



# PROMOTING CHINA–EUROPEAN UNION COOPERATION ON GREEN AND SUSTAINABLE FINANCE

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Energy transition is an essential element of the global effort to meet the objectives set out in the 2016 Paris Agreement on climate change. According to the International Energy Agency (IEA) and the International Renewable Energy Agency (IRENA), limiting the global mean temperature rise to below 2°C is only possible with ‘an energy transition of exceptional scope, depth and speed’.<sup>1</sup>

A global energy transition of this scale requires more finance, and that finance must be better targeted and must draw on public and private sources. The shortfall in investment in future energy projects is estimated at \$20 trillion (€16.5 trillion) between 2020 and 2050. Furthermore, not all of the \$75 trillion (€62 trillion) already allocated is adapted to achieve energy transition.<sup>2</sup> Most spending will be in China, the United States and countries in Europe—which are among the top carbon emitters

globally—but the global energy system will have to be transformed alongside domestic and regional efforts.

This SIPRI Policy Brief outlines how China and the EU can meet their responsibility to scale-up, mobilize and direct the finance needed to transition to low-carbon solutions. It focuses on the incentives and disincentives that regulators in China and in the EU are creating in their respective jurisdictions and the measures that might be available to close differences in approach in order to boost investment to the necessary levels.

In 2020 China made a commitment to reach climate neutrality by 2060, but at the 2021 World Economic Forum, Chinese President Xi Jinping noted that this will require tremendous hard work.<sup>3</sup> The European Union (EU) plans to become carbon neutral by 2050. The European Green Deal, the set of policy initiatives at the heart of achieving this goal, includes transition to a clean, affordable and secure energy system as a key element.<sup>4</sup>

<sup>1</sup> Organisation for Economic Co-operation and Development (OECD), International Energy Agency (IEA) and International Renewable Energy Agency (IRENA), *Perspectives for the Energy Transition: Investment Needs for a Low-Carbon Energy System* (OECD/IEA and IRENA: Paris, 2017).

<sup>2</sup> The cost estimates are taken from Press, E. et al., *Transforming the Energy System: And Holding the Line on the Rise of Global Temperatures* (IRENA: Abu Dhabi, 2019).

<sup>3</sup> Xi Jinping, President of the People’s Republic of China, ‘Let the torch of multilateralism light up humanity’s way forward’, Special Address at the World Economic Forum, 25 Jan. 2021.

<sup>4</sup> European Commission, ‘The European Green Deal’, Communication from the

## SUMMARY

● Energy transition is an essential element of the global effort to meet the objectives set out in the 2016 Paris Agreement on climate change.

China and the European Union (EU) have agreed to work together to help deliver the financing needed to achieve energy transition, but more is needed.

To promote China–EU cooperation, this SIPRI Policy Brief recommends: (a) exploring a dedicated China–EU green finance initiative; (b) presenting a joint China–EU proposal on clear definitions and standards of sustainable green financing to the International Partnership on Sustainable Finance; (c) generating a joint curriculum to train staff in multilateral development banks, private investment banks, insurance companies and green banks; (d) pursuing joint finance for projects that find private capital difficult to attract; and (e) deploying independent evaluation teams to scrutinize how rating systems are applied in energy transition projects.



The global Covid-19 pandemic seems to have accelerated energy transition planning. For example, the EU has ring-fenced 30 per cent of its €1.8 trillion post-Covid-19 economic recovery funds for projects that meet criteria established for sustainable investment, including €225 billion focused on energy transition.<sup>5</sup> Public funds are needed to support important initiatives that find it hard to attract private capital such as energy efficiency projects and the development of sources of renewable energy based on technologies that are not yet mature. Meanwhile, the volume of private investment into renewable energy projects, which far outweighs public sector spending every year, accelerated in 2020.<sup>6</sup> The growth in net inflows into sustainable investment suggests that the financial sector expects companies that demonstrate the sustainability of their activities to outperform the market.<sup>7</sup> However, the requirements of energy transition are enormous, and anticipated investment is not sufficient.

When the People's Bank of China (PBOC) and the European Commission were among the co-founders of the International Platform on Sustainable Finance (IPSF) in October 2019, China and

the EU agreed to work together to help deliver the financing needed to achieve energy transition.<sup>8</sup>

The regulatory framework for sustainable finance was included in the European Commission proposal for transatlantic cooperation following the victory of Joe Biden in the 2020 US presidential election.<sup>9</sup> Biden's newly appointed special envoy for climate, John Kerry, has emphasized that one priority is to 'unlock new sources of sustainable finance to green capital markets'.<sup>10</sup> To achieve this, the new US administration intends to promote close collaboration between the public and private sectors and with other countries. Kerry has emphasized that cooperation with China on climate-related policies should be seen as a 'standalone' issue protected from the friction that exists in the wider China–USA relationship.<sup>11</sup> It now seems possible that proposals for action submitted for the 26th United Nations Climate Change Conference (scheduled for November 2021) may be based on China–EU–USA dialogue.

