



SARASIN

## Sarasin Basic Report

Sarasin Sustainable Investment

# "Made in China" - Is this a Sustainable Label?

Risks and Opportunities of the China Boom from a Socially Responsible Investment Perspective

In cooperation with:



**Association for Sustainable and Responsible Investment in Asia (ASrIA)**

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**Makiko Ashida**

++41 61 277 74 70  
makiko.ashida@sarasin.ch

**Eckhard Plinke**

++41 61 277 75 74  
eckhard.plinke@sarasin.ch

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- ◆ **ASrIA** ([www.asria.org](http://www.asria.org)) is a not-for-profit membership association dedicated to promoting and developing SRI in Asia. ASrIA's mission is to assist the financial community to understand and integrate sustainable investment criteria into investment decisions, and to empower investors by increasing the choice of SRI products available in Asia. Established in 2001, ASrIA already has more than 100 members, including investment institutions and other companies. In order to raise awareness about SRI, ASrIA runs conferences, seminars and workshops, and publishes research on SRI issues. In 2002 and 2003 ASrIA published two major reports about environmental and labour conditions in China (ASrIA 2002, ASrIA 2003), which were a major basis for this report.
  
- ◆ **Ökoverision** ([www.oekoverision.de](http://www.oekoverision.de)) is a sustainable investment fund of ÖkoWorld Lux. S.A., a subsidiary of the German financial services company Versiko AG. Launched in 1996, it is one of the sustainability funds in Europe with the longest track record. The fund is managed by Sarasin. A criteria committee appointed by ÖkoWorld decides on the basic eligibility of companies for the fund, based upon a set of environmental and social criteria and the research information provided by Sarasin. The criteria committee is independent and composed of representatives of NGOs working in the areas of the environment, human rights and consumer protection, as well as individual experts in the various aspects sustainable development. The committee discussed the issue of the eligibility of companies operating in China repeatedly during the last years. Thanks to Ms. Melissa Brown, Executive Director of ASrIA, as well as Mr. Martin Kunz and Mr. Andreas Kraemer, co-heads of the criteria committee of Ökoverision, for reviewing drafts of the study. Research undertaken by Mr. Kunz for the criteria committee of Ökoverision (Kunz 2003) was a major basis for Section 5.2. of this study.

Thanks especially to the companies which provided information about their operations in China. This information is the basis of major parts of this study.

## Summary

### **China - the world's workshop**

Since China opened up to foreign investors in the 1980s, the eyes of the world have been fixed on its economy. Some 1.3 billion potential consumers, the rapid economic growth (9% per year) and low labour costs have lured numerous Western and Japanese companies into China, making the country the world's largest recipient of Foreign Direct Investment (FDI). Today FDI is 50 times the level of 1985. The major players are labour-intensive businesses such as manufacturers and retailers of clothing and shoes, as well as consumer electronics products (e.g. DVD players and computers). Most of them are export-oriented, although some of them are gradually focusing more on the domestic market in China.

### **Behind the bright economic prospects: Concerns about sustainability ...**

The bright economic prospects contrast with concerns about their sustainability. Low wages and poor labour conditions are a negative side of the attractive labour costs. A large migration movement is putting pressure on wages for unskilled workers, which are sometimes below legal minimum standards. High employee turnover rates and poor health and safety conditions are frequently encountered.

China's rapid industrial growth and its high demand for energy put pressure on global energy markets and the environment. China is the world's largest consumer of coal, the second largest importer of oil, and the second largest emitter of the greenhouse gas carbon dioxide (CO<sub>2</sub>). Inside the country, regional environmental problems, such as air pollution, water pollution and water shortage, are pressing issues. Chinese cities have some of the worst air pollution in the world.

### **... and the restrictive political and legal environment**

China has quite a comprehensive legislative framework to protect the environment and set minimum labour standards, but enforcement is weak. Political and legal restrictions to basic labour rights impede an effective defence of workers' interests against poor labour conditions. Independent trade unions are not permitted in China and state-owned enterprises often do not comply with basic environmental and labour standards. This situation has been criticised by NGOs, trade unions, government bodies and other observers in Western countries especially.

### **Risks for multinationals operating in China**

Under these critical conditions, multinational companies are expected to work on environmental and social issues linked to their business activities in China. Their social responsibility concerns not only their own factories but also their supply chains. The different environmental and social challenges associated with operating in China also result in business risks, i.e. reputation risks (poor labour conditions can create negative publicity and damage the value of brands), operational risks (e.g. poor productivity and high employee turnover due to poor labour conditions) and legal risks.

**Why is socially responsible investment (SRI) so keen to take on China?**

The aim of SRI is to invest in companies which are dealing with environmental and social issues linked to their business activities in a responsible way. Not only as a matter of principle, but also to reduce investment risks, socially responsible investors can hardly ignore the "flight to China". The more business exposure companies have to China, the more important it is for them to deal with the "China challenges".

**The aim of the study**

For this purpose, investors need to define what they expect from companies operating in China: SRI criteria and benchmarks. The aim of this study is to find an indication for "good practices" and benchmarks for the socially responsible conduct of companies operating in China. To this end we analysed sample cases of multinational companies operating in China with a good track record in corporate social responsibility standards and practices. The selected companies represent different industries (retail, clothing, machinery, and electronics) and countries (Europe, USA, and Japan).

**Different exposure of companies to the "China challenges"**

Companies are exposed to the "China challenges" to different degrees depending on the scale of their business activities in China, their business models and industry sectors. Companies having their own factories in China are less exposed than companies which outsource production to local companies (suppliers), where control is limited. In addition, criticism of poor labour conditions is mainly targeted at local companies. Consumer goods companies and retailers are more exposed to the "China challenges" than capital goods companies, for example, since their market success depends on their brands, which are vulnerable to reputation risks. Thereby, "good practice" models can be different depending on the specific sector and business model.

**Good practice examples ...**

Reflecting the degree of exposure to the "China challenges", the sample companies have focused on the following areas of "good practice":

- ◆ Supply chain standards: Besides retailers, the sectors consumer goods and to some extent consumer electronics have been most proactive in improving labour standards in their supply chains, since they have outsourced a major part of production and are most vulnerable to reputation risks. Many companies have established ethical supplier codes and started audit programs to monitor and improve labour standards in their supply chains. Some have started cooperative programs (e.g. supplier training) and cross-sector joint initiatives to apply common standards for suppliers. The main focus of these activities up to now has been on health and safety improvements. Health and safety is one area that increasingly does have government support.
- ◆ Companies with own factories in China are generally less exposed to the "China challenges" than consumer goods and retail companies. Nevertheless, most of them have company-wide environmental management systems in place, which include their sites in China. Most of them have environmental programs in China,

which go beyond local environmental regulations. Many companies have also implemented occupational health and safety programs as part of their environmental management. However, statements about the actual health and safety performance of the companies are not possible, since they do not provide the relevant data. Ideally it should be on a par with the performance of the manufacturing sites in Europe, North America and Japan. Most sample companies stated that they paid basic wages above the legal minimum and that their social security payments and working hours comply with the local legal regulations as a minimum requirement. This is likely to be satisfactory, since Chinese labour law sets reasonable standards here (the problem is the poor enforcement of the law). Some companies provide extra benefits for employees, such as housing subsidies and additional holidays.

