Current Status and Future of ESG in China

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Abstract: This paper first introduces the historical origin, development status and related elements of ESG. From the historical evolution, it can be found that ESG investment is in the rapid upward channel with a prospecting development. Countries around the world have established proper ESG evaluation systems and information disclosure systems, which provides investors with key investment information, and forces companies to improve their own rules, regulations and behaviors. This paper also explores whether ESG investment has significant excess returns for the broader market by means of literature integration and empirical testing. Lastly, this paper summarizes the current mainstream investment strategies and studies their applicability in the stock and bond markets, putting forth suggestions for policies and rating systems.
Keywords: ESG; Rating System; Disclosure System; Green Investing

1. Perceptions and Interpretations

1.1 Personal Interpretation

With the development of the global economy and the continuous improvement of human material civilization, the consciousness for green investment is gradually awakening. In addition to the hard indicators of economic level, human beings have begun to pay attention to social responsibility, environmental protection and benign corporate governance issues.

In the U.S., ESG-focused funds skyrocketed from $21.4 billion to $51.1 billion, a nearly 10-fold increase from $5.4 billion in 2019. In Asia excluding Japan, sustainable fund assets under management nearly tripled to $36.7 billion in March 2021 from a year earlier. The fundamental reason for ESG's attention is the sustainable and healthy development strategy of the "global village", which is a reconciler for the dynamic and balanced development of the economy, life and the environment.

1.2 Personal Bond

Before I could remember anything, my family and I spent summer and winter holidays by the sea. I love diving and underwater photography, which had led me to focus on the marine environment from a very young age. I have always perceived the underwater world as colorful tropical fish perching on coral blocks. However, fish laying on glass bottles that have fallen to the bottom of the sea and nudibranchs crawling on the surface of calcified coral fans entered my sight, I was deeply shocked, followed by a surge of anxiety. My commitment in environmental protection has only grew ever since. Environmental protection is embedded in all aspects of our lives; I hope to raise environmental awareness in every field. After being exposed to economics courses in high school, I realized that green investment is a very promising direction. By chance, I learned about the development of ESG at the international level and the fact that it is not yet widespread in China. I then have the idea of in-depth research and understanding of ESG, hoping to find the answer to the common development and progress of the economy and the environment.

2. General Concepts

2.1 ESG Explained

Definition: ESG is an investment philosophy that focuses on a company's environmental, social and governance performance (Environment, Social and Governance). Based on ESG evaluation, investors can evaluate their investment behavior and the contribution of enterprises in promoting sustainable economic development and fulfilling social responsibilities by observing the ESG performance of enterprises.

Development History: The concept of ESG investment originated from ethical investment in the mid-20th century. After nearly 100 years of development, its coverage has gradually expanded, and finally an ESG system with environmental, social and corporate governance as the three main pillars has been formed.

2.2 Global ESG

Overview of Overseas ESG Investment Global Responsible Investment Assets Continue to Expand

a) As of November 2020, there have been more than 2,500 signatories to the United Nations Principles for Responsible Investment (UN PRI), with total assets under management reaching US$86.3 trillion.

b) Accelerated development of passive investment: ETF funds tracking the MSCI ESG index are in a state of rapid growth, and the total asset management scale has reached 37.2 billion US dollars.

3. Disclosure System

3.1 Global ESG Disclosure System

Trading institutions in more than 30 countries and regions around the world have put forward requirements for information disclosure of ESG, with most them being encouraging disclosure, while some exchanges made disclosing compulsory. By looking at the system, it mainly includes the UN Principles for Responsible Investment (UN PRI), ISO26000 Social Responsibility Guidelines, OECD Corporate Governance Guidelines for State-owned Enterprises, and etc.

3.2 ESG Disclosure System in China

The concept of ESG has also been gradually established and developed in China in recent years. Judging from regulatory rules, apart from the relevant policies issued by the Stock Exchange, mainland China has not yet officially issued laws and regulations on ESG information disclosure, yet relevant disclosure requirements have been reflected in the social responsibility report or the individual disclosure rules of E, S, and G.

The Environmental, Social and Regulatory Reporting Guidelines issued by the Stock Exchange in 2012 can be regarded as the only legal document in China that has specific requirements for ESG as an entirety.

3.3 Comparison

Since most countries had more time to develop ESG, there are stricter and more complete systems of information disclosure for corporates. In addition to the mandatory regulations of regulatory agencies, various social organizations also continue to instigate companies to increase the disclosure of non-financial information. At present, China still has a lot of room for development in the information disclosure system. The A-share market has not yet established a unified information disclosure system, while the ESG disclosure field in the Hong Kong stock market has nearly 10 years of exploration experience. However, judging from how policy has developed, the ESG information disclosure system will be gradually improved in the future.

4. Rating System

4.1 Global ESG Rating System

There are five international institutions that have carried out the construction of ESG rating system. The general idea is to divide the non-financial data of the enterprise into three aspects: E, S, and G, and continue to subdivide them into secondary and tertiary indicators under each level. Specifically, it mainly includes MSCI ESG Index, Thomson Reuters ESG, FTSE Russell ESG, Dow Jones ESG, and etc.