## VARYING APPROACHES TO FINANCING PRINCIPLES

Compatible China–EU approaches to domestic and external financing could add momentum to the global

Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2019) 640 final, 11 Dec. 2019.

<sup>5</sup> European Commission, 'EU's next long-term budget & NextGenerationEU: Key facts and figures', Fact sheet, 11 Nov. 2020.

<sup>6</sup> Morningstar, 'ESG fund assets recover strongly, hitting USD 1 trillion mark in Q2 2020', July 2020; and Climate Policy Initiative (CPI) and IRENA, *Global Landscape of Renewable Energy Finance 2020* (IRENA: Abu Dhabi, 2020).

<sup>7</sup> Tett, G., 'Ethical investing has reached a tipping point', *Financial Times*, 18 June 2019.

<sup>8</sup> International Platform on Sustainable Finance (IPSF), Annual report, 16 Oct. 2020.

<sup>9</sup> European Commission and High Representative of the Union for Foreign Affairs and Security Policy, 'A new EU–US agenda for global change', Joint Communication to the European Parliament, the European Council and the Council, JOIN(2020) 22 final, 2 Dec. 2020.

<sup>10</sup> John Kerry, Special Presidential Envoy for Climate, 'Remarks at the Keynote Session of B20 2021 Inception Meeting', 21 Jan. 2021.

<sup>11</sup> White House, Press Briefing by Press Secretary Jen Psaki, Special Presidential Envoy for Climate John Kerry and National Climate Advisor Gina McCarthy, 27 Jan. 2021.



transition to low-carbon energy systems. However, China and the EU differ over how to describe the energy transition, which principles should guide investment and how to measure progress.

### China's approach

China promotes green investment principles that focus on reducing emissions but within what President Xi has called an open world economy that discards 'discriminatory and exclusionary standards, rules and systems'.<sup>12</sup>

China has been working to establish a green financial system for roughly a decade. In 2012 the China Banking Regulatory Commission issued green credit guidelines.<sup>13</sup> In 2015 the PBOC issued a report by its Green Finance Task Force that emphasized the urgent need for China to transition to a green and sustainable development model and recommended the establishment of a green finance system with specialized investment institutions, fiscal and financial policy support, and financial and legal infrastructures.<sup>14</sup> In August 2016 the PBOC and six other government agencies jointly issued guidelines for establishing the green financial system.<sup>15</sup> In May 2020 the PBOC further proposed that clean coal would no longer be eligible for green bond financing.<sup>16</sup>

<sup>12</sup> Xi (note 3).

<sup>13</sup> China Banking Regulatory Commission, 'Notice of the CBRC on issuing the Green Credit Guidelines', 24 Feb. 2012.

<sup>14</sup> *Establishing China's Green Financial System: Report of The Green Finance Task Force* (People's Bank of China (PBOC)/United Nations Environment Programme (UNEP): Beijing and Geneva, 2015).

<sup>15</sup> PBOC, 'The People's Bank of China and six other agencies jointly issue "guidelines for establishing the green financial system"', 1 Sep. 2016.

<sup>16</sup> Yamaguchi, Y. and Ahmad, R., 'Investors applaud China's plan to ban clean coal from

In addition, the PBOC has indicated that it will review banks' performance in the green finance sector (as a share of their total business mix) on a quarterly basis.<sup>17</sup>

The development of green finance in China has also been reflected in external partnerships. In 2017 the PBOC was a co-founder of the Network for Greening the Financial System (NGFS).<sup>18</sup> By the end of April 2019, the number of NGFS members had increased from 8 to over 80, including the central banks and regulators of

many countries participating in the Belt and Road Initiative (BRI).<sup>19</sup> In April 2019 Chinese and international partners officially launched the BRI International Green Development Coalition (BRIGC) at the second Belt and Road Forum for International Cooperation.<sup>20</sup>

In 2017 the Belt and Road Ecological and Environmental Cooperation Plan and the associated Guidance on Promoting a Green Belt and Road were promoted at the first Belt and Road Forum and adopted by 27 countries.<sup>21</sup> China's success in bringing its population out of poverty has made it sensitive

### *Proposals for action at the 26th UN Climate Change Conference may be based on China–EU–USA dialogue*

green bond financing', S&P Global Market Intelligence, 9 Sep. 2020.

