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Green Investment Banking Business in Commercial Banks

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Green finance started relatively late in China, but it has huge potential. Green finance receives more support from policies, enterprises, markets, and technology. The investment banking departments of commercial banks could combine provision of fund and provision of expertise, and thus offer comprehensive services to enterprises and governments.

Green finance is usually referred to as sustainable finance or environmental finance, indicating a change in the operational philosophy, management policies, and business processes in the financial sector in terms of environmental protection. By providing financial services such as green credit, green securities, and green insurance, projects in green industry could be key recipients of support, enjoying the priority and preferential policies in funding provision, amount, duration, and interest rate. With the financial sector prioritizing support to green industry, sustainable development is expected to realize. Overseas green investment banking businesses include green bonds, green asset-backed securities (ABS), green funds, and green consultancy services.

Investment banking departments of commercial banks should actively look for business opportunities in the demand for green finance, engage in green finance businesses with investment banking thinking and instruments, develop green investment banking business at an earlier stage, seize the commanding heights of the market, and provide products and services such as green bonds, green financial bonds, green equity, green ABS, and green industrial funds, to enhance the development of green finance.

Green investment banking business in China: A late starter with huge potential

By the end of 2017, the total balance of green financing in China was RMB8.6 trillion, of which RMB8.2 trillion was provided by 21 major banks, up by 13% and accounting for almost 10% of the total balance of credit. It is worth attention that the quality of green credit assets is

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relatively high. By the end of June 2016, the non-performing loan (NPL) balance from the green finance sector is RMB22.625 billion, or 0.41% in terms of the NPL ratio, while the average NPL ratio of the same period is 1.76%. Green finance has a low NPL ratio mainly because green credit effectively controls environmental risks and improves the sustainability of enterprises and projects. In addition, the state supports and encourages such investment areas, so green credit has high asset quality. For the products within the category of investment banking, green equity finance has a balance of RMB220 billion; green bonds have a total balance of RMB433.37 billion, of which RMB227.43 billion is newly issued, up by 9.4% and accounting for more than 30% of the global increase; the balance for green non-financial corporate bonds is RMB134.9 billion; the balance for green funds is RMB10.7 billion, and carbon assets amount to RMB58.4 billion.

In general, China only recently entered green finance area: The profit-generating model is yet to be diversified, businesses are still at an exploratory phase, and development of the green finance market still faces many problems. First, the channels for financing are still narrow and the tools are limited. Financing tools are mainly green credit, green bonds, and public-private partnership (PPP), while instruments like financial leasing, ABS, and trusts, are rarely used. The balance of green credit from commercial banks accounts for only a small proportion of the total. Second, there is a lack of awareness from a strategic perspective. Some regions are still seeking growth at the cost of environment, and the function of finance for resource allocation in the market does not fully guide environmental behavior. Third, there is a lack of external incentives and supervision. The social responsibility to protect environment among financial institutions still requires improvement due to insufficient corresponding restraint and incentive mechanism. Additionally, the government has yet to establish mechanisms to encourage financial institutions to engage in green finance and to monitor their behaviors. Fourth, there is a lack of highly educated professionals with a variety of skills in this cross-sector area. The scarcity of professionals puts a restraint on the development of green finance.

With policy incentives, the green finance market in China has entered a phase of all-round and in-depth development in recent years. The awareness and recognition of green philosophy in the market gradually increases, and market players are more diversifies and professional. Green finance products are increasingly diversified, as exemplified by the emergence of products like green funds, green stock index, green bond index, and carbon finance innovation products. The standard for green finance is being set up, and a unified green finance performance assessment and management system has laid a good foundation for the large-scale, standardized development of a green finance market in the future.

Green financing demand in China mainly comes from six sectors: sustainable energy, infrastructure construction, environment restoration, industrial pollution control, energy and resources conservation, and green products, which can be further categorized into 16 segments, including renewable and clean energy (electricity), urban water supply, energy saving, and farmland restoration. Funding demand plans are made according to the various requirements of different green development targets. In 2014–2020, low target plan requires green finance capital of RMB14.6 trillion, the mid-level target plan requires RMB24.3 trillion, and the high target plan requires RMB29.9 trillion.

In the context in which ecological civilization construction is included in the overall layout of the "five-sphere integrated plan," and preventing pollution is included as one of the "three critical battles" for China to become a well-off society, green finance will enter a new phase of development, and the huge potential for investment banking is yet to be tapped.

Framework for green investment banking business made by commercial banks

Participants in green finance include governments, environmental protection enterprises, and financial institutions. Governments are policy makers, with the responsibility of guiding, promoting, and supervising the green industry, while also being consumers of green finance. Environment protection enterprises are at the upper side of the entire industrial chain, providing various categories of products and services. Financial institutions provide financial services for governments and enterprises, working as an important guarantee for energy supply and adjustment. Investment banking departments in commercial banks, through investment banking products and professional consulting services, can acquire in-depth knowledge of the performance of their customers and combine the provision of funds and provision of expertise organically to serve enterprises and governments in an all-round manner.

Satisfying the fundamental capital demand by financing investment banking services

Financial products for green finance are actually simple and relatively mature. However, against the background of tightened regulation, innovation in financial products is restricted to some extent and has to conform to various regulations. Special attention should go to business forms such as the cooperation between investment and loan issuance, capital market business, and public–private partnership projects.

First, through the cooperation between investment and issuing loans, banks can enhance financing support to innovative green enterprises. Banks could select good green enterprises, make an equity investment, and provide credit support at the same time. Such business is mainly done for technological and innovative green enterprises with strong growth potential. The traditional banking has little knowledge of such enterprises in terms of risk management. Besides, some of these enterprises, being at the earlier stage of their life cycle and operating with light assets, would not be deemed wise targets in the traditional credit philosophy.

