ESG, China & Human Rights

Why the time has come for investors to act

Executive Summary & Recommendations

HONG KONG WATCH

Executive Summary

Ties between China and Global Finance are at record highs

Despite a growing fissure emerging between China and the West due to the human rights situations in Hong Kong and Xinjiang, the coronavirus pandemic, and the US-China Trade War, ties between China and Global Finance are growing and the total value of China's stock market has hit record highs.

More money is being invested in China by Western pension funds, sovereign wealth funds and other institutional investors than ever before. On 14 July 2021, the Financial Times reported that global holdings of Chinese stocks and bonds had surged about 40 per cent to over $800 billion. As a result of domestic pressures, the Chinese government have been actively making it easier for institutional financiers to invest by: removing investment quotas from the Qualified Foreign Institutional Investor scheme and the Renminbi Qualified Foreign Institutional Investor scheme; increasing market access in banking, securities and insurance industries; and opening the domestic bond market to investors.

Simultaneously, some of the world's largest investors are driving the push for increasing capital flows into China. For example, Blackrock, the world's largest asset manager, has been a vocal advocate of greater investment into China. In August 2021, the firm called for China to no longer be considered an Emerging Market but instead for the country to be placed in a separate category and for equity portfolio allocations of investors into China to increase to two or three times their current size.

Can investment in China be justified in the era of ESG investing?

Paradoxically, rising investment into China coincides with the boom in 'Environmental, Social and Governance' (ESG) investing. In recent years, firms have begun to acknowledge that the environmental and social impacts of their investments matter alongside the returns on investment. They are therefore seeking to mitigate the environmental and social costs of their

investments. As part of their 'social' duties, many have signed up to the United Nations Guiding Principles on Business and Human Rights, acknowledging that they have a duty to respect and protect human rights in contexts where they are investing.

Can investors square their increased commitment to 'responsible investing' with huge inflows into an authoritarian state like China? Firms currently argue that there is no conflict between their China portfolios and their ESG priorities. But this view cannot be justified. We identify three areas which should be of considerable concern to firms seeking to meet their ESG commitments: Human Rights, National Security and the Environment.

Human Rights

In practice, most of the attention of ESG investors has been placed on environmental costs, with little attention given to human rights. In July 2021, more than 34 per cent of the bonds in the ESG version of the J.P. Morgan Emerging Markets Bond Index were issued by countries labelled "not free" by Freedom House. Firms are particularly reticent about engaging with human rights in China because of their desire to capitalise on a growth market.

The result of this has been that there has been considerable investment into Chinese firms which have troubling human rights records. There is a clear knowledge gap between financial professionals who know that enormous amounts of the money of ordinary people, institutional investment, pensions and government funding is being invested in China, and the members of the public, media and policy makers who would have serious ethical and practical reservations about what seems to be a reckless and problematic course of action. This information gap has provided cover for financial institutions to pursue profit without regard for the social impacts of their ties with firms that are closely affiliated with egregious rights abuses in Hong Kong or Xinjiang.

Environmental Protection

But even firms pre-occupied by the environment have reason to be cautious of China. Firms deepening their ties with the Chinese government must consider the environmental costs of government policies. China generates the largest CO_2 emissions in the world. While only accounting for 17% of GDP and 18% of the world's population, it produces 28% of the world's greenhouse gas emissions. This is partially because 60% of the country's electricity is currently generated by burning coal. China's CO_2 emissions per dollar of GDP are running at about three times that of the EU, and the Global Subsidy Initiative estimates that China's subsidies for fossil fuels are running at about USD 100 billion per annum. Many prominent Chinese firms which feature on global investment indices directly benefit from these subsidies and policies.