<sup>17</sup> Bloomberg News, 'China plans quarterly look into banks' green finance performance', 21 July 2020.

<sup>18</sup> Banque de France, 'Joint statement by the founding members of the Central Banks and Supervisors Network for Greening the Financial System: One Planet Summit', Press release, Paris, 12 Dec. 2017.

<sup>19</sup> PBOC, 'Building a green belt and road with green finance', 26 Apr. 2019.

<sup>20</sup> BRI International Green Development Coalition, 'Green development guidance for BRI projects baseline study report', 2020 Policy Study Series, Dec. 2020.

<sup>21</sup> Chinese Ministry of Finance, 'Guiding principles on financing the development of the Belt and Road', 16 May 2017.



to poverty reduction, employment stability and rapid industrialization in partner countries. These priorities are reflected in the guidance documents. However, while the guidance emphasizes respecting the existing international obligations of partners when making investment decisions, it does not promote new ones.

### **The European Union's approach**

The EU has promoted sustainable investment principles as a condition for trade, investment and technology exchanges. Senior officials have stressed that 'human rights and fundamental freedoms are non-negotiable' and that promotion of the principles that the EU sees

as standards is an essential element of policy.<sup>22</sup> By making financing conditional on respect for standards on governance and human rights

that are determined in Europe, the EU is sometimes accused of using financial instruments to reduce the political control of sovereign states over their own development path.

The EU will continue to design new tools to benchmark projects against criteria based on democratic governance and respect for human rights. It is also currently exploring how to take account of human rights in business decisions by introducing the 2018 Organisation for Economic Co-operation and Development (OECD) Due Diligence Guidance for Responsible Business Conduct into EU practice—either as a voluntary

<sup>22</sup> Von der Leyen, U., President of the European Commission, Statement by President von der Leyen at the joint press conference with President Michel, following the EU–China Summit videoconference, 22 June 2020.

code of conduct for business or in legislation.<sup>23</sup>

The EU is regrouping, rescaling and combining financial instruments in its new financial framework for 2021–27, to better tailor them to the UN 2030 Agenda for Sustainable Development. The changes have been made in a framework that treats the internal and external dimensions of the European Green Deal in an integrated way. A quarter of the finance for distribution by the European Commission under the newly unified Neighbourhood, Development and International Cooperation Instrument is thus earmarked for action supporting climate objectives.<sup>24</sup>

In summary, if the different approaches to finance promoted by China and the EU spread through their respective regional arrangements and partnership frameworks, it may make international coherence harder.

### **DEVELOPING FINANCIAL INSTRUMENTS TO PROMOTE INVESTMENT**

The scale of demand for energy transition has encouraged financial markets to develop products and services to channel investment. Investment banks and financial services have increased their knowledge about energy systems, how they work and how they are transforming. Multilateral development banks, which have long experience with sustainable

<sup>23</sup> Krajewski, M. et al., *Human Rights Due Diligence Legislation: Options for the EU*, Policy paper (European Parliament: Brussels, June 2020).

<sup>24</sup> Montesi, C., 'The external dimension of the Green Deal', European Commission, International Cooperation and Development, 8 Apr. 2020.

*The EU will continue to design new tools to benchmark projects against criteria based on democratic governance and respect for human rights*



development projects, are also increasing their understanding. Insurance companies have learned more about how to price risk for energy transition projects.

### **Green financing**

In the global financial sector, innovation is responding to the expanding demand for sustainable projects. Green and sustainable financing must make a wide range of projects ‘bankable’ and this does not apply only to large-scale projects. Examples of innovations include public green banks and green bonds. Green banks specialize in supporting projects in ways that respond to local context and for which generating profit is a by-product of facilitating sustainable development rather than a main objective.<sup>25</sup> Green bonds—another innovation where beneficiaries promise to use funds to support projects that meet sustainability criteria—have experienced rapid growth. A record high of \$257 billion (€212 billion) worth of green bonds was issued in 2019—a 51 per cent increase over 2018.<sup>26</sup> Overall, roughly €1 trillion flowed into sustainable investment funds in the first half of 2020, equal to the total amount for 2019.<sup>27</sup>

Nevertheless, difficulties and risk factors need to be addressed to facilitate investment into energy transition. Green bonds represent a small, if growing, share of the bond market.<sup>28</sup> They are mostly used by

large, international private financial institutions and focus on projects implemented by major corporations. Energy transition also requires a mix of incentives and disincentives to move the large number of small- and medium-sized companies that make up global supply chains in the right direction.