**...and remaining challenges**

The following challenges have not yet been addressed by the "good practice" companies sufficiently:

- ◆ Labour rights: Independent trade unions are prohibited in China<sup>1</sup>. Whether in their own manufacturing sites or their supply chains, companies have made little effort to find solutions to involve workers more in decision-making processes independently from the official trade unions. Many sample companies have trade unions belonging to the official ACFTU. Workers' committees, however, often do not represent the interests of employees vis-à-vis the management, but merely organise social activities. Some companies do not have any unions, partly because of the industry culture, for example, technology companies used to have no trade unions company-wide. Many ethical supplier codes require compliance with the Core ILO Conventions<sup>2</sup>, however, only a few companies have started to improve labour conditions in their supply chains.
- ◆ Employment agencies: Many companies manufacturing in China hire workers via local employment agencies. In most cases, they do not have direct control over the contract terms provided by the agencies. Their contract conditions tend to be worse than those of directly hired workers.
- ◆ Supply chain standards: Up to now, the initiatives to improve labour standards in the supply chains have been limited to specific industries (consumer goods and retailers), which are highly exposed to the "China challenges". The majority focus on key suppliers and selected issues such as health and safety. Notably companies impose conflicting demands on their suppliers: Better labour standards

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1) Under Chinese law, independent trade unions are prohibited. All unions must be organised under the umbrella of the All-China Confederation of Free Trade Union (ACFTU), which is controlled by the state.

2) The Core ILO (International Labour Organisation) Conventions: forced labour, child labour, freedom of association, right to collective bargaining, and discrimination.

and general purchasing standards (price, lead time and quality). Cross-sector joint initiatives can be useful for integrating ethical criteria into purchasing policy without sacrificing competitiveness for individual companies.

**Different SRI approaches to assess companies with regard to the "China challenges"**

The eligibility of a company for SRI is based on the rating of how a company deals with the environmental and social issues linked to their specific business activities. The "China challenges" are still part of the overall environmental and social challenges the company faces, for example, product safety, development of environmentally friendly products and corporate governance. Using a rating system like the Sarasin Sustainability Matrix<sup>®</sup>, the assessment of the China business constitutes only part of the overall assessment of the company. Therefore, especially if the scale of business the company has in China is small, it could be that the company's sustainability rating is good enough to achieve eligibility for SRI, even if the company does not show clear commitment to deal with the "China challenges".

This result is not enough for some socially responsible investors and they prefer a more stringent approach. The SRI fund Ökovision applies an additional "negative screening" criterion: Companies with significant operations in China are excluded from investment, unless they can provide evidence for specific activities to improve labour conditions.

**Conclusion for SRI Investors**

Taking into account the unresolved challenges, poor local labour conditions especially, socially responsible investors must look carefully at companies with major business activities in China. Nevertheless, the different examples analysed in this study demonstrate that companies can be found that are suitable for SRI, depending on the SRI approach. It is thus possible for socially responsible investors to match the goal of finding financially attractive companies operating in China with the goals of keeping high environmental and social investment standards and reduce investment risks associated with "non-sustainable" business practices, even if a more stringent "negative screening" approach is applied<sup>3</sup>.

SRI investors can make a contribution to promote more sustainable development in China by investing in companies working on the "China challenges" seriously. Dialogue with companies as part of the sustainability research process, as well as selected company contacts initiated by SRI funds like Ökovision, can help to increase companies' awareness of the different issues in China.

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3) There may still be investors who want to exclude companies operating in China from SRI completely, as there remain challenges which have not been properly resolved yet, the issue of labour rights especially.

# 1 Introduction

## **China: The world's workshop**

The eyes of the world are fixed on the Chinese economy. Some 1.3 billion potential consumers and low labour costs have lured numerous Western or Japanese companies into the country. Around the globe, shelves are stacked with the low-cost goods churned out by "the world's workshop", such as DVD players, computers, clothes and sports goods. Further liberalisation following China's accession to the World Trade Organisation (WTO) in 2001 has further increased the attractiveness of China as a manufacturing location.

## **Concerns about the sustainability of the China boom ...**

In contrast to its bright economic prospects, China's boom is giving rise to concerns about the implications for sustainable development. China's hunger for energy and its rapid industrial growth are an enormous strain on global energy markets, and on the global and regional environment. Its growing energy consumption has contributed to the rise in oil prices and increasing carbon dioxide (CO<sub>2</sub>) emissions, which are the major cause of global climate change. Regional environmental problems such as air pollution, water pollution and water shortages are pressing as well (Economy 2004). Furthermore, low wages and poor labour conditions in Chinese factories are a negative side of the attractive labour costs, and are not generally addressed effectively by domestic policies in China.

## **... and the restrictive political environment ...**

Political and legal restrictions to basic labour rights impede an effective defence of workers' interests against these practices. Independent trade unions are not permitted in China, and provincial and municipal authorities are typically rather hostile to trade union activity. This situation has been criticised by NGOs, trade unions, government bodies and other observers in Western countries especially.

## **... impose challenges on companies operating in China**

Companies operating in China are faced with these concerns. Clothing and sports goods companies have been in the focus of NGO campaigns criticising low pay, overtime, safety problems and child labour in their supply chains. Recently the electronics industry, which has shifted and outsourced manufacturing to China, came under fire as well. This NGO criticism can lead to significant damages to a company's reputation. Other risks associated with poor labour conditions include quality problems, low productivity and high employee turnover rates. Companies dealing with the challenge of operating in China therefore not only have to take their social responsibility seriously, but also need to reduce business risks.

## **How should companies behave in China?**

The question for companies is what they could do to deal with the different critical issues. This study highlights the question from a socially responsible investor's point of view. Socially Responsible Investment (SRI) is an investment style which, in addition to financial considerations, takes into account environmental, social and ethical criteria as an integral part of investment decisions, in line with the principles of sustainable development. Bank Sarasin is one of the leading managers of sustainable investments in Europe.

Socially responsible investors look for companies which deal with the critical issues responsibly, provided such companies can be found at all. For this purpose, criteria and benchmarks must be developed to define what social responsibility means for companies in China. This study gives an overview of the criteria applied by Sarasin and the investment fund Ökoviision (Section 5). They are based on an analysis of sample cases of international companies operating in China, in an attempt to identify current and good practice vis-à-vis the different critical issues (Section 4).

**Sample companies** For this purpose we selected 15 sample companies with substantial activities in China. The selection includes companies with a track record in corporate social responsibility overall (attested by eligibility for investment in the Ökoviision fund and/or a positive Sarasin sustainability rating) and is meant to represent a spectrum of different industries (retail, clothing, machinery, electronics) and countries (Europe, USA, Japan).

