of them emphasized, but also suspected, the business value of SI. Whether there is a positive correlation between Chinese companies’ environmental and social performance and their financial performance is a question on top of many investors’ minds.

CHALLENGE #3: QUESTIONABLE BUSINESS CASE

When BSR interviewed domestic investors, many of them emphasized the business value of SI, but were also quite skeptical. Investors want to know whether there is actually a positive correlation between the environmental and social performance of Chinese companies and their financial performance. Organizations such as UNEP FI and SAM cite numerous international academic and brokerage firm studies that qualitatively and quantitatively show a positive association between the adoption of ESG criteria and enhanced financial performance. However, many investors feel that this empirical data does not reflect the Chinese situation.

In China, many companies can still be profitable despite paying little attention to their environmental or social performance. It is vital that this changes through strengthened legal enforcement, appropriate pricing of resources, effective punishments and increased risks for poor E&S performance.

Most companies still lack the capacity and experience to collect and disclose detailed ESG information and there is limited high-quality information from third parties such as civil society.

CHALLENGE #4: LIMITED ESG INFORMATION

The amount and quality of ESG information from Chinese companies which is in the public domain is very limited. The concept of releasing corporate ESG information is still foreign to many companies, and stakeholder pressure and government regulations on disclosure have only recently begun to play a role. Most companies still lack the capacity and experience to collect and disclose detailed ESG information, and there is limited high-quality information available from other groups such as civil society or government. Furthermore, the responsiveness of companies’ investor relations departments to surveys or direct questions is also low.[4] Of the 100 companies which received questionnaires from the Carbon Disclosure Project (CDP) in 2008, only 5 companies actually completed them.

Most international SI funds are still managed from centrally located investment centers. The ability to provide answers to the types of questions that international investors ask is somewhat limited; many of the issues, in particular human rights, are not on the radar screen for Chinese companies, and language is another barrier.

CHALLENGE #5: LACK OF FUNDING SOURCE FOR SI

Pension funds, insurance companies, and certain types of international investors (such as endowment fund, retirement funds, and family offices) generally have longer investment horizons than ordinary investors. Their longer-term investment behaviors require them to consider long-term risks associated with potential investee companies, including environmental and social risks.

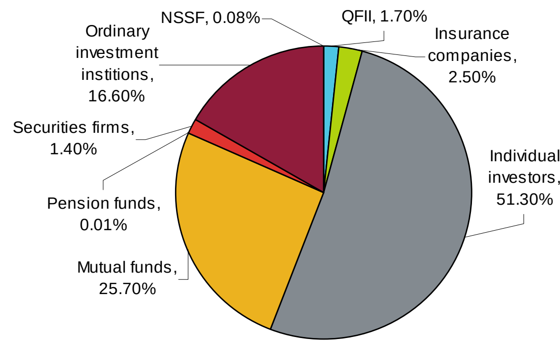
However, these institutional investors currently play a relatively limited role in China and their investment in stock markets is restricted. As shown in Figure 1, stock exchanges have limited funding from insurance companies, pension funds, and institutional investors. Only 2.5% of market share is from insurance companies, 0.8% from NSSF, 0.01% from pension funds, 25.7% from mutual funds, and 1.7% from QFIIs. China’s investment regulations put ceilings on the proportion of assets these institutions can allocate to stock markets. For

[4] Japan Research Institute presentation at TBLI Conference Asia 2009,

instance, enterprise annuity funds can allocate no more than 30% of their assets to equity investments. International investors can only make investments within their limited QFII quotas. It will be hard to develop a sustainable investment market if long-term institutional investors' participation in stock exchanges is restricted to such limited influence on the market. In addition, domestic family offices, foundations and endowments are essentially absent from the market.

Allowing China's nascent institutional investors to eventually make unlimited equity investments, and increasing the quota for QFII investment would be two ways to expand sources of capital for SI and strengthen long-term investors' influence in the market.

Figure 1: Market Share of Different Types of Investors in China's Stock Market, Dec. 31st, 2007



Sources: CSRC, China Capital Markets Development Report

International sustainability research agencies overseas do not currently provide extensive research coverage of A share stocks.

CHALLENGE #6: ABSENCE OF ESG RESEARCH INSTITUTIONS FOR CHINA SI MARKET

Presently, there are no domestic research companies specializing in ESG analysis. Chinese SI investors currently rely on in-house analysts to conduct such research, normally on a part-time basis. The international ESG research companies have been exploring the China market, but progress has been slow and market demand is limited.

International sustainability research agencies based overseas also do not currently provide extensive research coverage of A-share stocks. These research agencies often restrict their research to components of the MSCI World or the Dow Jones Total Stock indexes. Less than 100 of the 2,700 components of the MSCI World are Chinese (many of which are listed overseas or in Hong Kong). The limited research coverage of A-share stocks affects the ability of international SI investors to make investments in mainland Chinese markets. International SI investors are more focused on H shares, in part because H shares are more commonly researched by analysts and provide more English-language disclosures, and because of QFII restrictions and the absence of A shares on popular benchmarks.

CHALLENGE #7: A LACK OF EXPERIENCED PRACTITIONERS

There are few domestic analysts or experts who understand both ESG materiality issues and SI financial evaluation methodologies, and limited availability of training or knowledge on SI.

International SI investors have relatively more experience on ESG analysis, but lack personnel who understand the Chinese market and associated ESG issues. QFIIs have analysts in China, but almost none have SI experience.

