

ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 4: Strengthen Discounted Green Loans



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Detailed Recommendations 4: Strengthen Discounted Green Loans

Interest rate discounts for green loans are an effective measure to stimulate private investments more than ten times the size of a relatively small fiscal initiating fund. China has continuously stepped up its efforts on energy conservation and environmental protection and issued dozens of policies on fiscal spending. Nevertheless, current fiscal spending on energy conservation and environmental protection is dominated by direct subsidies while fiscal spending of interest rate discounts represents a relatively low share and the policy of interest rate discounts exists but plays a relatively limited role. We believe that in order to bring about more private investments with the incentive of a limited fiscal fund, efforts should be made to increase the application of fiscal interest rate discounts in the sector of energy conservation and environmental protection and improve the highly efficient fiscal interest rate discount mechanism for green loans.

(I) The case for creating an efficient government interest rate discount mechanism for green loans

Also known as discounted loan interest rates, interest rate discounts refer to the government policy of offering subsidies on the interest rates of loans in certain sectors by certain proportions (partial or total) to support the development of these sectors. In the current composition of fiscal spending on energy conservation and fiscal spending, direct government subsidies for products account for a significant share while fiscal spending of interest rate discounts remains insignificant with a limited the scope of application.

1. Characteristics and effectiveness of interest rate discounts

First, interest rate discounts serve as a leverage to stimulate private investments. As an indirect mechanism to steer private investments, interest rate discounts have a strong leverage effect. Theoretically speaking, $\text{leverage effect} = \text{volume of private investments induced by interest rate discounts} / \text{interest rate discounts} = 1 / \text{interest rate discount ratio}$. The government may stimulate a significant amount of investment using a relatively small amount of initiating fund under the interest rate discount policy.

For instance, it is assumed that the annual loan interest rate of financial institutions is 10 percent while a project requires an investment of one billion yuan yet is only able to afford 5 percent of annual interest rate. Obviously, this project cannot receive commercial bank lending under market-based operations. However, if the fiscal policy of interest rate discount is followed to subsidize 5 percent of interest rate, the bank would be willing to offer the loan at an interest rate of 10 percent while the project would be able to be financed without incurring additional interest spending. In this process, the government only pays an interest rate discount of 50 million yuan to

enable the utilization of financial capital worth one billion yuan with a leverage effect of 20 times, which effectively supports project development.

Second, interest rate discounts have steering and stimulating effects. They represent both a government investment activity and a fiscal incentive. As a mechanism whereby the government indirectly steers investments, interest rate discounts reflect government economic intentions without affecting the decisive role of the market in resource allocation and, by sending signals to private capital, mobilizes and steers private investments towards areas in line with national policy intentions. While alleviating corporate interest payment burdens, interest rate discounts have also reduced the risks of loan recovery for the banks and thus increased loan payment ratio. Hence, the policy of interest rate discounts has powerful effects of steering and stimulation.

Third, interest rate discounts have a low-risk advantage. Different from the inefficiency and great risks of financial losses that may arise from fiscal direct investments, interest rate discounts act as an initiator of corporate, bank and private investments at the cost of a relatively small initiating fiscal fund and project investors and loan issuance banks are also concerned with the investment return and thus will strive to mitigate risks. Given the relatively small share of spending on interest rate discount in project development capital, losses of public finance will be limited to the funds for interest rate discount even if an investment project fails. This will reduce or lock up the risks of fiscal subsidies.

2. Defects exist in current direct fiscal subsidies for environmental companies

In recent years, China has implemented a series of policy measures of environmental protection, energy conservation and emission abatement. Dozens of fiscal spending policies have been introduced and fiscal spending composition has been adjusted to promote energy conservation and efficiency, development of new energy and renewables, efficient and integrated resource utilization and circular economy, emission abatement and environmental protection. Between 2007 and 2012, the Chinese central government allocated more than 400 billion yuan to support China's green and low-carbon development.

Nevertheless, most of these fiscal spending policies are direct point-to-point subsidies or incentives such as fiscal incentives for energy conservation technology renovation, central fiscal incentives for phasing out backward capacities, fiscal incentives for contract energy management, fiscal subsidies for the development of demonstration projects by the energy management centers of industrial enterprises, *ad hoc* funds of energy conservation and emission abatement in public transport sector, *ad hoc* fund for energy conservation and emission abatement in civil aviation sector, fiscal subsidies for the promotion of efficient lighting products, fiscal subsidies for energy efficient home appliances, *ad hoc* fund for circular economy, etc.