Company	Country	Employees worldwide	Industry Sector	Activities in China
ABB	CH	116,000	Electrical power and automation equipment	Manufacturing (18 sites); 6,600 employees
Adidas-Salomon	DE	16,000	Sports goods	Outsourcing; small manufacturing (200 employees)
B & Q (Subsidiary of Kingfisher)	UK	36,000	Retail (Do-it-Yourself Goods)	Sourcing (Do-it-Yourself Goods); 8 stores (2,600 employees)
Canon	JP	103'000	Office and consumer electronics	Manufacturing (9 sites); (19'800 employees)
Geberit	CH	4,400	Sanitary products (toilet flushing systems) and piping	Manufacturing (2 sites); (300 employees)
Hewlett-Packard	US	141,000	Computer hardware	Manufacturing (2 sites), outsourcing; 2,000 employees;
IBM <sup>c)</sup>	US	320,000	Computer hardware and IT services	Manufacturing (3 sites and 1 joint venture), outsourcing; 3,000 employees
Kyocera	JP	50,000	Electronic components, devices and consumer products	Manufacturing (4 sites); 9,100 employees <sup>b)</sup>
Marks & Spencer	UK	70,000	Retail (mainly clothing, also food)	Sourcing (clothes)
Matsushita Electric <sup>c)</sup>	JP	288,000	Consumer electronics and electronic components	Manufacturing (4 sites); 11,700 employees
Ricoh	JP	74,000	Office electronics	Manufacturing (5 sites); 2,500 employees
J Sainsbury	UK	148,000	Retail (supermarket chain; mainly food, but also non-food)	Sourcing (mainly non-food, e.g. detergents, toys and cookware)
Seiko Epson <sup>c)</sup>	JP	85,000	Computers and peripherals, electronic components, office electronics, and others	Manufacturing (43 sites); 31,700 employees
Sharp <sup>c)</sup>	JP	46,000	Consumer electronics, electronic components, solar cells	Manufacturing (5 sites)
Sulzer	CH	9,000	Machinery and services	Manufacturing (2 sites) 500 employees <sup>a)</sup>

a) The company provided information for one site mainly (about 150 employees).

b) The company provided information for one site mainly (about 4,100 employees).

c) For these companies only published information was analysed.

**Sample companies  
analysed in this study**

The information about the companies is based upon written answers to a questionnaire, interviews with company representatives, as well as published information (research reports, press releases, company publications and presentations). 11 of the 15 companies provided information on our request, while for four companies only published information was used.

## 2 China is becoming the "World's Workshop"

### 9% growth per year

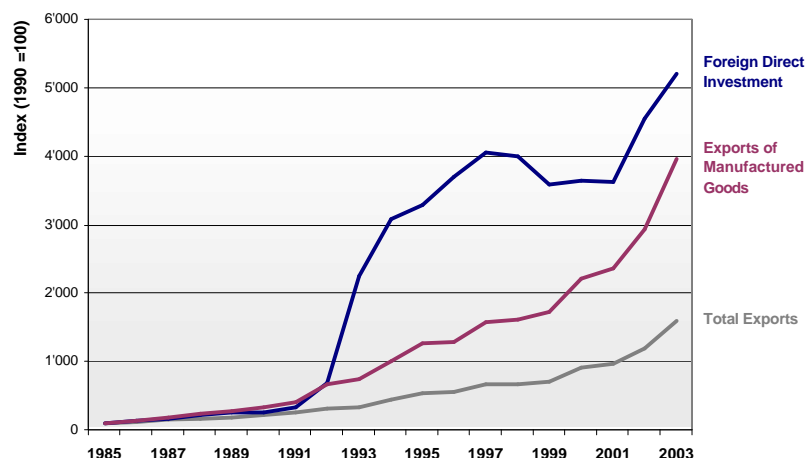
With a per capita gross national income of 960 USD, China still belongs to the world's poorer countries (for comparison: Germany 23,000 USD, Turkey 2,500 USD). But due to its large population of 1.3 billion, China's economy is the sixth largest in the world. It is also one of the fastest growing economies. Over the past 25 years, China's real gross domestic product has expanded at an average of 9% per year.

### Economic growth driven by foreign direct investment (FDI)

This remarkable progress started when the country first opened up for reform and foreign investment in the late 1970s. At that time the Chinese government set up four Special Economic Zones and Export Processing Zones for foreign companies. By 1998 at least 1,000 cities and towns in China took part in export processing or were engaged in foreign investment. Over 20 million workers are employed in the main export processing centres in the eastern coastal regions (e.g. Shenzhen, Zhuhai and the Pearl River Delta in Guangdong Province).

Foreign Direct Investment (FDI) has been a major driver of economic growth. With more and more companies from Europe, North America and Japan having started manufacturing operations in China, FDI has increased by a factor of 50 since 1985. The country has been the largest recipient of FDI among developing countries for several years now (nearly one fourth of FDI inflows into developing countries went to China during the 1990s). In 2003, China even surpassed the USA as the world's largest recipient of FDI overall, with 57 billion USD.

### Development of investment inflows and exports in China

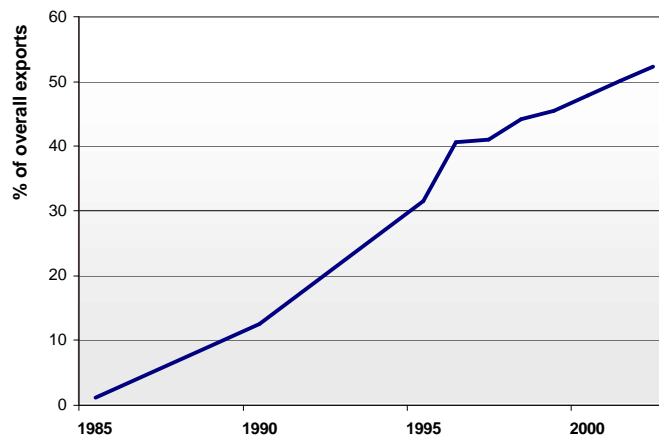


Source: Asian Development Bank

**Dominant business model of foreign companies is export processing**

Although the prospect of a vast domestic market of 1.3 billion consumers has lured many companies to China, cost advantages have been the main driver for FDI up to now. Companies shifted manufacturing operations to China to produce for export, or they started to source products or components from local Chinese suppliers. As a consequence, exports of manufactured goods have increased even faster than FDI (17% average annual growth between 1985 and 2003), and foreign companies account for more than 50% of Chinese exports today. 90% of exports are manufactured goods now, making China the largest merchandise exporter of the developing countries. The country's importance as an exporter is expected to increase further, following the accession of China into the World Trade Organisation (WTO) in 2001 and the ending of the Multi-Fiber Agreement, which will remove trade barriers.