National Security

Alongside these areas of concern, some Western investment in recent years runs counter to the stated foreign policy interests of democratic governments and national security. For example, some Western companies have directly funded Chinese companies that are destabilising the Southeast Asia region. The Burma Campaign's 'Dirty List' shows that several Chinese companies which receive British, Canadian and European institutional investment are heavily involved in arming and funding the military in Myanmar, which has just launched a coup and is the process of an extremely violent crackdown on protests (Burma Campaign, 2021). This demonstrates clearly that some investment is indirectly funding companies that are destabilising the region and the foreign policy interests of countries which support Myanmar's transition toward a democracy.

China's strategy of civil-military fusion is particularly important. This is the government's strategy to harness civilian enterprises, particularly dual-use technologies, for military ends. Institutional investment in some Chinese firms in key industries may inadvertently fund the upgrading of the Chinese military.

A spotlight on investment in 4 types of problematic Chinese firm

Our research finds that there are four types of firms which investors should scrutinise and consider divesting from:

1. Firms blacklisted by the United States.
2. Chinese technology giants complicit in human rights violations in Xinjiang.
3. China's state-backed banks which are the largest bankroller of Chinese state-owned enterprises.
4. China's fossil fuel giants.

Firms blacklisted by the United States

Most mainstream Chinese firms are reliant on state patronage and are often willing enforcers of the Chinese government's agenda. Some of these have been designated by the US Government as no-go stocks for US investors because of their ties with the People's Liberation Army and gross human rights violations in Xinjiang. Firms which have been blacklisted by the United

States include Hikvision, China Unicom, SMIC, Zhejiang Dahua Technology, China Mobile, iFlytek and others.

But international investors around the world, outside the United States, continue to invest in many of these firms. Examples of investments by significant international institutional investors in these firms include:

- **The New Zealand Superannuation Fund has significant funds invested in 14 companies that the United States Government have blacklisted including Hikvision, China Unicom, SMIC, Zhejiang Dahua Technology, iFlytek and others.**
- **The Norwegian Sovereign Wealth Fund has money invested in China Mobile, China Unicom, and SMIC.**
- **Multiple Canadian and British pension funds have funds invested in firms including Hikvision, Zhejiang Dahua Technology, SMIC, and CNOOC.**
- **The Australian Super Fund has money invested in Hikvision and iFlytek.**

Chinese technology giants complicit in human rights violations in Xinjiang

Explicitly blacklisted firms are not the only firms where alarm bells should be ringing. Many mainstream Chinese firms, particularly the technology giants, have been involved in either the creation of the Xinjiang surveillance state, the creation of the prison camps or the use of forced labour. Investors should also be cautious of private technology firms like Alibaba and Tencent. Alibaba has produced facial recognition software that specifically targets Uyghurs and has helped construct the surveillance state and prison camps in which over a million Uyghurs are currently detained. It has also developed a privately run social credit application, Sesame Credit, which may be absorbed into the Chinese state's dystopian social credit system. WeChat, owned by Tencent, has been accused by Human Rights Watch of censoring and putting its users under surveillance on behalf of the Chinese state.

These firms currently receive enormous investment because they are heavily weighted in international indices.

- **Alibaba is the stock with the second heaviest weighting on the MSCI Emerging Markets Index and has the third heaviest weighting in the FTSE Russell Emerging Markets Index.[1]**
- **Tencent is the stock with the third heaviest weighting on MSCI Emerging Markets and second heaviest weighting in the FTSE Russell Emerging Markets Index.**
- **Both firms receive serious investment by index-tracking exchange-traded fund which follows either of these indices, as well as pretty much every bespoke China fund whether they are provided by Baillie Gifford, Blackrock, Schroders, Allianz Global, Vanguard or others.**

(1)
All references to equities were accurate as of 30 July 2021 unless otherwise stated

- **They are heavily invested in scores of serious pension funds in North America, Europe, East Asia, and Australasia (see Table 1, p.6).**
- **They also are paradoxically major holdings in a number of ESG funds. For example, Alibaba and Tencent are the 2nd and 3rd holding in Blackrock's iShares MSCI EM ESG Enhanced UCITS ETF. JP Morgan's Global Emerging Markets Research Enhanced Index Equity (ESG) UCITS ETF tells a similar story, with China making up over thirty five percent of the fund's weighting and Alibaba and Tencent accounting for a combined eight percent of the total fund.**

