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The Impact and Challenges of ESG Investment Philosophy on Chinese Capital Market and Investment Practice

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Abstract: Environmental, social and governance (ESG) investment philosophy has gained significant traction in recent years. This philosophy focuses on investments in companies that prioritize environmental sustainability, social responsibility, and good corporate governance practices. This paper examines the impact of ESG investment philosophy on the Chinese capital market and investment practices. It highlights the growing interest in ESG investments in China and the challenges that arise in implementing ESG practices. Additionally, this paper discusses the need for increased transparency and standardization in the ESG information disclosure and rating system, as well as the importance of education and training for investors and professionals in the financial sector. It also explores the potential benefits of ESG investment, such as long-term financial performance, and positive social and environmental impacts. Overall, this essay concludes that the ESG investment philosophy presents both challenges and opportunities for the Chinese capital market and investment practices, and that continued efforts are needed to foster sustainable investing practices in China.

Keywords: ESG investment, Chinese capital market, investment practices, challenges

1. Introduction

ESG is the abbreviation for Environmental, Social, and Governance, and it is an essential concept in corporate management and financial investment that has emerged in recent years [1]. In the ESG investment philosophy, which includes the ESG information disclosure, ESG rating system, and ESG investment, the production, operation activities, and financial investment of enterprises should not only focus on the economic indicators but should also consider ecological, environmental protection, social responsibility, and corporate governance [2]. The history of ESG investment can be traced back to the 18th century when the concept of ethical investing emerged, and the modern ESG movement began to take shape in the 1960s and 1970s when investors began to express concerns about the social and environmental impact of their investments. In 2004, the United Nations officially released the report ‘Who Cares Wins’ led by Kofi Annan, the Secretary-General, and co-written by many financial institutions. This report is the first time to propose the concept of ESG. In 2006, the United Nations Principles for Responsible Investment (UNPRI) formally introduced the concept of ESG, recognizing the importance of environmental, social and governance factors when evaluating sustainable development and establishing principles for socially responsible investing. The following year,

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Goldman Sachs included ESG factors in its 2007 Environment Report, setting out requirements for ESG investment in investment banking practices.

Since then, the concept of ESG investing has continued to grow and evolve. In recent years, there has been an increasing focus on the integration of ESG factors into mainstream investment decision-making, driven by research indicating companies with strong ESG performance outperform peers over the long term. This trend has led to a proliferation of ESG investment products, ratings, and rankings. Active ownership and engagement have become key in ESG investing, leading to the development of impact investing and shareholder activism.

The Chinese government has also been promoting sustainable development, including setting targets for carbon neutrality and promoting renewable energy. In 2016, the Shanghai Stock Exchange launched an ESG index, which has become increasingly popular among investors. In 2019, the China Securities Regulatory Commission issued guidelines on the disclosure of ESG information by listed companies, which has led to greater transparency and accountability. To promote the development of green finance, which includes ESG investment, in 2020, China launched a pilot program for green finance in the Guangdong-Hongkong-Macao Greater Bay Area, aimed at promoting green investment and finance. This essay will discuss the current situation of ESG investing development in China and the limitations and challenges Chinese corporations faced during the progress of ESG investing from the aspects of investment practices and the commercial bank in China based on the example of Noah Private Wealth Management and the Industrial Commercial Bank of China. Also, the conclusions from the essay can offer references for ESG investors and other stakeholders, as well as provide some suggestions and instructions for those companies which are promoting the development of ESG investing.

2. Basic Current Situations and Importance of ESG System in China

ESG investment is a critical job highly valued and recently promoted by the Chinese government. As one of the world's largest and most influential economies, China should play a key role in boosting the development of ESG investing and contributing to sustainable development. For example, the Chinese government and companies apply ESG investment philosophy to specific investment projects, such as ‘The Belt and Road Initiative’, and enhance the understanding and recognition of the international community on Chinese foreign investment activities. Additionally, the development of ESG investment is also significant to the internal Chinese economy as the rapid growth of the Chinese economy raises some serious problems for the environment and the ecosystem, although many benefits exist [3]. In addition, the COVID-19 pandemic has highlighted the importance of social and environmental factors in investment decisions, with investors increasingly focusing on companies’ resilience and the ability to adapt to crises. Last but not least, China is the world’s largest emitter of carbon dioxide, which has led to increasing pressure from investors and regulators to address the environmental impact of Chinese companies. Therefore, it is becoming increasingly important for Chinese companies to demonstrate their commitment to sustainability and responsible business practices to attract investment.