**Share of exports from companies with foreign ownership in China**

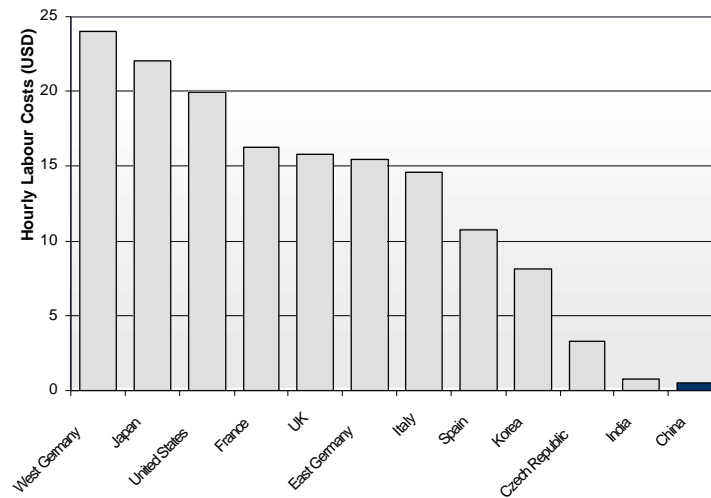


Source: Gang, Xiaojing 2003

**Low labour cost is the major driver**

Low labour costs make China attractive for labour-intensive manufacturing, such as assembly operations. Hourly labour costs are a fraction of those in industrialised countries. They are also much lower than in competing developing countries, e.g. 50% and 40% lower than in Malaysia and Thailand respectively (Nikko Citigroup 2003). For consumer electronics products this translates into overall production cost advantages of between 10% and 30% compared with production in Japan (Nikko Citigroup 2003). With the exception of the market for skilled labour, wage inflation is low, as China has vast reserves of labour which are replenished by large migration movements (see section 3.1).

**Labour costs in the manufacturing sector in different countries compared to China**



Source: Oxford Economic Forecasting

**Consumer goods and consumer electronics industries ahead**

Shifting manufacturing to China is most attractive for industries producing commodity products and components in standardised labour-intensive processes. Consumer goods (textiles, foot-wear, apparel, etc.) and consumer electronics industries have been among the most active sectors to shift or outsource manufacturing to China. Examples include Hewlett Packard (USA), Canon (Japan) or Adidas (Germany). Today, about 70% of all photocopiers sold worldwide, 70% of all computer motherboards and 55% of all DVD players are produced in China.

**Share of China in the worldwide production of selected electronics products in 2002**

Product	Share of China in worldwide production volumes
Photocopiers	70%
Computer motherboards	70%
DVD Players	55%
Microwave ovens	40%
Personal Computer	30%
Mobile Phones	30%
Video Players	30%
TV Sets	25%
Car Audio	20%

Source: Nikko Citigroup 2003 and Brown/O'Rourke 2003, rounded figures

**Strategies targeting the domestic market on the rise?**

Although the dominant business model of international companies in China has been export processing, a number of companies have produced for the domestic market right from the beginning of the "flight to China". They include companies supplying industrial markets which have to be close to their customers, such as

machinery, electrical equipment, plant engineering or materials (e.g. chemicals). Sample companies include ABB and Sulzer (Switzerland).

The majority of the consumer goods companies targeting the potentially huge consumer markets in China have not been successful up to now (Economist 2004). The basic reason is that the domestic market is actually limited, as China's growth path has been based upon capital accumulation rather than consumption. Therefore, disposable incomes have remained small (around 550 USD annually per person on average). However, currently the increasing wealth of some parts of the population is opening up opportunities for consumer goods companies on the domestic market. Some consumer electronics companies (e.g. producers of mobile phones like Kyocera) have started to expand their marketing activities inside China already.

Most sample companies selected for this study have applied the "classical" export-processing approach in China.

**Different business models in China ...**

The business models of multinational companies operating in China not only differ in their market orientation (export vs. domestic), but also in their manufacturing strategy and their reliance on local Chinese suppliers respectively. The spectrum ranges from retailers (e.g. Sainsbury) purchasing finished products from often a large number of local manufacturers, through to consumer goods companies having outsourced manufacturing to dedicated local suppliers (e.g. Adidas), and to companies producing in China in-house, with a high vertical range of manufacture (e.g. Sulzer, Geberit). For many consumer electronics companies the difference between outsourcing and in-house manufacturing is not clear-cut, as most of them source at least raw materials and some components from local suppliers (e.g. Hewlett Packard).

**Business models of sample companies in China**

	Own manufacturing sites in China	Outsourcing/purchasing in China
<b>Export Processing</b>	Consumer goods and components: - IBM - HP - Ricoh - Kyocera (about 80% export overall) - Canon	Retailer: - B&Q/Kingfisher - Sainsbury - Marks & Spencer Sports Goods/apparel: - Adidas Consumer electronics partially: - HP - IBM
<b>Supplying domestic markets</b>	Industrial goods: - Sulzer (Chemtech: 80% domestic) - ABB - Geberit (75% domestic) Consumer goods and components starting: - Kyocera (telecom products) - Canon	Starting: B&Q (8 stores in China)

**... have different risk profiles**

The nature of the business model has implications for their risk exposure and their long-term viability (see section 4.1):

- ◆ The export-processing model is heavily based on the labour cost advantages in China. This advantage can be volatile, taking into account competition from other countries in the region, a pull on wages due to shortages of labour with continuation of economic growth, or potential political interventions. A recent example of the latter is a discussion started by US trade unions seeking trade sanctions against imports from China. The unions accuse the Chinese of "social dumping" because of the poor labour conditions in China. In conclusion, the long-term risk for the viability of the export-processing business model tends to be higher than for the domestic market model.
- ◆ Outsourcing to local suppliers in China tends to imply higher risks than in-house manufacturing. It is more difficult to control manufacturing processes, quality, labour conditions etc. in supplier's factories than in a company's own manufacturing sites.

### 3 Challenges for Sustainable Development

China's dynamic rate of economic growth brings social changes and puts pressure on natural resources, which in combination with the non-democratic political system puts the sustainability of the development path into question. These challenges shape the climate in which companies operate in China (see section 4.1).

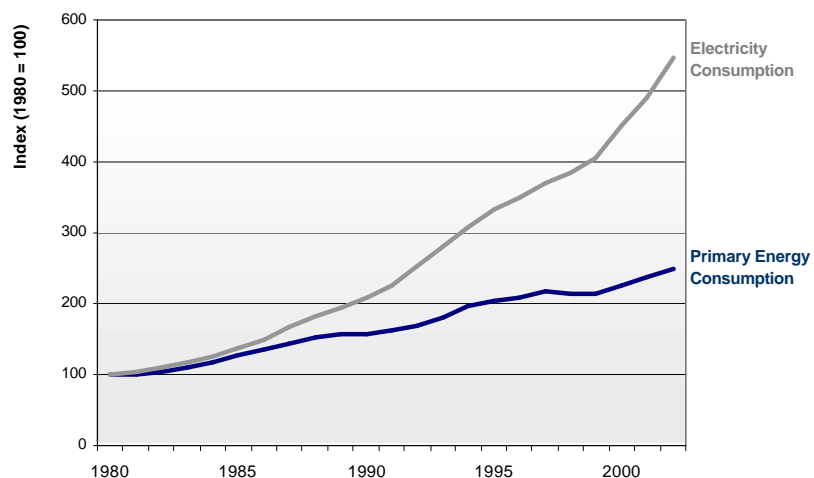
#### 3.1 Energy and Environmental Challenges

##### Hunger for Energy

China's per capita energy consumption is quite small (10% and 20% of US and German levels respectively), but total energy consumption, and thus China's pressure on global energy resources, is still high, due to the sheer size of the population. China is responsible for 11% of world energy consumption (2001), a share that will increase further, pushed by economic growth: Primary energy consumption increased by a factor of 2.5 between 1980 and 2002 and is projected to double again by 2025.