### **Information and standardization**

The OECD has documented difficulties that investors face in understanding how potential investments facilitate transition to more sustainable activities.<sup>29</sup> In the future, investors will need additional, as well as more detailed, information as they decide which companies and projects to include in their investment portfolios.

Without standard methods to assess environmental, social and governance dimensions of activities along with appropriate benchmarks and measurements, projects might claim achievements that are not justified. A fragmented approach might open the way for projects that are not making a genuine contribution to energy transition. Disagreement over how to classify the financing of coal-fired power stations is an example of the practical impact of lack of standardization.<sup>30</sup>

The global financial sector is now asking how to generate detailed information, understand it and use it in investment decisions. An active discussion has emerged about

<sup>25</sup> Coalition for Green Capital, ‘The case of green banks’, Presentation to Accelerating Finance for NDC Implementation through National Financing Vehicles Workshop, Kampala, 25 Feb. 2020.

<sup>26</sup> Climate Bonds Initiative, ‘2019 Green Bond Market Summary’, 5 Feb. 2020.

<sup>27</sup> Morningstar (note 6).

<sup>28</sup> European Council, Issuance of an EU green bond is expected in 2021. General

Secretariat of the Council, European Council meeting (10 and 11 Dec. 2020), Conclusions, EUCO 22/20, 11 Dec. 2020.

<sup>29</sup> OECD, *Investment Governance and the Integration of Environmental, Social and Governance Factors* (OECD: Paris, 2017).

<sup>30</sup> Tan, H., ‘China is massively betting on coal outside its borders: Even as investment falls globally’, CNBC, 6 Apr. 2018.





classifying green and sustainable activities, measurable indicators of implementation, and reporting frameworks that integrate these indicators into financial reporting. China and the EU currently approach these issues differently.

### **Assessment and implementation**

Chinese banks have developed measures to implement the 2016 guidelines for establishing the green financial system.<sup>31</sup> These guidelines influenced the Green Investment Principles for the Belt and Road Development published in December 2018.<sup>32</sup>

Chinese banks and funds that together provide roughly 60 per cent of the financing of BRI projects have begun to develop methods to classify projects according to their environmental impact. The China Development Bank has a four-tier classification for projects to guide investment decisions: environmentally friendly; environmentally compliant; requiring rectification; and high risk.<sup>33</sup> The Export–Import Bank of China uses a method described as the ‘four Nos’ based on an analysis of the overall performance of the customer requesting finance as well as a project assessment.<sup>34</sup>

The EU has been developing a set of measures since March 2018 that are intended to promote private

finance for sustainable growth.<sup>35</sup> The measures include an EU Sustainable Finance Taxonomy that will classify projects according to the degree to which they support sustainability goals. A project has to meet one of six objectives to qualify as sustainable, the first of which (making a substantial contribution to climate change mitigation) focuses heavily on energy transition.<sup>36</sup>

The EU is planning procedures for disclosure and reporting to help private investors fully understand whether a project is achieving sustainability goals. EU measures for disclosure and reporting have been influenced by the 2017 recommendations of the Task Force on Climate-related Financial Disclosures established by the Financial Stability Board of the Group of Twenty (G20). The EU is now assessing how to update a 2014 directive on non-financial reporting to guide companies with over 500 employees on how to disclose measures addressing social and environmental challenges in their operations using standard criteria. In consultation with the private sector, it is developing qualitative indicators for factors such as employee welfare, respect for human rights and anti-corruption

<sup>31</sup> PBOC (note 15).

<sup>32</sup> ‘A first gathering for implementation of the Green Investment Principles for the Belt and Road’, Paulson Institute, Commentary, 26 Sep. 2019.

<sup>33</sup> Climate Bonds Initiative, Climate Bonds Taxonomy, ‘China Development Bank’, Jan. 2021.

<sup>34</sup> Export–Import Bank of China, *White Paper on Green Finance* (Export–Import Bank of China: Beijing, 2016).

<sup>35</sup> European Commission, ‘Action plan: Financing sustainable growth’ Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, COM(2018) 97 final, 8 Mar. 2018.