The Chinese economy has responded significantly to the ESG investment philosophy in recent years by promoting the environment, economic development, and population coordination. Additionally, the new development concept of 'comprehensive strengthening the construction of ecological civilization,' ‘innovation, coordination, green and openness, and sharing,' as well as the commitment of 'striving to achieve the carbon peak by 2030 and carbon neutrality by 2060' have been proposed by the Chinese government. China is also carrying out international cooperation in sustainable finance, as well as enhancing the understanding and recognition of the international community on Chinese foreign investment activities. For example, the 'China Green bond Principles' further unified the regulatory requirements for green bonds in the domestic bond market and clarified

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that 100% of the funds raised should be used for qualified green projects, which is consistent with the international standard ('Green Bond Principle') [4]. In general, there are 3 characteristics of ESG-related policies. First of all, ESG-related policies in China are mainly composed of departmental regulations in the Chinese government and the industry self-regulatory rules, thus the policies are usually started from a certain industry or field to promote sustainable development and finally form a practical plan for implementation. In addition, at present, Chinese ESG-related policies have involved the main process of ESG practice for entities and financial institutions, such as incentives and punishments, concept guidance and so on. Lastly, the ESG policies around the physical enterprises and financial sectors are well coordinated and developed, mainly concentrated on areas of pollution prevention and low-carbon transformation. Also, as the financial system is an important channel to promote the ESG investment philosophy, the related ESG policies are developed and emerged rapidly.

3. The Situations and Limitations of ESG Information Disclosure Standard

The ESG investment philosophy has been actively practiced in Europe, the United States, and other developed areas, which has promoted the development and maturity of the ESG system. ESG disclosure is an essential part of the ESG system as it influences the data collection process and further affects data integrity, transparency, and accuracy. The results of research by Murata and Hamori show that ESG information disclosure reduces the risk of future stock price crashes. However, the effect and ability to predict are different in different regions [5]. Compared with foreign countries, the progress of ESG investment in China is still at the entry-level because it started late [6]. In 2020, Jialin Feng, Huaqian Li, and Zhongjuan Sun compare the disclosure standard in China with developed areas [7]. They found no clear guidelines, standards, comprehensive policy systems, or regulatory service departments in the Chinese ESG information disclosure system [7].

Noah Private Wealth Management Provides services for the selection of foreign and domestic financial derivatives, asset management and investment portfolio management. This company aims to build a sustainable working environment and contribute to carbon emission reduction. For example, reducing paper usage for administrative processes and helping employees change their energy usage behaviour. For the external environment, the company encourages their clients to use online service to reduce resource loss and require the suppliers to cooperate with them to provide sustainable products and achieve ‘Green Purchase’. Additionally, Noah set up a foundation that focuses on Chinese citizens' spiritual growth and happiness index and holds public welfare activities mainly for vulnerable groups in society. In 2020, the donation expenditure reached 7,163,377.83 yuan, of which 8.8% went towards poverty alleviation, 49.4% for supporting activities about anti-epidemic, donations for education equity developments accounted for 19.4%, 10% for autism projects and sustainable development donations accounted for 11.6% [8]. Moreover, Noah pays attention to gender equity and focuses on women’s social influence. More than 63% of employees are female, and gender equity also improves the social influence of females, like highly participating women in the workplace and creating a gender-friendly new economic era. Gender equity may also create different possibilities and boost the new trend of economic growth. From the perspective of customers, Noah also cares about data security to protect the customers’ privacy. The information security department conducts special inspections on the protection of customer privacy data annually, and any violations of security regulations are found to be punished following the company’s management regulations. Also, the company will report the illegal activities to relate judicial department. In 2020, according to the regulations about privacy protection developed by the government, Noah has already finished the self-checked job, set some privacy policies, and updated the version for four apps and WeChat official account, as well as for the Enoch Education Mini Program [6].