Without doubt, these fiscal policies have played a proactive role in promoting energy conservation, reducing emissions and achieving green and low-carbon development. However, many flaws and problems also exist in the direct fiscal subsidies for enterprises, including:

First, green development involves numerous areas and policy issuance is frequent and fragmented. Lack of policy coordination and planning, together with repetitive policy-making in various areas, has led to inefficiency in environmental policy-making.

Second, point-to-point fiscal subsidies to companies gave rise to backdoor connections and corruption. Some government employees may not obtain a complete, accurate and truthful picture of all the enterprises that apply for such incentive measures.

Third, companies have focused on the ex-ante applications of direct fiscal subsidies yet neglected project implementation and effectiveness. According to the audit results of energy conservation and environmental protection projects conducted by the National Audit Office for 1,139 energy conservation and environmental protection projects in 10 provinces, 44 projects involving 1.587 billion yuan of project funds implemented by 42 companies and entities failed to meet the expected effects of energy conservation and emissions abatement due to unrealistic design objectives and inadequate supervision and management during project implementation. A few enterprises and project implementation agencies successfully received project funds worth 141 million yuan by providing misstatements and fabricating information and misused ad hoc funds worth 129 million yuan for activities not related to energy conservation and emission abatement such as daily office administration and corporate operation.

3. Interest rate discounts can lead to multi-win results for enterprises, banks and government finance

With interest rate discounts, companies can reduce financing cost and increase profitability in making green investments. Interest rate discounts provide an expectation of robust development for subsidized industries and projects, which will attract more private investments into green sectors and provide a stronger financial support to relevant industries.

In conducting their financial business operations, banks mainly consider the safety, profitability and liquidity of financial assets. By offering interest rate discounts, the government will cover loan interests in part or in full to alleviate the interest payment burdens of companies, increase loan payment ratio and reduce the risk aversion of financial institutions for loans, and thus incentivize lending by financial institutions.

Compared with direct subsidies, interest rate discounts can achieve greater social benefits at the cost of a minimum amount of interest rate discount funds on the part of the government, incentivize a much greater amount of private investments and thus optimize the allocation of social resources. Meanwhile, under the interest rate discount mechanism, professional commercial banks and other economic entities will assume the responsibility of project screening and to some extent reduce the responsibilities of fiscal management and supervision.

(II) Creating an efficient government interest rate discount mechanism for green loans

1. Interest rate discount policy for green loans will exist in the long run

China began to implement the policy of interest rate discounts for loans back in 1984. For instance, these interest rate discounts were extended to certain technology upgrade projects encouraged by the government. Afterwards, with deepening understanding, the interest rate discount policy was applied more extensively and played a proactive role in many areas such as steering private investments towards infrastructure construction. Currently, the fiscal policy of interest rate discount has been employed by the central government in such areas as: investments under central budget; capital construction projects; infrastructure projects; technology upgrade projects; grain and cotton production; ethnic goods; state-run farms in border and poverty-stricken areas; national tobacco reserves; national seed reserves for disaster relief and preparations against natural disasters; national key scientific and technological research projects; integrated agricultural development; raw milk procurement; poverty relief; water conservation and irrigation; tourism; services; importing; guaranteed small loans; national educational loans; post-disaster reconstruction; forestry; recycled and energy efficient building materials; energy conservation of public buildings; and environmental protection.

Interest rate discount policies related to green loans can be divided into the following five categories. First, *Interim Administrative Measures for Interest Rate Discounts of Central Finance* (Fiscal Budget [2001] No.388), which aims to enhance the management of fiscal interest rate discount funds, increase their efficiency and create an internal restraint mechanism; second, *Administrative Measures for Interest Rate Discounts of Loans for Technology Upgrade Projects* (the Ministry of Finance [2002] Decree No.26), which explicitly covers projects of energy conservation, emission abatement and environmental protection; third, *Interim Administrative Measures for Ad hoc funds of Energy Conservation Projects of Government Office Buildings and Large Public Buildings* (Finance and Education No.558 [2007]), which regulates the spending of interest rate discounts for the energy efficiency renovation of buildings; fourth, *Interim Measures for the Management of Fiscal Subsidy Funds for Recycled and Energy Efficient Building Materials* (Finance and Construction [2008] No.677), which provides interest rate discounts for capacity expansion by enterprises of recycled and energy efficient building materials; fifth, *Administrative Measures for Interest Rate Discount Funds Offered by Central Finance for Loans of Infrastructure Projects in National-level Economic and Technological Development Zones and National-level Border Economic Cooperation Zones* (Finance and Construction [2012] No.94), which explicitly cover environmental projects of wastewater and domestic waste treatment in the development zones and energy system optimization projects, residual heat and pressure utilization projects, green lighting projects and other key energy conservation projects implemented by the development zones to conserve energy.

