Principles for Responsible Investment

POLICY BRIEFING: THE ROAD TO COP 26 (CHINA)

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INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 4,000 signatories globally (comprising pension funds, insurers, investment managers and service providers), with approximately US$120trn in assets under management.

Responsible investment explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets.

The COP 26 summit in Glasgow in November 2021 is expected to see countries agree to the next steps on the path to deliver net-zero global emissions by 2050. Investors are increasingly supportive of policy actions to reach net zero and are ready to contribute capital and collaborate with policy makers to design and implement policies that facilitate investment flows at scale.

As the world's largest responsible investor network, the PRI is working to help investors protect portfolios from risks and identify opportunities in the shift to a low-carbon global economy, including through policy engagement. Ahead of COP 26, the PRI is seeking to support governments and policy makers to make commitments and implement policies that align with the goals of the Paris Agreement.

This briefing, which is one of a series of climate policy country briefings, presents the PRI's recommendations for priority climate-related policies for China that would help leverage investors' interests in supporting China's journey to carbon neutrality. If acted upon effectively, these measures would help cement China's role as a global leader in climate action.

FROM NET-ZERO COMMITMENTS TO CLIMATE POLICY ACTION

At the United Nations General Assembly in September 2020, President Xi's declaration of China's aims to have carbon emissions peak before 2030 and achieve carbon neutrality before 2060 set a grand vision for the country for the next four decades. As a critical actor in the global race to zero emissions, China has established near-term targets and made progress on reducing carbon and energy intensity and increasing renewable energy deployment. However, to remain aligned with the "30-60" national goals, concrete, near-term decarbonisation strategies and policies are needed.

Investors globally recognise the importance of major economies urgently establishing targets and plans to deliver net-zero emissions in line with the goals of the Paris Agreement. As analysis from the PRI's Inevitable Policy Response project shows, a delayed, disruptive and disorderly policy response to climate change risks undermining the value of financial assets as well as increasing the difficulty of reducing emissions at the required rate. On the other hand, timely and ambitious action creates certainty, helping businesses and investors seize the opportunities for growth and job creation that are provided by the sustainable and low-carbon industries of the future.

For these reasons, investors are increasingly supportive of policy action to reach net zero and stand ready to contribute capital and collaborate with policy makers to design and implement the concrete and actionable policies needed to facilitate low-carbon investment flows at scale.

POLICY RECOMMENDATIONS

The PRI recommends that economic, environmental and financial policy makers and regulators support ambitious, whole-of-government action to facilitate low-carbon investment flows and help achieve China's carbon peak and neutrality goals. Mutually supportive policy and regulatory reforms should include: (1) alignment of sector-specific emission reduction plans with the goals of the Paris Agreement; (2) taking actions to enable more effective carbon pricing mechanisms; and (3) improvement of underlying financial regulatory frameworks to better facilitate investors' allocation of capital to support the climate-neutrality goal.

1. ALIGN SECTOR-SPECIFIC EMISSION REDUCTION PLANS WITH THE GOALS OF THE PARIS AGREEMENT

To achieve overarching development and carbon-neutrality goals, sector-specific emission reduction plans and policies with clear near- to mid-term trajectories are a top priority. Clear sector-specific pathways that are aligned with the goals of the Paris Agreement can provide important signals for industry and the stability and confidence required for investors to allocate increased capital towards sustainable, low-carbon investments.

Based on research by Vivid Economics as part of the PRI's Inevitable Policy Response project, the PRI's net-zero roadmap for China provides policy recommendations regarding key sectors for decarbonisation, including power, buildings, road transport and industry. Together, these recommendations represent economically and technically achievable near-term actions to help set China on a pathway to carbon neutrality by 2060, consistent with broader development goals. Clear sector-specific plans will be required to realise these objectives and support consistent capital investment.

As priorities, policy makers should:

- **Translate of existing pledges into detailed policies in key sectors** that are consistent with the carbon peak and neutrality goals and which are parallel to renewables deployment.
- **Cancel all new coal power plants immediately and indefinitely**, in line with China's international policy, including "efficient coal" plants, and issue guidance on a net-zero aligned phase out to maintain energy security and avoid a disorderly transition and stranded assets.
- **Design and implement Paris-aligned transition strategies for low-carbon steel and cement,** including detailed objectives of decarbonising energy-intensive industry and commercialising carbon capture and storage technologies.
- **Set a 2035 deadline to end all fossil fuel vehicle sales** and develop a policy pathway to deliver 100% zero-emission vehicles by this date.