The understanding of most Chinese companies on ESG investment remains shallow and the penetration rate of ESG investing in the Chinese market has not yet reached the level achieved in the developed countries, although ESG investment has shown significant growth in the Chinese mainland market and the methodologies used by leading Chinese investors are comparable to those of leading investors in other developed and emerging markets. In addition, most Chinese investors are still learning ESG investment and finding an appropriate way to practice it. From the report published by the CFA institute, it is clearly shown that many investors would apply ESG integration after some leading investors demonstrated that ESG integration can achieve a high investment return [9]. Currently, there is no track record for ESG products and most Chinese investors are more concerned with returns maximization rather than the sustainability of the investment [9]. Xu Yan, Chief Investment Officer of Hwabao WP Fund Management Co., Ltd, thinks as most Chinese asset management companies are more concerned about returns maximization and also the performance bonus of managers are related to the return rate of a project as the owners of these assets and equities also require a high return rate, following that, most investment managers focus on better return rate, rather than the consideration of social responsibilities [9]. Therefore, education about sustainable living, environmental protection, and the awareness of saving natural resources is necessary and extremely important. People should have a clear understanding of what ESG is and how to use ESG investment to acquire returns for asset management companies and the owners of assets in a long-run investment.

4. ESG Rating System and Related ESG Products in China

The Industrial and Commercial Bank of China is one of the members of the People's Bank of China Green Finance Committee and established the research team of Green Finance in 2015. Also, until the end of 2022, the Industrial and Commercial Bank of China has continuously written and published a report on social responsibilities for fifteen years. Also, ICBC published the Green Finance Topic Report from 2019 to 2021. The report discloses ESG information, including the aspects of environment, society, and governance, for example, the situation of financial help for vulnerable groups, the information about the sustainable operation of the bank, corporate governance and ESG governance, and so on [2]. Additionally, the ICBC constructs an ESG rating system which is the first among Chinese commercial banks and helps other commercial banks explore ESG investment and green finance. This rating system is called Zhongzheng 180 ESG index. In this system, the rating score of 180 limited companies that issue stocks on the Shanghai Stock Exchange has normally distributed, and the fluctuations in mean and variance are small, proving the stability of this rating system of ESG [2].

The Industrial and Commercial Bank of China also issues some ESG products to develop sustainable investment. Also, the ICBC issued eight kinds of green bonds from 2017 to the end of 2021 to respond to the Chinese government's strategic goals (achieving carbon peak and carbon neutrality). Other important ESG and green finance activities taken by the ICBC is developing the 'The Belt and Road Initiative' Green Finance (Investment) Index at the start of 2019. This index provides methodologies to avoid the risk brought by the environment and increase the awareness of investment along the areas of 'The Belt and Road Initiative,' as well as improving the efficiency of investment. Therefore, the Industrial and Commercial Bank of China is leading in green finance and ESG investment among Chinese banks and financial institutions.

On the other hand, while developing ESG policies, ICBC and other companies still face some challenges. First, more than the degree of ESG information published is needed to satisfy the demand for sustainable investment, which may lead to information asymmetry and even influence the validity of investment. In developed countries, ESG information disclosure systems are mainly formulated by international organizations, and the improvement of information disclosure standards is constantly

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promoted by investment demand. In September 2020, GRI, CDP, SASB, CDSB, and IIRC jointly issued a plan to build a unified ESG disclosure standard, while in China, there need to be more unified ESG disclosure standards [2]. Additionally, China's rating system differs from the rating system, which is more mature and professional in foreign countries. However, the ESG rating system in foreign countries needs to fit the situation in China as the recognition of sustainable corporate is different in China and western countries. In developed countries, they reject to use of fossil fuels. At the same time, in China, the energy supply structure determines that coal is still the primary energy source for social and economic development. Additionally, it is different in the aspect of social development. For example, in China, the government requires the company to provide accurate information about giving financial help to vulnerable groups, while it is not required in western capitalist countries. Therefore, the Chinese government must unite other relevant agencies to play their authoritative role and formulate a set of nationally unified ESG disclosure guidelines and regulatory rules, as well as clarify the mandatory nature of ESG information disclosure based on the actual situations in China and the experience gained from other successful examples in western developed countries. An appropriate ESG rating system in China mainly focuses on the criteria which have already arrived at a common understanding on the international platforms, such as the performance of resources usage, pollution emissions, the protection of the ecosystem and the social responsibility to the employees, suppliers, and other stakeholders. Also, special Chinese social and economic environments should be considered, like poverty alleviation programs with financial services, funding vulnerable groups in remote areas and some other key topics in China. Additionally, because there are many differences between different industries when setting the best practical parameters, the relevant department should also consider different development plans and standards for different industries in China. As the disclosure of ESG information is an important challenge during the process of exploring ESG investment practices, the Chinese government should develop regulations for publishing ESG information referring to relevant international examples and enhance the awareness of ESG information disclosure among Chinese enterprises with full consideration about the feasibility of ESG information disclosure, like the cost burdens on the companies.