A major reason for the persistently high level of oil prices we are facing today is China's increasing oil demand. In 2003 China overtook Japan to become the second largest importer of oil after the USA. China's energy system relies heavily on coal. 69% of primary energy consumption of commercial fuels is made up of coal, making China the biggest coal consumer worldwide (27% of world coal consumption). Electricity consumption has grown by an average rate of 8% per year over the last decade (1992-2002), having increased more than five-fold since 1980. Power generation (mainly coal-based) is running up against capacity constraints and additional capacity is needed urgently.

##### Growth of energy and electricity consumption in China



Source: EIA, US Department of Energy

**Global Climate: Beware of China!**

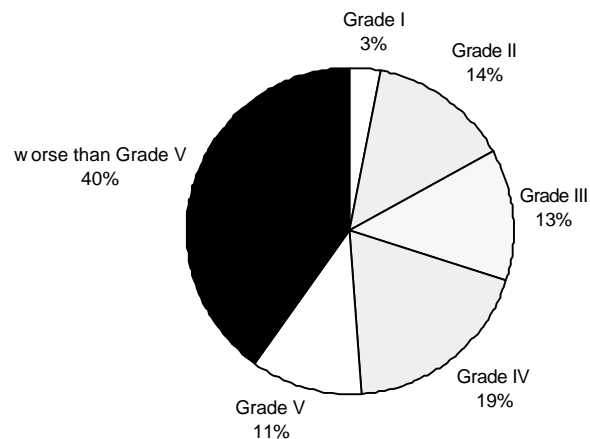
The increase in energy consumption and the reliance on coal are pushing up China's contribution to global climate change. CO<sub>2</sub> emissions are projected to double by 2025, thwarting international efforts to control greenhouse gas emissions. In 2001 China was responsible for 13% of global CO<sub>2</sub> emissions. This share will increase to 18% by 2025.

**Deterioration of environmental quality**

Industrialisation and urban growth have also resulted in regional environmental problems:

- ◆ Water shortage: China has 25% of the world's population but only 6% of its water. As water resources are unevenly distributed over the country, nearly half of China's population live in critically water-scarce areas (in the northern parts of China). Population growth, combined with resource mismanagement and industrialisation, are making water scarcity a pressing issue. In China 300 out of 640 major cities face water shortages. Groundwater levels over large parts of the North China Plain have fallen due to overextraction.
- ◆ Water pollution: As a consequence of insufficient wastewater treatment capacities, the water quality of China's major rivers is problematic (see Figure). 40% of river waters are of poor quality (Grade V: usable for agricultural purposes only), only 30% can be used directly for drinking water (Grade III and better). However, the discharge of most pollutants into the wastewater has at least been reduced over the last 10 years.

**Water quality in the seven main river basins in China in 2002**

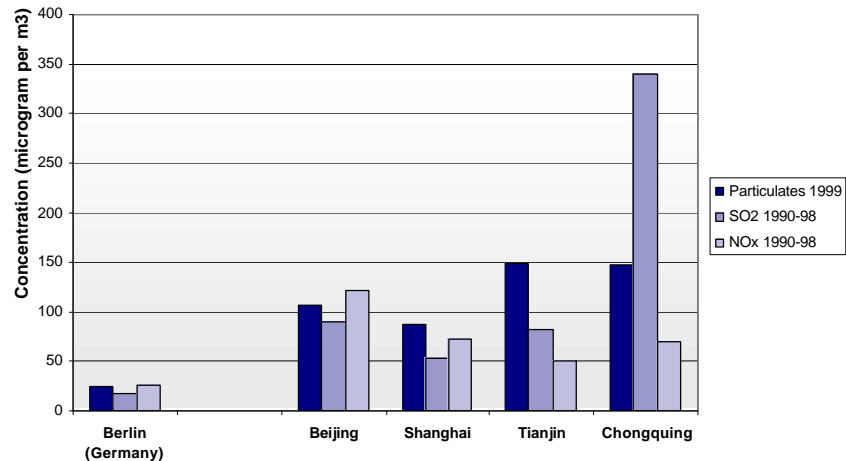


Source: SEPA 2003

- ◆ Air pollution: Coal consumption is a major reason for air quality problems in Chinese cities. The ranking of the world's Top 10 cities with the worst air pollution includes 5 (for particulate matter), 7 (for sulphur dioxide SO<sub>2</sub>) and 6 (for nitrogen oxide NO<sub>x</sub>) Chinese cities respectively (World Bank 2003). The State Environmental Protection Agency stated that in 2002 only a third of the monitored cities

complied with the national air quality standards overall. 50% of the monitored cities are affected by acid rain (SEPA 2003).

### Ambient air quality in big Chinese cities



Source: World Bank 2003

- ◆ Waste management is a problem as well. Industrial waste volumes have increased significantly, especially in industrial zones. There is a shortage of appropriate treatment and disposal facilities. Another issue which has been criticised by NGOs is the import of electronics waste (e.g. used computers) into China (Basel Action Network and Silicon Valley Toxics Coalition 2002). Recycling and disposal capacities are inadequate.

### Environmental legislation in place, but enforcement is poor

The Chinese government has taken action to protect the environment. It started a number of state-run environmental programs and established environmental protection legislation. The current 10<sup>th</sup> Five-Year plan (2001 - 2005) contains emission reduction targets and key environmental projects (e.g. wastewater treatment, desulphurisation of power plants and hazardous waste disposal). According to recent projections, the major targets of the Five-Year Plan will probably not be achieved, however. China's environmental legislation is falling into line with international environmental standards, with an Environmental Protection Law as the main body and a number of specialised laws and national and local regulations. However, enforcement is poor (ASrIA 2003). This is partly the result of limited capacities of the local administrations, and partly because the legislation leaves considerable room for interpretation by local officials. Implementation is often negotiated on a case-by-case basis (UNDP 2002).

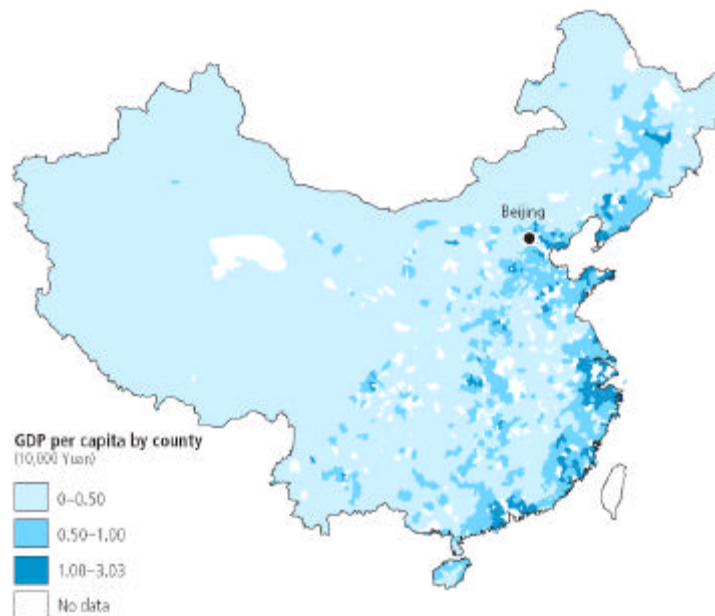
### 3.2 Social Challenges

The current social challenges in China are linked with large structural and regional changes and imbalances, in combination with the prevailing non-democratic nature of the political system.

