China Debt Dynamics

Green finance: Sowing the seeds of China's next wave of NPLs

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Since 2017, China's banks have been actively cleaning up their balance sheets, resulting the disposal of trillions of yuan worth of nonperforming loans (NPLs). But even as banks deal with a previous generation of bad loans, separately they're **laying the foundations for a new wave of distressed debt in the area of "green finance."**

As outlined in this piece below, in recent years **ShoreVest has already begun to make successful investments where our credit clean-up expertise is needed in the area of sustainability.**

The need for green credit clean-up solutions has its background in Beijing's regulatory direction. In September 2020, Xi Jinping announced that China's carbon dioxide emissions would peak by 2030 and that China would achieve carbon neutrality by 2060. Since then, low-carbon development and the green transition have been among China's top economic priorities. But achieving those goals is expensive. It's widely estimated that China needs to invest RMB 3-4 trillion yuan annually to reach peak carbon emission by 2030.

China's banks have been at the vanguard of efforts to realize Xi's vision. Over the past four years, the average **annual growth of banks' green loans has been greater than 30%** [Fig. 1]. In contrast, overall growth of banking sector loans has increased only 10% annually over the same period. Meanwhile, at the end of September, **green loans accounted for almost 14% of all outstanding bank loans - more than twice their level in 2020** [Fig. 2].

Fig. 1

Banks' green loans have surged since 2020

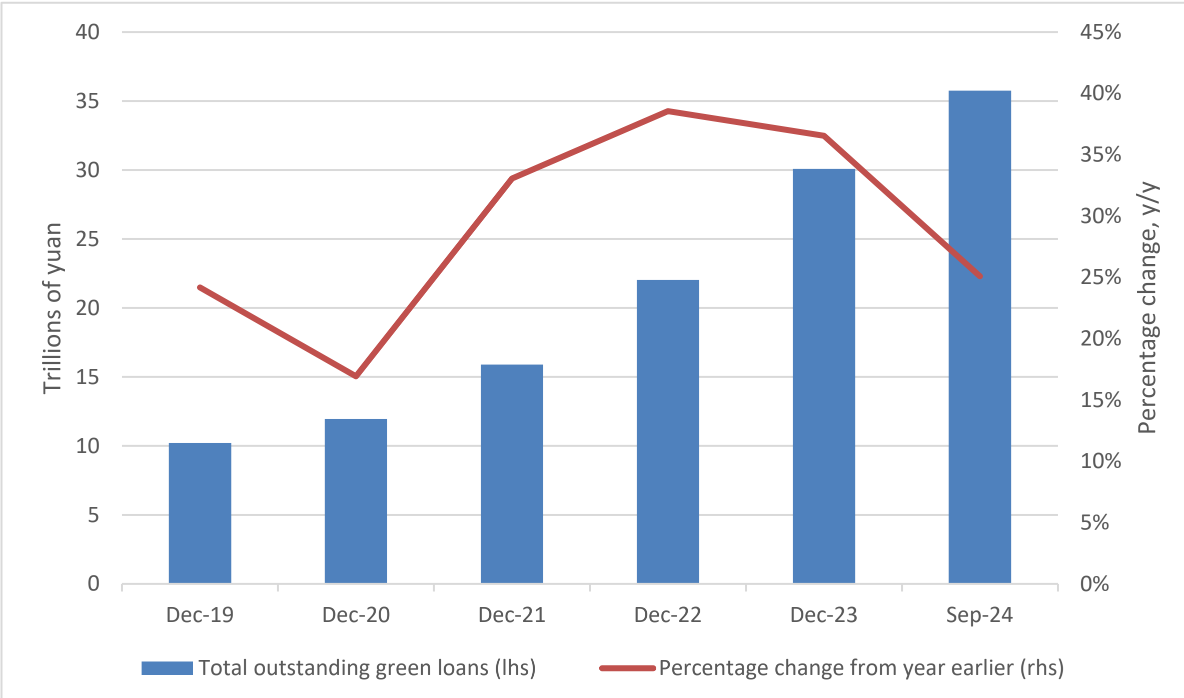
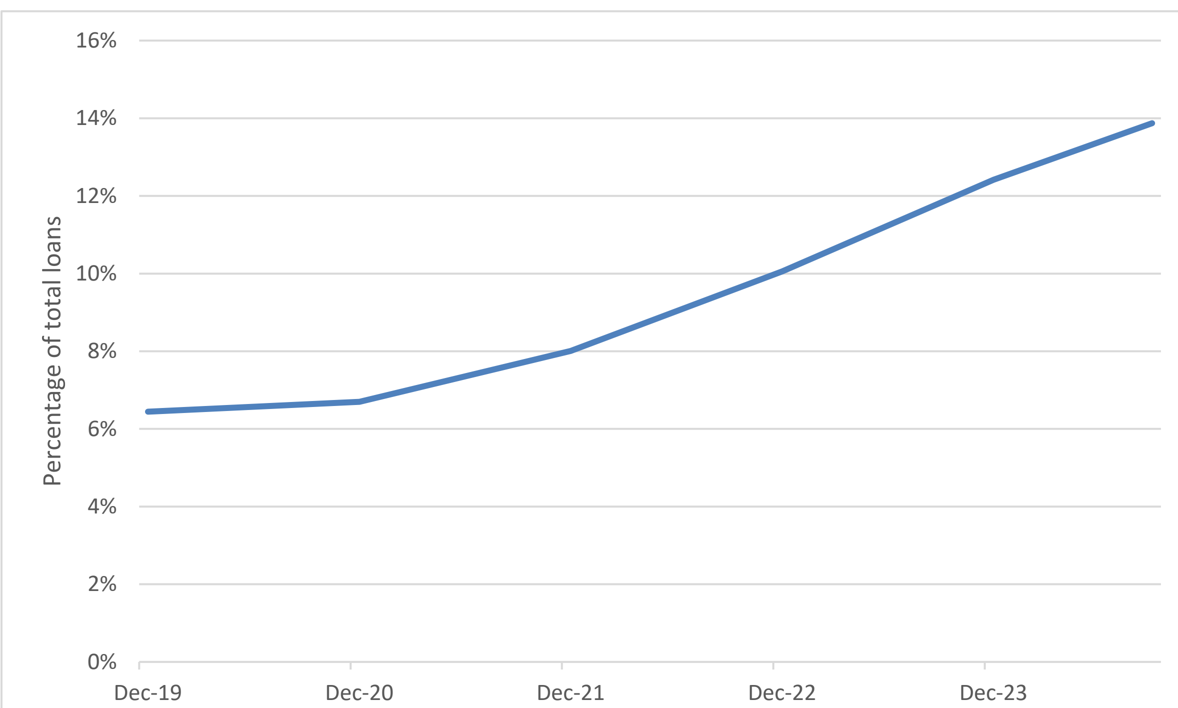