5. Discussion

For the long-term development of ESG investment in China, there is a need for the government to increase the degree of opening in the financial industry. This can help to raise the attractiveness of the Chinese sustainable financial market to international investors. China has already taken some steps in this direction, such as the launch of the Shanghai-London Stock Connect program in 2019, which allowed Chinese companies to list on the London Stock Exchange, and foreign investors to invest in Chinese companies listed in Shanghai. However, more needs to be done to improve the regulatory framework and create a level playing field for foreign investors in China. Additionally, the Chinese government should also participate in the formulation of related international regulations and further cooperation based on Chinese-related ESG practices. As a signatory to the Paris Agreement, China has committed to reducing its carbon emissions and promoting sustainable development. By participating in the formulation of international ESG regulations, China can help to shape the global ESG investment landscape and promote the adoption of ESG practices by other countries and regions.

Despite the progress made, China still faces challenges in ESG development, especially the lack of ESG data and information disclosure. Compared to developed countries, Chinese companies generally lag in disclosing their ESG information. In China, the ESG information disclosure of A-share listed companies is a mainly optional choice. Neither the Shenzhen Stock Exchange nor Shanghai Stock Exchange compels listed companies to consciously fulfil their social responsibilities. However, Hongkong Exchanges require listed companies not to disclose ESG information, but to explain it publicly to the market [2]. As of 2020, only 22% of A-share listed companies disclosed

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their ESG information, and the quality of disclosure varies widely. The lack of ESG data and information disclosure makes it difficult for investors to conduct ESG analysis and assess the long-term sustainability and potential risk of a company [10]. Additionally, a scientific and systematic ESG rating system is crucial for developing the ESG index and related derivatives. As mentioned above, the ESG rating system is based on different perspectives in China and foreign countries which means the ESG rating system in China should follow the characteristics of the Chinese domestic capital market. Therefore, within the Chinese domestic market, the Chinese government should encourage companies, financial institutions and third-party service institutions to explore information collection and sharing, optimize the Chinese rating system of ESG, deepen the understanding of Chinese ESG development and finally form a beneficial cycle, where the efficiency of services in the third parties increases, more financial resources continuously invested into the market and also the enterprises start to pay more attention to the environment and society, rather than only the high return rates.

Another important factor in the progress of ESG investing is the investors. Currently, there are a small number of green investors and so the Chinese government should take some actions to promote ESG investment in the market. Firstly, increasing awareness and promotion of ESG investment and green investment concepts through investor education and advocating for green investment across society. This can create a positive social environment for ESG investment and encourage more investors to learn and accept ESG green investment concepts. Moreover, financial institutions can set reasonable investment thresholds for ESG wealth management products and offer certain rate discounts. Providing individual investors with a broader range of ESG investment products to choose from can encourage them to participate in ESG investment concepts and then participate in ESG investment.

6. Conclusion

In the capital market, the ESG investment philosophy is accepted by the market to a large extent, and it also gives some response to the market value of public limited companies. Also, ESG investment can help to gain an extra rate of returns in the long run and ESG investment matches the goals of sustainable living proposed by the United Nations and the green sustainable strategies for development in China, which means long-term financial, environmental and social impacts will be positive. This essay makes a summary of the basic current situation of the development of ESG investing in China, as well as the challenges the Chinese government, financial institutions and corporations will face in the future progress. Additionally, this essay discusses the ESG information disclosure standard, rating system and related products based on the example of Noah Private Wealth Management and the Industrial and Commercial Bank of China. Lastly, according to the analysis above, this essay gives a discussion on the long-term development of ESG in China. This essay found that the Chinese government should encourage ESG information disclosure and set up a relatively complete disclosure system. Additionally, China needs to develop an ESG rating system based on the characteristics of the Chinese capital market. Moreover, cultivating investors is also significant for long-term ESG development. Therefore, this essay can give some suggestions to the investors who focus on green finance and other stakeholders as the example of the Industrial and Commercial Bank of China is a classic one in the progress of ESG in China. On the other hand, there are not enough data samples in the real cases and also there are not enough case studies to prove the universality of conclusions, as well as not all perspectives of the ESG investment philosophy, are considered. Overall, in future studies, more cases and data should be analyzed and also ESG information disclosure should be encouraged to have a better understanding of ESG development in China and the risks faced in the progress

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