4.2 ESG Rating System in China

ESG rating system in China has substantially developed since 2015. On August 7, 2015, the Chinese Academy of Social Sciences along with other institutions established the "Enterprise Green Development Evaluation Index System", and selected the top 500 and top 200 Chinese enterprises for green development. Subsequently, the Central University of Finance and Economics and the UNIDO-UNEP Green Industry China Office successively released the "Green Leading Stock Index" and the "Research Report on Green Evaluation of Chinese Enterprises", marking the further development of China’s green finance and ESG rating system.

4.3 Comparison

The development of ESG rating systems in China and abroad is unbalanced. Internationally, there are currently requirements for ESG information disclosure for all types of listed companies, and there are corresponding laws to restrict them. The rating system and investment system are relatively complete. On the contrary, China's ESG development is lagging behind. Due to the long-term implementation of the approval system in China's capital market and the imperfect delisting system, the information disclosure of listed companies is incomplete and inactive, and the ESG system cannot be effectively established. At the same time, China's rating body is more focused on one certain aspect of E, S, and G rather than treating them as a whole. There is still a lot of catching up for China.

5. Investing Purposes and Directions

5.1 Purpose

5.1.1 Academia Views: Higher Returns, Better Metrics

The mainstream view of ESG investment in academia is that companies with better ESG performance have a better overall performance, which will attract investors to invest, thereby promoting the company’s stock price and financial performance.

On the risk side, some people have applied ESG investment to investment in China's A-share market, and found that companies with lower ESG indices are more prone to fail, while stocks with higher ESG indices are more likely to achieve excess returns. Therefore, ESG index can also be used as a leading indicator of crisis warning for investors.

5.1.2 Evidence from Practice: ESG-Themed Funds Outperform

The number of ESG-themed funds in China is limited, and the establishment time is relatively short.

China Industrial Secs, in its research on foreign equity fund PRBLX, found that the performance was better than that of the broader market index over the same period, and the volatility was lower than that of the broader market index.

5.1.3 Factual Analysis

This paper simulates and constructs a fund portfolio with high ESG performance. Among the CSI 300 constituent stocks, 50 stocks with the best ESG performance (with FTSE Russell ESG as the standard) are selected as investment targets, and then a stock fund based on ESG concept is constructed, in which the holding ratio is 93% stocks +6 %Bank savings. Each stock is allocated using an equal weight method.

From the statistical results, the top 50 stocks involved a total of 17 industries, 15 in the capital market service industry, accounting for 30%, and 10 in the monetary and financial service industry, accounting for 20%. There are 5 computer industries, accounting for 10%.

In terms of specific performance, during the 10-year period from 2011 to 2020, the average monthly rate of return of ESG funds was 1.23%, and the CSI 300 index was 0.74%. The former was better than the latter.

5.2 Investment Strategies and Applications

5.2.1 Investment Strategies

According to the classification of GSIA, there are currently 7 mainstream investment strategies in the world, including negative elimination, positive screening, normative screening, ESG integration, sustainable development theme investment, impact/community investment, corporate participation and shareholder behavior.

With respect to ESG investment categories, equity and fixed income are the mainstream investment products, accounting for 51% and 36% respectively.

In terms of ESG investor structure, ESG investment is dominated by institutional investors. As of 2018, 75% of global ESG investors are institutional investors.

Application in Equity

Existing studies have found that ESG investing has a certain momentum. When a stock's ESG performance is better or positive information is released, investors "chasing the market" in the short term, making the stock continue to rise.

At the same time, China's information disclosure system is nowhere near to perfection, and companies with relatively complete ESG information disclosures are often industry leaders or have volumes. Against this backdrop, the fund's stock picking can easily overlap with other stock picking strategies.

Taking E Fund ESG Responsible Investment Fund as an example, the fund currently heavily holds stocks such as: Huzhou Laojiao, Kweichow Moutai, Wuliangye, Tencent, Meituan, Aier Ophthalmology, and etc. It follows a mainstream investment regardless of ESG, making the fund difficult to exhibit a unique alpha.

5.2.2 Application in Fixed Income

Compared with the lack of information disclosure system in China's equity market, ESG investment strategies have more room to play in the bond market. Thanks to the increased layout of green financial policies, the issuance scale of green bonds in China is in a stage of rapid expansion. By the end of February 2021, the issuance of green bonds that met the domestic green certification standards exceeded 1.2 trillion yuan.

China's current ESG-related bond investment portfolio is still in its infancy. According to the statistics of Ping An Securities, there are mainly 4 fixed-income funds with ESG integration as their investment strategy, namely Yinhua China Bond 1-3 Year Agricultural Development Bank (009541), Industrial Green Pure Bond One-Year Fixed A (009237) , Fuguo Green Pure Debt (005383), Furong Fujin Special Financial Debt Pure Debt (006613).

Judging from the overall performance of the market, bond indices with ESG as their investment strategy have strengthened year by year. Take the ChinaBond-ESG Preferred Credit Bond Wealth Index as an example. The index was compiled in 2018 and began to outperform the market in 2019. It can be seen that there is still a lot of room for growth in the application of ESG strategies in the fixed income category in China.