**Structural and regional changes**

Productivity increases in the agricultural sector and the downsizing of state-owned enterprises have made large numbers of employees redundant. The official urban unemployment rate has reached more than 4% in 2003, and the actual rate is estimated at around 7% (Nomura 2004). A large number of people are finding jobs in the growing urban and industrial centres of the country, including foreign enterprises. These centres are concentrated in eastern coastal areas which also include the main export processing zones, while the inland regions have lagged behind. As a consequence, China is experiencing a large migration shift toward the coastal regions. It is estimated that around 150 million migrant workers have left their homes to search for employment in the east.

**Geographic distribution of income in China 2000**



Source: UNDP 2003

**Migrant workers: Weak legal status ...**

Migrant workers make up a large part of the employees in trade zones and industrial centres. Their living conditions are hard, living far from their families, often in dormitories adjacent to the factories where they work. Their legal status is weak, as they usually do not have permanent residence rights (ASrIA 2002). This is the consequence of the traditional "Hukou System", which assigns a fixed registered permanent residence ("Hukou") to every citizen. The Hukou is responsible for education, health and other benefits. Changing residence is difficult under this system. Peasants who move to the industrial centres looking for work have to pay money to the local authorities for a Certificate of Temporary Residence (CTR) or remain in the area as an illegal migrant. Terms and conditions for granting CTRs differ widely between cities and provinces. Recently these restrictions were relaxed, but not lifted completely.

**... and pressure on wages**

Migrant workers constitute a vast reserve of labour, putting pressure on wages for unskilled work. Average hourly wages in China are less than 5% of West European or US levels. The Chinese labour law requires local governments to set regional minimum wages. They vary widely between regions, ranging between about 30 and 60 USD per month. Workers are often paid less than the legal minimum, according to recent investigations of NGOs in Chinese factories (CAFOD 2004, Oxfam 2004a). In many cases workers are paid by the piece, at rates which do not allow them to achieve the legal minimum without working overtime. Non-payment of overtime was frequently observed too. Wages are often further eroded by systems of fines and charges for recruitment fees for employment agencies, residence permits or security deposits. The use of company facilities such as canteens or dormitories is often charged for as well. Another problem found in supplier audits of retail companies such as Marks & Spencer was the underpayment or non-payment of social insurances, although workers are entitled to unemployment, pension, health, death and maternity insurance by law. Another abusive control mechanism for workers frequently observed is payment of wages in arrears (ASrIA 2002). This practice is often applied to ensure workers return to the factory after holidays. It has been experienced that a large number of workers do not come back after the Chinese New Year especially.

**Disparities in wage levels**

In contrast to the huge supply of basic factory labour, there is a significant shortage of qualified workers on the Chinese labour markets. As a consequence, salaries have increased rapidly: Experienced engineering supervisors, for example, are likely to be paid 14'000 - 24'000 USD per year in the Shanghai region, 10-15 times what ordinary factory workers are paid (Financial Times, June 20, 2004). These disparities tend to increase social tensions. Multinational companies have problems finding skilled workers and are faced with high fluctuation rates.

**Poor and dangerous labour conditions**

Labour conditions in Chinese factories are also a cause of concern. Reports by NGOs (CAFOD 2004, Oxfam 2004a, Global Alliance 2004) and companies with supplier audit programs found the following problems:

- ◆ Excessive overtime: The Chinese labour law specifies a normal working week of 40 hours and a maximum of 36 overtime hours per month. However, recent surveys of NGOs (Oxfam 2004a) and independent institutions (Impactt 2004) have found that these limits are frequently exceeded. A survey conducted by the provincial Department of Labour and Social Security of Guangdong reveals that 85% of the 26 million migrant workers in the province have to work for 10 to 14 hours every day and nearly half of them have no rest day (Global Alliance 2004).
- ◆ Poor health and safety: Most companies with programs to improve working conditions in supply chains have emphasized health and safety. The International Labour Organisation (ILO) estimates the average occupational accident rate in China at 11.1 per 100,000 workers, compared to 4.4 in the USA. Problems

identified in factory surveys (e.g. CAFOD 2004) include lacking health and safety departments and training, insufficient fire protection devices, inappropriate storage and handling of chemicals, improper protection equipment for workers, and poor ergonomic design of workplaces.

- ◆ Inhumane treatment: Factories often publish rulebooks which instruct workers on every aspect of factory life. Harsh penalty systems are found in many factories, imposing fines (deductions from wage) for any violation of the rules (e.g. coming to work late, talking during work, leaving the workplace, spitting, etc.). Also cases of physical punishment were reported (Global Alliance 2004).
- ◆ Poor quality of on-site facilities: Many workers live in dormitories adjacent to the factories and take their meals in the factory canteen. Canteens and dormitories vary widely in standard. The dormitories often have rooms with several beds. Some of them are acceptable, others are dirty, inadequately heated and ventilated, and without hot water or sufficient washing facilities. Fire safety is a frequent problem too.

**Violation of basic labour rights - the government's role**

The problems experienced by Chinese workers are closely linked to their inability to bargain collectively to improve working conditions" (CAFOD 2004). China does not comply with the Core Conventions of the International Labour Organisation (ILO), freedom of association and right to organise and collective bargaining. Linked with the non-democratic political structures, independent trade unions are not permitted in China. Provincial and municipal authorities are typically rather hostile to union activity, and state-owned enterprises, which do not uphold basic labour standards, frequently shape the competitive and regulatory realities for a range of foreign companies operating in China.



Assembly of cameras in a factory in China

Source: Corbis

Under Chinese laws, all workers have the right to join a trade union. However, all unions must be organised under the umbrella of the All-China Confederation of Free Trade Unions (ACFTU), which is controlled by the state. The right to collective bargaining is greatly restricted, as the function of the ACFTU representatives in the companies is often organising social events or consulting workers, rather than representing the interests of employees vis-à-vis the management. The right to strike is restricted too. In many factories unions do not exist at all, not even the official ACFTU. It is estimated that union membership in private and foreign-invested companies is less than 20% (US Department of State 2004).

NGOs and other observers do not necessarily ask for the same models as in Europe (work councils) to be established, especially as this more confrontational model is not very compatible with China's cultural background, which is based on harmony and personal relations. However, the restrictive environment against independent trade unions makes it difficult even to establish "adapted" models to involve workers.