2. ENABLE EFFECTIVE CARBON PRICING MECHANISMS

China's emission trading scheme (ETS), the world's biggest, began operating in July 2021. In its initial phase, it covers the power sector, with plans to expand coverage to wider industrial and aviation sectors by 2025. Enabling the ETS to effectively impose a price on carbon emissions at a level that is aligned with Paris Agreement goals will be central to guiding China's economy on to a carbon-neutral pathway, and to provide clear and consistent signals for industry and investors.

The PRI welcomes the State Council's agenda to consolidate existing departmental rules on the ETS into a new State Council regulation which will set up a comprehensive regulatory framework for the national ETS. The PRI also welcomes the inclusion in the proposed ETS regulation of China's emissions peaking and carbon neutrality goals. For the ETS to fulfil these goals, it is important to set carbon emissions targets for the ETS that align carbon pricing policy with China's overall climate governance and targets.[1] Moreover, ongoing reforms of China's power market and the development of the ETS share similar goals of promoting the uptake of low-emissions and least-cost resources and should be coordinated to be mutually enforcing.

The national ETS is critical to the development of China's climate policy and to its embrace of market mechanisms. To transition the ETS from the current efficiency-based design and towards one that incentivises more cost-effective and structural sectoral decarbonisation that is aligned with China's 30-60 emissions goals, technical reforms to the ETS are also needed.

As priorities, policy makers should:

- **Set a clear timeline** for the inclusion of additional energy-intensive sectors in the ETS.
- **Transition to an absolute cap** by 2025, with a linear reduction factor and supply adjustment mechanism to ensure effective carbon pricing.
- **Implement economic dispatch** reforms across regional power markets by 2025 to complement efficient functioning of the ETS and ensuring that the cheapest and cleanest generation is called upon to supply power ahead of polluting fossil fuel generation.
- **Align power market reform with the ETS** to amplify the effects of shared policy goals, while remaining considerate of the balance between market-based mechanisms and administrative control.

3. REFORM FINANCIAL REGULATION FRAMEWORKS

To effectively re-orient economies and direct investment towards net-zero goals, governments need to reform and improve existing finance and investment regulation frameworks. The PRI welcomes the issuance of the Guidance on Promoting Finance and Investment to Address Climate Change by five key Chinese government bodies.[2] Further collaboration by regulators and government bodies to improve standards and regulations to encourage private and international capital to better integrate climate change and sustainability factors into decision-making should be a priority. This will help to provide an enabling environment for investors to manage climate-related financial risks and better contribute to China's low-carbon transition.

As priorities, policy makers should:

- **Publish regulations to clarify institutional investors' duties to incorporate climate-related considerations** in their investment decision making, to provide climate-related disclosures and to report on their ESG incorporation policies and performance targets.

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[1] IEA (2020). *China's Emissions Trading Scheme: Designing efficient allowance allocation*

[2] Ministry of Ecology and Environment of the People's Republic of China, "Guiding Opinions on Promoting Investment and Financing to Address Climate Change"

- **Introduce a stewardship code** to better guide investors to use their influence (including exercising voting rights and filing shareholder resolutions) to encourage portfolio companies to accelerate the transition to net zero, thus maximising the overall long-term value of their portfolios and mitigating their exposure to climate-related risks.
- **Establish mandatory and standardised corporate climate disclosure requirements**, including alignment with the recommendations of the Task Force on Climate-related Financial Disclosures to enhance transparency on the financial impacts of climate-related issues on investees and support efficient allocation of capital in the transition to a net-zero economy. It is also important to collaborate with other ministries to create a consistent sustainability reporting framework across corporate and financial institutions.
- **Raise the standards of the existing Green Bond Endorsed Projects Catalogue (2021 Edition)**, to articulate science-based, technology-neutral performance screening criteria and continue the EU-China "Common Ground Taxonomy" efforts on converging green investment taxonomies by the end of this year.
- **Develop national/regional sustainable finance strategies** that encourage the low-carbon transition for the whole economy.

For further information on a broader sustainable investment policy framework, please see A toolkit for sustainable investment policy and regulation (part 1) published by the PRI and the World Bank.

CLEAR POLICY ACTION INCREASES INVESTOR CONFIDENCE

While climate change poses significant risks for society and the economy, the net-zero transition also provides opportunities to build the industries of the future, supporting sustainable development and prosperity. Investors are clearly signaling their interests to invest in these opportunities, but they will require reliable, near-term and concrete policies to do so.

These measures recommended by the PRI would help to establish clear near- to mid-term emissions reduction trajectories and plans for the real economy, and to build the foundations for a financial system that supports a rapid and orderly transition to a net-zero carbon economy. Alignment with net zero and broader sustainability goals should be consistent and coordinated across government financial, economic and sectoral policies.