Chinese State-Owned Banks

Chinese state-owned banks are the largest bankroller of Chinese state-owned enterprises, who in turn have spent the last decade buying up a substantial amount of strategic infrastructure in the West, as well as being the largest lenders to the Belt and Road Initiative which has been accused of exploiting developing nations and being used as a tool for 'debt diplomacy'. These firms, in turn, fund Chinese-state owned enterprises like the China National Oil Corporation, China General Nuclear Power Group or Beijing Construction Engineering Group who have been blacklisted by the United States.

China's state-owned banks are a serious beneficiary of institutional investment. The Chinese Construction Bank is one of the top 10 constituents of both the MSCI Emerging Markets Index and the FTSE Russell Emerging Markets Index. As a result, these equities are prominent in global pension funds around the world.

Chinese Fossil Fuel Giants

Chinese fossil fuel giants currently continue to be major beneficiaries of investment. But firms looking to invest in the Chinese economy should be considering the role of state subsidies in the Chinese fossil fuel industry as they make their ESG calculations.

For example, the China Petroleum & Chemical Corporation, or Sinopec, is currently embedded deeply into many international funds and receives considerable pension fund investment. Yet Sinopec is the largest oil and gas refining company in the world. As with state-owned Chinese companies of its size, Sinopec has close links with the Chinese military and state, developing body armour for the Chinese military. Between January and September 2019, the firm received $450 million in government fossil fuel subsidies.

In March 2021, Sinopec announced that it had found abundant flows of natural gas and crude oil in the Uyghur region in Xinjiang, where over a million Uyghurs are currently incarcerated, stating that it would be one of its key drilling basins in 2021-25. This falls in direct contravention to a recent

warning by the International Energy Agency that any new oil, coal, or natural gas investments risk the chance of the world meeting its 2050 carbon neutral target. Investors must monitor whether Uyghur forced labour is used in the mining of these resources.

Table 1 - Selected institutional investment in Chinese equities

Latest public figures as of July 2021, unless otherwise stated

Institutional Investor	Funds Invested in Alibaba	Funds Invested in Tencent	Other key Chinese Equities
UK Parliamentary Contributory Pension Fund	£ 0.9m (USD$ 1.23m)	£ 2.3m (USD$ 3.16m)	China Construction Bank, Sinopec, CNOOC (Until 2019)
UK Universities Superannuation Scheme	£ 371.79m (USD$ 511m)	£ 413.96m (USD$ 569m)	China Construction Bank, Sinopec
Australian Super Fund (Balanced pre-mixed investment option)	Aus$563m (USD$ 403m)	Aus$409m (USD$ 293m)	Bank of China (Aus$4.9m), China Construction Bank (Aus$9m), Hikvision (Aus$3.2m), Iflytek (Aus$1.2m), China Mobile (Aus$13.3m)
Norwegian Sovereign Wealth Fund	USD$6.7bn	USD$5.9bn	Sinopec (US$205m), Baidu (US$759m), Bank of China (US$261m), China Construction Bank (US$1bn), China Mobile (US$371m), SMIC (US$92m), China Unicom (US$42m)
New Zealand Superannuation Fund	NZ$93.47m (USD$ 64.68m)	NZ$87.95m (USD$ 60.87m)	**14 entities sanctioned by US including:** AVIC (NZ$250,933), China Communications Construction Co. (NS$472,202), China Mobile (NZ$7,151,619), Hikvision (NZ$961,223), China Unicom (NZ$219,492), SMIC (NZ$2,306,284), Zhejiang Dahua Technology (NZ$219,670). **Others including:** iFlytek (NZ$229,702), Bank of China (NZ$5,871,296), China Construction Bank (NZ$15,384,971)
BCI (Canada)	Can$1.1bn in the two combined (Mar,2020) (USD$887m)		**March 2020:** China Communication Construction Group (C$2m), CNOOC (C$56.1m), Hikvision (C$45.3m), China Mobile (C$104.6m), Zhejiang Dahua Tech (C$14.42m), China Construction bank (C$91.98m)
CDPQ (Canada)	Can$938.6m (USD$744m)	Can$666.9m (USD$529m)	**18 companies on the US sanctions list, including:** AVIC, CNOOC Ltd, CoStar Group Inc, Inner Mongolia First Machinery Group Co, Zhejiang Dahua Technology Co, and Semiconductor Manufacturing International Corp.
Japan Government Pension Investment Fund	£ 2.57bn (USD$2.04bn)	£ 2.2bn (USD$1.74bn)	Sinopec (£62 million)