**Insecure employment terms**

Often workers do not have written contracts or are hired on one-year contracts, repeatedly renewed, leaving them with no job security. A survey of the NGO Oxfam among garment factory workers in the Guangdong province found that almost all migrant workers were given one-year contracts and 60 per cent of those interviewed had no written contract (Oxfam 2004a).

**Marks & Spencer supplier auditing program - Common challenges encountered in China (Marks & Spencer 2004):**

- Culture of excessive working hours and seven-day working
- Non-payment or under-payment of 'Social Insurances' and maternity benefit
- Health and Safety violations - both in dormitories and factories
- Falsified documents (i.e. double sets of time cards/payroll records)
- Limited trade union and employee involvement

It is common practice for foreign-owned companies to outsource the recruitment of workers to external employment agencies. As the agencies act as the direct employer, the companies do not have direct control over the work contract terms. Low pay and discrimination of workers by employment agencies have been criticised by NGOs.

**Labour law: Great on paper, but poor enforcement**

In contrast to actual labour conditions, "Chinese labour law sets out high standards in many areas, such as working hours, overtime premiums, wages, and child labour" (Global Alliance 2004, p. 17). Recently a number of new laws were introduced, above all new regulations about health and safety. Health and safety is the one area that increasingly does have government and labour authorities' support, in contrast to issues such as unionization.

However, as is the case with China's environmental legislation, the law tends to be poorly implemented. Firstly, the capacities of the administration to monitor and enforce the regulations are restricted, and secondly, the law contains a number of "loopholes" or vague formulations (e.g. extension of working hours is allowed in special circumstances) and local or regional authorities have a certain freedom in interpreting the law. This situation reflects also the specific cultural background: Traditionally China has been subject to the "personal rules" rather than the "rules of law" (stressing the importance of personal relations).

**Corruption**

The tradition of putting personal relations before legal rules is the background for a widespread presence of corruption in business life in China. A number of managers of companies operating in China have stated that it is practically impossible to do business in China without corruption.

All these different challenges for sustainable development in China shape the climate for doing business in China. The question is what companies could do and should do to act in a socially responsible manner under these conditions.

## 4 How can Companies operate in a Socially Responsible Way in China?

### 4.1 Environmental and Social Challenges translate into Business Risks

To what extent should companies be made accountable for environmental and social issues in China? In the wider context of this question, China is just a representative for the issue of globalisation overall, although a very important one.

#### Ethical point of view

From an ethical point of view, companies should not make a profit from low environmental and social standards, which cause environmental degradation or bad labour conditions in the countries and communities in question ("social dumping").

#### Socially responsible investment point of view

From the view of socially responsible investment, corporate social responsibility is not only an ethical matter but also a strategy to reduce risks, which could negatively affect financial performance. The different environmental and social issues discussed previously constitute the environment in which companies do business in China. If companies fail to take their social responsibility seriously, they may be exposed to business risks, especially:

- ◆ Reputation risks
- ◆ Operational risks and
- ◆ Legal risks.

#### Reputation risks: Customers prefer "socially responsible" brands

Recently many global brands have been damaged by criticism from NGOs and "anti-globalists". More and more consumers expect multinational companies to work on environmental and social problems linked to what they sell and how they conduct business. NGOs help to raise consumers' awareness. The well-publicised cases in the sports goods industry (especially child labour in factories in developing countries) show that such negative publicity can damage brands and erode market positions substantially. Reputation risks are particularly high for consumer goods companies, where the brand is important.

#### Marks & Spencer on their motives for establishing responsible sourcing (Website):

"Companies' share prices, reputations and customer relationships have all suffered by their failing to respond to public opinion on a variety of social issues. Companies without a strategy for responsible sourcing may find they lose business to those who can show they are taking the issue seriously, and adhering to their own responsible sourcing policies. Responsible sourcing is therefore a business imperative for Marks & Spencer."

Whilst NGOs have traditionally campaigned against textile and consumer goods industries, now they are casting a sharp eye on the electronics industry. Their criticism is aimed at working conditions in companies producing electronics components, toxic releases into the environment, poor occupational health and safety, and dumping of US computer waste in China.



Logo of the "Boycott Nike" Campaign

**Operational risks: Low labour standards strike back**

Poor environmental and labour conditions can cause operational risks, and reduce productivity and quality of products. Poor labour conditions (e.g. wages, overtime and health and safety) concern unskilled workers, especially migrant workers. They can result in high employee turn-over rates (see Table). Under poor labour conditions, workers tend to change jobs quickly, driven by small wage differences. High turnover rates cause organisational friction and "sunk costs", as workers have to be trained on the job until reaching a satisfactory productivity level.

Workers often work overtime to compensate for low wages. Excessive overtime can cause mistakes and reduce product quality. Poor health and safety conditions increase occupational accidents and illnesses, and reduce productivity.

**Employee turnover rates in sample cases**

Company	Employee turnover rate in China (% per year)
ABB	5%
Sulzer	9%
Geberit	approx. 20%
Kyocera (Shanghai)	20-30%
Canon <sup>a)</sup>	1-20%
Ricoh	20%

a) Depending on site

**Legal risks: Liabilities and political pressure**

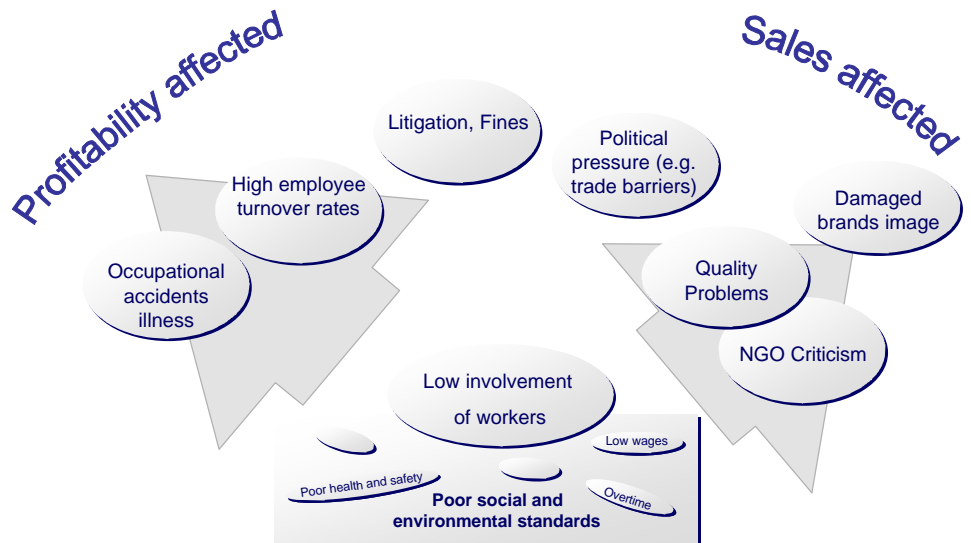
Poor environmental and social conditions can provoke liability suits against companies. For example, cleaning up contaminated sites can be an issue. In a report of the California Global Corporate Accountability Project in 2002, contamination of ground and drinking water around high-tech factories in Asia was criticised. Another issue is occupational health and safety. One example is a series of lawsuits against IBM alleging that workers in the company's chip-making facilities were exposed to chemicals, causing high levels of cancer. IBM settled a number of cases recently, but 100 or more are still pending. The cases are being closely monitored by the entire industry.