Judging from existing international experiences, ESG strategies have strong anti-risk capabilities in the bond market. During the 2020 epidemic, the MSCI ESG weighted index outperformed the broader market, and remained more steady.

6. Conclusion

ESG investment is on the rise, and it plays an important role in the selection of asset portfolios. Whether it is the existing research in academia or the experiences from application, it is proved that the investment portfolio under the ESG strategy has an excess return relative to the market.

ESG investment is still in its infancy in China. For one part, due to imperfect information disclosure system, public funds with ESG strategies mainly invest in leading companies. On the other hand, due to the small transaction scale of China's bond market, it is difficult to effectively judge the effect of ESG strategies in it.

Public funds should add negative exclusion strategies or consider ESG factors when screening and investing in asset portfolios. Among stock funds, public funds should not only consider the fundamentals and financial status of the company, but also pay attention to the non-financial performance (ESG) of the company, improve ESG information through field research and other methods, and avoid the occurrence of gray rhino and black swan events. The resulting net asset value fluctuates significantly. Among fixed income funds, focus should be on the layout of green bonds and ESG integration strategies.

7. Suggestions

7.1 Policy

China now has very few policies related to ESG investment, while mostly of the policies separate E, S, and G. As the largest carbon emitter, China's annual carbon emissions account for 28% of the world's. In recent years, China's dual-carbon policy and the development of some new energy sources have made great contributions to global emission reductions.

These policies include but are not limited to:

Altering the mode of domestic enterprises. As China is a coal-based country, the construction of resource-based and environment-friendly economic system should start from the transformation of large and medium-sized coal-based enterprises, transforming into a renewable energy-saving firms.

Double Carbon Policy. Carbon peaking and carbon neutrality is one of the most practical and effective way to reduce emissions in China. Carbon peaking refers to an area or industry annual carbon-dioxide emissions of its record high, and then through a plateau in the process of falling, carbon dioxide emissions by increasing roll off historical turning point, marked the carbon emissions and realize the decoupling of economic development, with goals include up to maximum peak; Carbon neutrality refers to the carbon dioxide emitted directly and indirectly by human activities in a certain area within a certain period of time (generally a year), and the carbon dioxide absorbed through afforestation and other carbon dioxide offset each other to achieve "net zero emissions" of carbon dioxide.

Vigorously developing new energy as a transition from fossil energy to renewable energy. Natural gas and other new energy are clean, low-carbon, rich in resources and convenient to use. Developing new energy can balance the trade-off between industry and emission reduction, especially with the transformation of coal enterprises, which will lead China to a new era of new energy conservation and achieve economic growth while being environmentally friendly.

Setting the goal of building zero-carbon communities and zero-carbon cities is to reduce the proportion of coal energy used, improve the use of renewable energy (wind photovoltaic power generation, solar hot water, biological energy, geothermal energy, etc.), build infrastructure, and promote the construction of comprehensive energy stations and smart micro modules with multiple complementary functions. "Top-down" construction of large-scale energy system, regional energy system and user-side energy system urban household waste emission reduction, mixed waste from landfill to burning, government and enterprise joint construction of urban waste treatment facilities, strengthen waste management, as far as possible to reduce the source and 100% waste classification.

7.2 Rating System

7.2.1 Financial Regulators to Financial Enterprises and Their Products

Bonds: The main focus should be green bonds. These bonds are usually asset-linked and backed by the issuing entity's balance sheet, while for ESG, bonds should consider more S and G on top of green bonds. Regulators should set an industry standard to advance corporate ESG investing.

Stocks: Stocks should be classified to limit corporate emissions. Different industries have different final emissions due to different manufacturing processes. It would be unreasonable to use the same standard to measure different stocks. Pharmaceutical companies emit more pollution than the food manufacturing industry, and forcing the pharmaceutical companies to lower emissions to food industry levels will make the industry unprofitable, and ESG will be difficult to promote.

Index: ESG index can refer to ETF, which can be classified into: broad-based index & thematic index. Example of broad-based index would be the top 50 companies meeting ESG market capitalization put together as an ESG market capitalization 50 index; example of thematic index would be classification by industry, such as food manufacturing, pharmaceutical manufacturing, and etc.

7.2.2 Ratings for companies:

In terms of E in ESG, emissions are the key to assessing whether a company meets the ESG rating. Enterprises whose emissions substantially exceed the standard cannot achieve the protection of the environment in ESG. Only companies that do not exceed a certain amount of emissions (which vary by industry) can initially achieve E requirements, which demands monitoring agencies to strengthen supervision.

S and G in ESG are often discussed together, and public satisfaction and past behavior of enterprises are very important indicators. Whether an enterprise satisfies ESG, on the one hand, it can detect whether the enterprise has some fraudulent consumer behaviors such as false advertising/selling fake and shoddy goods by conducting public opinion surveys. At the same time, you can also check to see if there are any civil lawsuits against the business in past cases. Testing agencies can also decide whether the company meets social responsibility by setting a series of criteria.

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