However, under the philosophy of coordination of investment and loan issuance, practices will no longer be confined by the traditional rules, creating new profit earning possibilities for banks that operate in an environment with a narrower net interest margin. Specifically, banks can achieve this using a "following investment first, heading investment later" tactic. Since banks have only limited knowledge of the industry at first, they should cooperate with professional green investment organizations with good performance, affluent expertise and experience, and purchase shares of fund as limited partners (LPs) to acquire equity on the one hand and reduce the overall investment risks through a diversified investment of funds on the other. After that, commercial banks should further their research to understand and select the enterprises in which they invest, give loans to eligible and well-performing ones, and build and improve their own research team and risk management systems while doing this business. Once the investment system is complete, commercial banks could take the lead in further investment. By utilizing their investment subsidiaries within the group, commercial banks could then start to forge their own green investment philosophy.

Second, by diversifying measures to support financing in the capital market, banks can facilitate green enterprises' financing activities mainly via various investment banking businesses and services. Such businesses include setting up green industry funds, supporting their initial public offerings, private placements, merger and acquisitions (M&As), and offering green ABS.

Take setting up a green industrial fund as an example. First, banks can focus on enterprises and invest in those that are more mature and have requirements on M&As. Second, banks can follow the developments of green projects and support project building. Green industrial funds will be an important driver of the sustainable growth in China in the future, and banks could acquire shares of government-led funds as LPs, while providing a basket of financial services, including funds settlement, custody services, and payroll services for enterprises and projects. As another example, take the development of green ABS products. Green ABS is a financing means to mobilize existing green assets and a means of withdrawal from green projects. Investment banking institutions of commercial banks should make great efforts to conduct green ABS business.

Banks can conduct this kind of business in three aspects. The first is to find high-quality green underlying assets, encourage the enterprise to initiate the process of asset-backed securitization, and purchase shares as a funds provider. The second is to provide diversified consulting services for the issuance of finance products as a financial consultant. The third is to issue green ABS products as an issuer. Additionally, it is a mainstream trend in recent years for enterprises to grow stronger or transform their businesses through M&As. Commercial banks can take such an opportunity in several ways. Banks can use green industrial funds or set up special green M&A fund, provide financial support through M&A loans, or help enterprises complete the M&A process as financial consultants. In addition, they can take part in green PPP projects, and so on.

Third, commercial banks could find high-quality customers to promote green debt-to-equity businesses. Debt-to-equity is strongly promoted by the government in recent years, and commercial banks could play a more active role in seeking opportunities from their high-quality customers. Specifically, debt-to-equity opportunities in the green industry are concentrated mainly in the following four categories of enterprises: (1) clean energy enterprises, especially those with high up-front cost and long recovery term; (2) environment protection infrastructure enterprises with stable cash flow; (3) green technology and innovation enterprises with cutting edge technology that might lead the future development in their industries; and (4) enterprises who issue shares or bonds to repay debts.

Acquiring more value by investment banking services that provide expertise

First, banks can provide consulting services for governments on policy planning. Governments are the main customers to whom commercial banks provide their expertise. Investment banking divisions of commercial banks should, based on the circumstances of the locality, make pertinent and in-depth interpretation of policies for local governments, especially to clarify the opportunities and challenges that policies could bring along to the growth of the locality, and put forward feasible suggestions that consider both the present interests and future development. They can, meanwhile, also help local governments draft mid- and long-term green development plans in combination with the products from different business lines of banks, and formulate comprehensive green finance development plans to facilitate the development of a green environment protection industry in the locality.

Second, investment banking divisions can provide consultation on strategy and operations for enterprises. Banks should make different arrangements according to the specific nature of the enterprise in terms of providing financial expertise. For manufacturing enterprises, commercial banks should focus on understanding the firms' financial status, corporate governance, profit model, products, and so on, while also considering the macro economy, industry development, and features of products. Banks should also assess the core competitiveness of the enterprise, appraise the status of the enterprise in the industry, give suggestions for its operation, and help formulate and optimize the enterprise's development strategy.

For operating companies, banks should focus on making rational assessments of projects based on the company's actual profitability, cash flow generation ability, payment reception stability, and so on. Banks should provide financing consultation and help these enterprises find sources of funding.

Third, intermediary businesses can match the needs of enterprises and governments with the following two approaches. The first is cooperation between governments and enterprises: Commercial banks and investment banks could use resources of enterprises to help attract investment to support government policies, introduce proper enterprise resources according to their needs, and help enterprises to design all-round green solutions. The second is cooperation between enterprises: At the capital market, based on the demands of enterprises, banks could provide services such as M&As and restructuring.

Building a unified mechanism of investment and research

For investment banking divisions of commercial banks, if their research teams could do some research and thoroughly investigate the circumstances of high-quality companies from the green company database of the banks, get involved early, follow their development in the long run, and visit them periodically, they could gain a better understanding of the companies, which will help both to tap customer needs in depth and to develop the green investment banking business and risk management. An exchange mechanism could be set up between research and business teams in an investment banking department, so they can share research results and seek for opportunities. The ultimate goal for such exchange and collaboration is to facilitate investment through research. Therefore, timely and effective communication is necessary. On the one hand, business teams could seek for business opportunities by comprehensively considering the achievements of research team; on the other hand, business teams could share their recent successful cases and thus provide guidance for research work to adapt to the risk of the market and enhance practical value of research.

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