The Way Forward

The three broad recommendations are:

- » Forming a China SI Working Group
- » Enhancing ESG research and disclosure
- » Increasing ESG education

Significant challenges remain to be overcome for SI to take off in China. Some of them can be overcome in the relatively short term, but others, like changing investors' corporate attitudes to ESG and market infrastructure, will take several years. To tackle these challenges, individual market intervention solutions have been collected through extensive discussion with market participants. Analyzing these solutions, three strategic approaches crystallize; namely, connecting people, researching ESG issues, and educating. BSR has developed the three approaches into three concrete strategies – forming China SI working group (CSIWG), enhancing ESG research and disclosure, and increasing ESG education. (see Figure 2)

Figure 2: Challenges, Solutions and Recommended Strategies

Challenges	Solutions
#1 Confusion over terminology	•Create awareness •Communicate SI understanding and experience
#2 Short-termism	•Change value measurement system •Change incentive structure
#3 Questionable business case	•Monitor and measure ROI of ESG improvement •Change resource pricing system •Build broad-based buy-in of sustainable investment knowledge and value
#4 Limited ESG information	•Increase ESG disclosures •Link ESG research with ESG information
#5 Lack of funding source	•Increase quota for QFII •Remove investment ceiling for institutional investors
#6 Lack of ESG research institutions	•Encourage ESG research •Introduce international research methodologies
#7 Lack of experience practitioners	•Provide Chinese investment practitioners with education about extra-financial analysis •Provide ESG education for future business leaders in China through integrating ESG courses into undergraduate and MBA courses

Recommended Strategy

- **China SI Working Group**
- **ESG Research & Disclosure**
- **ESG Education**

Forming the CSIWG will provide a platform for cooperation among the sustainability investment community and for communication to help define and envision sustainable investment in China, and to jointly work on solutions that can fill the gap between present needs and future vision. Enhancing ESG disclosure and research capacity primarily targets mainstream investors, which are a broader audience than SI investors alone. Higher quality and quantity of ESG data on companies along with robust ESG research intermediaries and easy access to ESG research information could accelerate the progress of mainstreaming ESG approaches. Finally, increasing public education about ESG, including integrating sustainability issues into key training programs, would build a broad-based buy-in and expertise on sustainable investment and CSR. Based on our discussion with stakeholders in both public and private sectors, BSR outlines 3-year plans for each of these steps.

THE FORMATION OF A CHINA SUSTAINABLE INVESTMENT WORKING GROUP (CSIWG)

Overall Objectives	» Foster cooperation among China's SI community and introduce international experiences and lessons to China to accelerate progress » Provide a direct communication platform and develop synergy among asset owners, asset managers, research institutions, civil society organizations, and government agencies » Identify systemic constraints and engage with policy makers/ industry leaders to address them
Challenges addressed	Confusion over terminologies; Short-termism; Questionable business case for SI, Lack of funding for SI

Readers are encouraged to read the full report for detailed three-year plans for each recommendation.

The draft action plan's three phases are:

1 Phase I: Establishment of the CSIWG.

2 Phase II: Awareness raising and knowledge sharing on topics such as sustainability indexes and mutual fund SI products and practices.

3 Phase III: Identification of systemic constraints and engagement with policy makers/industry leaders on issues such as allowing China's institutional investors to ultimately make unlimited equity investments and making A shares easier to invest in for international investors.

ESG DISCLOSURE AND RESEARCH ENHANCEMENT

Overall Objectives	» Increase the quality and quantity of ESG disclosures » Address absence of quality, practical ESG research and shortage of ESG research expertise in China » Reduce transaction costs for investors to access ESG research » Link ESG research with corporate ESG disclosures
Challenges addressed	Limited ESG information; Absence of ESG research organizations

The draft action plan's three phases are:

1 Phase I. Establish a network of investors, key disclosure-related initiatives, and companies, and undertake activities to improve ESG disclosure.

2 Phase II: Develop a China ESG Research Database Initiative.

3 Phase III: Leverage the online database to promote ESG research among academic institutions and sell-side research, and link ESG research with corporate disclosure through continued business-investor-researcher events, research and initiatives.

INCREASE ESG EDUCATION

Overall Objectives	Build broad-based buy-in of sustainability knowledge and value » Provide education to Chinese investment practitioners about extra-financial analysis » Provide ESG education for future business leaders in China through integrating ESG courses into undergraduate and

	MBA courses » Provide ESG knowledge to general public
Challenges addressed	Confusion over terminologies; Lack of funding for SI; Lack of experienced practitioners

The draft action plan's three phases are:

1 Phase I: Introduce CFA's ESG module to the Securities Association of China and China Banking Association who organize licensing examinations for securities and banking professionals respectively, and integrate ESG courses into these professional licensing examinations. Collaborate with ILPA and promote SI oriented practices among PE's Limited Partners.

2 Phase II: Benchmark ESG courses globally to identify best practice. Incorporate sustainability-related courses into undergraduate or MBA/EMBA courses.

3 Phase III: Train financial media and financial education organizations about ESG issues and SI. Educate general public through the media, opinion leaders and possible awards.

China has an opportunity to further leverage the role of sustainable investment to significantly benefit the country and business community. With rising awareness and understanding of ESG among mainstream investors, expectations of transparency would increase, leading to better corporate governance and ultimately more successful companies. The market would reward the most innovative companies that address the country's most critical sustainability challenges, and financial resources would be more efficiently allocated. With the right incentives and commitments from government, and large mainstream investors on board, sustainable investment could flourish and lend support to yet another of China's transformations.

DISCLAIMER

The report is based on literature review as well as interviews with individuals. The authors would like to thank the interviewees for their review of this report for accuracy. Any errors that remain are those of the authors. The views expressed in this publication are those of its authors and do not reflect those of BSR members. Please direct comments or questions to Adam Lane at alane@bsr.org.

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ABOUT BSR

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