<sup>36</sup> Council Regulation 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, *Official Journal of the European Union*, L198/13, 22 June 2020.



that industry can understand and apply.<sup>37</sup>

The European Banking Authority (EBA) is developing guidance to help investors understand the risks that projects might pose to sustainability goals as well as identifying ways and means for investment managers to monitor risk reduction and mitigation measures. Assessments are intended to be comprehensive, covering the physical, legal, financial and technological risks associated with an activity and making a project manager responsible for analysing risk along supply chains and within value chains. The EBA published its first report in December 2019, but this is expected to be a continuous process in cooperation with industry to refine and further develop assessment tools.<sup>38</sup>

## PROMOTING CHINA–EU COOPERATION

Chinese and EU thinking on energy transition and meeting climate challenges seems to be converging as the lines between developmental, commercial and strategic objectives are becoming blurred. For China, the main drivers of Chinese overseas investments in the past were a strategic need for critical natural resources and access to the transport routes bringing them to China.<sup>39</sup> The BRI was designed to promote energy security and to

bring Chinese goods to markets in Asia, Africa and Europe faster and more cheaply.<sup>40</sup> Recent agreements between China and its partners in the Belt and Road Forum emphasize implementing international and global agreements.<sup>41</sup> While the EU has promoted support to multi-lateral agreements as a key policy driver for many years, recently it has paid closer attention to projects that can strengthen its resilience and promote its own energy security.

China–EU dialogue needs to manage the uncertainties, both internally and in their relations with each other, that inevitably surround energy transition, which is a huge, complex task of permanent duration. If a fully harmonized set of instruments is currently out of reach, it would be beneficial for China and the EU to have a full understanding of the current methods used by the other. Although they both participate in relevant forums such as the G20 and the IPSF, a more focused bilateral discussion would be valuable.

If finance is generated within the Chinese or European regulatory frameworks, lack of harmonization may not be a barrier if investors understand the rules they must follow to qualify for financing and report how they use it. However, a patchwork of global standards, rules and definitions could hamper the joint financing of large-scale projects and perhaps also deter some investors from taking on

*China–EU dialogue needs to manage the uncertainties that inevitably surround energy transition*

<sup>37</sup> A proposal for a revised Directive is expected in 2021. European Commission, ‘Summary report of the public consultation on the review of the non-financial reporting directive 20 February 2020–11 June 2020’, Ares(2020)3997889, 27 July 2020.

<sup>38</sup> *EBA Action Plan on Sustainable Finance* (European Banking Authority: Paris, 2019).

<sup>39</sup> Economy, E. C. and Levi, M., *By All Means Necessary: How China’s Resource Quest Is Changing the World* (Oxford University Press: New York, 2014).

<sup>40</sup> Ratner, E. and Greenberg, M. R., ‘Geostrategic and military drivers and implications of the Belt and Road Initiative’, Council on Foreign Relations, 25 Jan. 2018.

<sup>41</sup> Ministry of Ecology and Environment, the People’s Republic of China, ‘Guidance on Promoting Green Belt and Road’, 8 May 2017.

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projects where risks and rewards have not been fully revealed.

As more governments make or adjust national commitments on carbon neutrality and carbon emissions, collaboration to establish common standards must keep pace to ensure that claimed achievements are substantiated.

A focused China–EU dialogue could play an important role in at least the following ways.

### *1. Explore a China–European Union green finance initiative*

As part of the bilateral investment agreement reached in principle in December 2020, China and the EU will address mutual investment in low-carbon energy solutions. To ensure that finance needed elsewhere is not diverted to internal projects and that carbon emissions are not transferred to other regions, China and the EU should open a dedicated bilateral initiative focused on joint finance for projects in third locations. A working group could report progress to the annual China–EU summit.

### *2. Contribute to clear definitions and standards of green financing*

China and the EU have a common view on sustainable development, climate change, energy saving and emissions reduction. But their principles, definitions and standards to assess green and sustainable finance differ. China and the EU co-chair the IPSF working group on taxonomies, and a joint proposal on how to generate a coordinated

approach could add momentum to the discussion of global standards.

### *3. Work together to build capacity and skills*

China and the EU could work together to generate a critical mass of staff that understand the needs of energy transition and have the skills to assess projects according to agreed criteria. A curriculum to train staff joining multilateral development banks, private investment banks, insurance companies and green banks could be a joint product.

### *4. Finance initiatives that find it hard to attract private capital*

The private sector does not yet regard some energy efficiency projects and renewable energy technologies as sufficiently mature to fund. Working together, China and the EU could channel public finance to such projects and technologies.

### *5. Facilitate independent scrutiny of rating systems*

Joint evaluation teams of Chinese and European non-governmental experts could evaluate rating systems for green and sustainable financing. This could build confidence that policies such as investments in different sources of energy are part of a tailored approach to meet climate objectives. Building confidence would simultaneously reduce suspicions that finance is used as an instrument to promote narrower interests.