2. Application of interest rate discounts is relatively limited

As mentioned above, the Chinese government extensively provides direct fiscal subsidies/incentives in various ad hoc funds of energy conservation and environmental protection while interest rate discounts for loans are mainly provided in some emission abatement and renovation projects.

According to the provisions of the guidelines on the application for ad hoc funds of environmental protection, aside from the desulphurization and denitration technology renovation projects of coal-fired power plants, interest rate discounts also apply to other projects and should receive priority support. According to this regulation, interest rate discounts for loans are actually applicable to all pollution prevention and treatment projects.

According to relevant regulations on local ad hoc funds of environmental protection, interest rate discounts for loans should be adopted in principle for pollution treatment projects or major pollution abatement projects, i.e. companies are encouraged to conduct pollution treatment with various loans mainly for the capital construction and equipment procurement of pollution treatment projects.

Judging by the actual use of the central ad hoc fund for environmental protection, interest rate discounts for loans have a limited scope of application. According to regulations, interest rate discounts for loans should apply to the desulphurization and denitration technology renovation projects of coal-fired power plants, yet the employment of interest rate discounts is relatively rare for other types of projects. As for the local ad hoc funds of environmental protection, some regions have prescribed the ways to support interest rate discounts for loans and some other regions have even called for complete interest rate discounts for key projects of emissions abatement. Based on our information, however, not many regions have actually employed interest rate discounts for loans. Some regions have even deleted provisions on interest rate discounts in revising their administrative measures for ad hoc funds of environmental protection afterwards.

3. Recommendations on perfecting interest rate discounts

According to our preliminary analysis, employment of interest rate discounts in the ad hoc fiscal funds of environmental protection has been inadequate and progressing slowly mainly due to the following reasons: First, the demanding requirements on the application materials for interest rate discounts. For pollution treatment infrastructure projects, loans for interest rate discounts must be used for the construction of pollution treatment infrastructures rather than manufacturing facilities, which are difficult to differentiate in reality and relevant documents of proof cannot be provided to the banks. Second, interest rate discounts for loans generally have a short duration of effectiveness involving a relatively small amount of interest while preparations of relevant application documents are costly for the applicants. As a result, not many companies have bothered to apply for interest rate discounts. Third, further expansion of interest rate discounts has been hampered by the limited human resources and expertise of fiscal authorities for evaluating candidate projects.

We would like to propose the following recommendations on improving the efficient fiscal mechanisms of interest rate discounts for green loans:

1. **Expand the use of interest rate discounts** in the fiscal spending on energy conservation and environmental protection and expand the scale of fiscal funds for interest rate discounts.
2. **Create a communication and information sharing mechanism** between government finance departments, banks and environmental protection agencies; streamline and optimize the decision making process for issuing green credits and loan discounts; and specify the responsibilities of the various stakeholders.
3. **Improve the development of interest rate discounts**, including:
 - a) *Moderately increase interest rate discount ratio.* Current requirements often stipulate that the discounted rate cannot be higher than the same-period lending benchmark rate issued by the PBoC or the lending rate of commercial banks; while other policies set limits based on the current year's real interest rate but have a ceiling of 3 percent. We recommend that the real interest rate be used as the upper limit for discounted rates for green loans, and the discounted rate should be applied to the full borrowing amount.
 - b) *Identify an appropriate duration of interest rate discounts.* At present, the discount interest rate policies provided for by the central government are in general shorter than three years, which greatly limits their application. We recommend the removal of the artificial three-year limit and that the discounted rate should be in effect based on the factual information relating to the green loans.
 - c) *Identify a list of projects that have access to discounted interest rates* on loans, and simplify and accelerate the review and approval process for projects matching the listed types.
 - d) *Improve relevant supporting measures* and provide certain risk compensation to banks making the loans, including:
 - *A guarantee system for green loans* with certain fiscal support;
 - *Third-party evaluation system*; enhancing the supervision and review of green loans;
 - *Result-based monetary incentives* to performing projects and banks in addition to applying discounted rate on the full amount of green loans.

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