Fig. 2

Green loans as a percentage of total bank lending has surged since 2020



The **rapid expansion in green credit has been fueled by implicit political and explicit regulatory incentives**. Of these, the most significant is the inclusion of green finance in the PBoC's quarterly macro-prudential assessment (MPA) of China's 24 biggest banks. The PBoC conducts MPAs as a way to monitor risk among China's most important banks. Banks that regulators deem to be too risky are docked points, and may be penalized with higher reserve or capital requirements, or with guidance from authorities to pare back certain activities. But the PBoC also rewards banks with active green lending programs with extra points. In effect, the PBoC tolerates higher risk among banks that extend enough green loans.

Green metrics have been incorporated into banks MPAs since 2017, but it was only after Xi announced his two carbon targets in 2020 that banks' green lending really started to ramp up. In 2021, China Development Bank - the biggest of China's three policy banks - said green loans would account for 30% of its credit assets by 2030. Bank of China announced it will provide at least RMB 1 trillion in green finance during the 14th Five-Year Plan period - which runs from 2021 to 2025 - and its proportion of green credit will increase each year.

Regulators' routinely remind banks that green finance is a priority. In October 2024, the PBoC, National Financial Regulatory Authority (NFRA), China Securities Regulatory Commission (CSRC), and the Ministry for Ecology and Environment (MEE), issued a joint notice saying banks are:

> *"Encouraged to beef up green financing support by increasing the supply of green credit and developing green financial products such as green bonds and green asset securitization."*

Green finance is defined by the People's Bank of China (PBOC) as **"financial services provided for economic activities that are supportive of environmental improvement, climate change mitigation, and more efficient resource utilization."** Put simply, any financial activity that supports the development of green projects, minimizes the climate impact of regular projects, or a combination of both, can be regarded as green finance.

Green finance isn't just about climate and carbon emissions, although supporting the installation of renewable energy generation and mass transit systems are a big part of Beijing's investment goals. Equally important is Beijing's drive to improve the overall state of China's environment through water treatment plants, soil remediation, and recycling facilities.

That said, it's likely that many of the loans banks classify as being green don't strictly meet the PBoC's criteria. In the past, banks' new loans mostly went toward home mortgages, housing and infrastructure projects, and manufacturers. However, in the first nine months of 2024, 37% of all new bank loans were official green, up from 9% in 2020. And yet, banks as yet haven't built up the internal expertise to identify legitimate green projects on such a grand scale, let alone manage the risks. Consequently, there's likely a lot of green-washing going on, as banks take loans they would have made anyway and rebadge them as green.

Moreover, **by setting up a regulatory framework that encourages banks to lend for political reasons, authorities have likely laid the foundations for the next generation of NPLs**. Overinvestment in green businesses has already resulted in overcapacity in electric vehicles, batteries, wind turbines, and photovoltaic components. A highly respected government advisor – Huang Yiping, the dean of an economic think tank at Peking University who sits on the PBoC's monetary policy committee – has recommended China launch a green Marshal Plan as a way for China to export overcapacity in green industries to the Global South. Without sufficient international demand, overcapacity could readily transform into distressed debt.

In ShoreVest's dealflow, we have already begun to see opportunities emerge as a result of this trend toward sustainability. By way of example:

- In 2020, ShoreVest participated in an asset-backed bridge financing and debt restructuring of a fundamentally sound **water-filtration** systems manufacturer. After solving the company's credit impairment issues, ShoreVest exited the investment in approximately two years at a higher-than-underwritten return.
- In 2024, ShoreVest provided an asset-backed financing in the **renewable energy** space to a solar energy company. This deal is similarly expected to generate outsized returns for credit, exiting in less than a year.
- ShoreVest has successfully **reduced carbon emissions** from underlying collateral on various other asset-backed financings and restructurings.

Although evidence of a new wave of green NPLs has yet to show in formal banking system data, ShoreVest is already seeing the early signs of a greater need for credit clean-up solutions among sustainability-related assets. And because the incentives are in place for banks to prioritize green loans ahead of due diligence and prudent lending, it's just a matter of time before China's next wave of NPLs starts to take shape in green finance.

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