Recommendations

The inconsistencies in regulations between global financial markets ensure that regulation by one or two international governments will not be sufficient to generate the type of behavioural change which is necessary to stop large amounts of money flowing into problematic Chinese equities and bonds.

Recognising this, our recommendations are split into two parts. Firstly, we consider what steps governments should be taking together. Multilateral regulatory action is needed in order to ensure that human rights are protected by investors. Secondly, we argue that firms must start to develop more robust and rigorous ESG guidelines when assessing investment into China.

The globalised nature of international finance means that governments cannot effectively regulate in isolation. What is needed is coordinated international action by governments to take place in concert with financial services firms beginning to acknowledge the ethical dilemmas inherent with investing in China and starting to take seriously potential ESG concerns.

Recommendations to Governments

On human rights and financial services

- Governments should enact legislation to ensure consistent ESG standards around the world.
- Governments should consider further legislative steps to halt investment in firms tied to gross human rights violations.
- Governments must properly address gross human rights violations in their financial regulatory frameworks.
- In 2021, the European Union is developing mandatory human rights due diligence regulations.
  This should refer to the UN Guiding Principles on Business and Human Rights (UNGPs) as the basis of engagement. Other countries and regulators should adopt similar regulatory regimes to ensure compliance worldwide.
- Governments should regulate to bar investment in firms complicit in genocide, ethnic cleansing, crimes against humanity or modern-day slavery.

On gross human rights violations in China

- Governments should designate which Chinese firms are complicit in crimes against humanity, genocide and other atrocity crimes against the Uyghurs and apply financial sanctions, including investment bans on those firms.
- Governments should bar the imports of goods where forced labour can reasonably be presumed to be in the supply chains.
- If firms complicit in the crackdown on human rights in Hong Kong or Xinjiang are international, their governments should consider withholding privileges until they stop aiding and abetting the repression in Hong Kong or Xinjiang.

Recommendations to investors and the financial services industry

On ESG and human rights

- Investment firms, standard setters and governments must give proper weight to human rights violations in their ESG metrics and regulatory frameworks.
- Firms complicit in genocide, crimes against humanity or modern-day slavery should be considered a 'sin stock'.
- Just as the Moody's or S&P ratings system acts to limit the potential credit rating of a company depending on which country the company is based within, a similar initiative ought to be considered when it comes to ESG. Countries could be ranked on a scale depending on their ESG score. The ESG rating of each firm could then be tied in some way, or even proportional to, the national ESG rating, with the potential ESG rating score capped by the national banding.

On ESG and China

- Investors should consider the extent of Chinese government fossil fuel subsidies when calculating ESG metrics.
- Companies and investors must undertake a process of enhanced human rights due diligence when engaging with firms that could possibly be tied to repression in Xinjiang.
- Firms based in Hong Kong should face serious ESG penalties, in terms of their weighting, if they are known to have:
    - *fired employees on the basis of their political stance;*
    - *boycotted advertising with Apple Daily or other pro-democracy news-outlets on the basis of their political stance;*
    - *endorsed the crackdown on Hong Kong's protestors;*
    - *frozen the assets of pro-democracy activists.*
- Investors should use their leverage with companies complicit in the crackdown in Hong Kong or Xinjiang to influence a change in behaviour.

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