Poor environmental and social standards can also act as a political argument for trade restrictions on imports from China. One notable case relates to the Multi-Fiber Agreement (MFA). The MFA is scheduled to be eliminated for all WTO member countries in 2005, removing trade barriers for textiles and garments. It is estimated that, as a consequence, China's share of the world garment exports will increase from 20% to 50%. Some groups in the USA have started to lobby for new trade sanctions, arguing that low labour standards result in distortion of competition. Similar pressure is starting to apply to the consumer electronics and IT industries, in the context of the discussions about "off-shoring", for example in the USA.

**Impactt Overtime Project: Higher productivity through reduction in overtime**

The Impact Overtime Project is a joint pilot project of 9 purchasing companies (including Marks & Spencer) aiming at reducing overtime in 5 Chinese supplier factories. Many factories suffered from low productivity and high turnover rates. Factory managers tried to retain factory workers by using fines, deposits or late payment of wages. Impactt encouraged them to use more positive approaches such as offering incentives and benefits. In addition, a productivity consultancy (e.g. improving recording and analysis of quality data) was organised for the factory managers and Impactt promoted communication workshops for factory workers, allowing them to raise issues. Finally working hours were reduced to near or below legal limits in all factories. The outcome of these measures was an increase in productivity by between 23 and 78%, and higher wages in 4 out of 5 factories. ([www.impacttlimited.com](http://www.impacttlimited.com))

**Environmental and social risks for companies operating in China**



**Companies have different risk exposures**

The exposure of company operations in China to these risks depends on industry sector and type of business activities:

- ◆ Industry sector: Consumer goods companies are more affected than manufacturers of capital goods (e.g. ABB, Sulzer), as they are more vulnerable to damages to the reputation of their brands.
- ◆ Markets served: The long-term risk for export-processing companies tends to be higher than for companies serving the domestic Chinese markets. Exportpro-

cessing relies heavily on the labour cost advantages in China. This advantage can be volatile, taking into account competition from other countries in the region, a pull on wages due to shortages of labour with continuation of economic growth, or potential political interventions (see above).

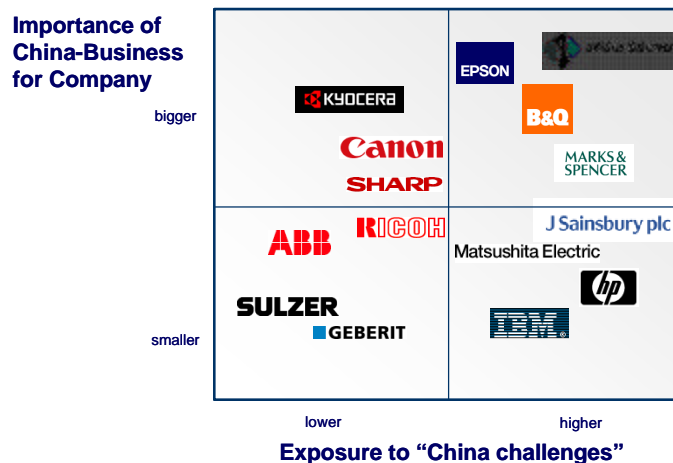
- ◆ Type of manufacturing operations: Risks relating to labour conditions are more relevant for consumer electronics and apparel companies, which hire unskilled workers for assembly operations. Companies with specialised manufacturing in China (e.g. production of electrical equipment or machine tools, or engineering) have more of a problem with shortage of skilled labour and associated wage inflation than with poor labour conditions.
- ◆ Supply chain: Most of the criticism against poor working conditions concerns local Chinese factories, and thus companies having outsourced manufacturing to local suppliers (especially sports goods and clothing companies as well as some computer companies) and retail companies purchasing in China.

**Importance of the China business determines a company's overall exposure to "China challenges"**

For individual companies, exposure to the different challenges in China depends also on the importance of their China operations for the business as a whole (in terms of proportion of employees, sales or purchases in China).

Based on both the risk exposure of a company's China operations and the latter's importance for the business as a whole, the sample companies can be grouped according to their overall risk exposure. The exposure is highest for companies like Adidas, B & Q, and Marks & Spencer (consumer goods, complex supply chains, high share of products sourced in China) as well as Seiko Epson (consumer goods, large manufacturing operations in China). The risk exposure is lower for companies like ABB, Sulzer and Geberit with a limited reliance on China and production of specialised products without complex supply chains in China.

**Exposure of the sample companies to environmental and social risks in China (Sarasin estimate)**



## 4.2 Initiatives by Companies operating in China to reduce Environmental Risks

### China sites are part of global environmental management systems

Many companies with manufacturing sites in China have group-wide environmental management systems. A central environmental department sets key group environmental targets and the regional units (e.g. China) identify key environmental issues in their regions, and report environmental performance information to the centre. The central environmental department reviews the performance of regions and sites. Environmental audits are conducted regularly (at least every two to three years) by both internal and external auditors. Some companies have already certified their operations in China to ISO 14001 and others are following this trend.

Some companies have no formalised environmental management systems in China, e.g. since their business activities have a relatively small impact on the environment (e.g. Geberit).

### Environmental standards and programs above Chinese local standards

Some companies have set up internal environmental standards which apply to all locations worldwide. Many of them are stricter than the local regulations in China (see Table). Many companies require compliance with local regulations only. This could be regarded as satisfactory, as China has reasonable environmental regulations in place, but they are not enforced consistently.

Thereby multinational companies can contribute to better compliance with local environmental regulations.

Furthermore, in the framework of their environmental management systems, many companies have established environmental programs to tackle specific environmental issues. Focal points of the environmental programs of companies in China include waste management, wastewater treatment and energy consumption. Appropriate waste treatment facilities are often lacking in China, therefore waste management is an issue for companies, especially management of hazardous waste.

### Wastewater emission standards of Kyocera for their operations in China

Water pollutants	Max. concentration in wastewater (mg/l)	
	Local Chinese Standard	Internal Kyocera Standard
Mercury	0.05	0
Hexavalent Chromium	0.5	0.05
Arsenic	0.5	0.01
Lead	1	0.05
Nickel	1	1

### Canon's environmental management in China

Its manufacturing sites in China are part of the global environmental management system. Regular audits are conducted at all the sites, and 4 out of 9 sites are certified to ISO 14001. Canon applies its own internal environmental standards, many of which are stricter than local Chinese ones (e.g. its waste water limitation is 80% of the relevant local standard). Special environmental programs in China include efficient water use by installing water recycling systems and waste management (38% waste reduction in FY2003 compared to the 1998 level; worldwide zero waste to landfill to be achieved by 2005).

### Supply chains are an issue

In conclusion, environmental standards and programs of the sample companies seem to be quite advanced in China. If their China operations are integrated into their global environmental management systems, low environmental standards should not be an issue for multinational companies operating in China.

A greater challenge seems to be the control of the environmental performance of the company's local suppliers in China (see section 4.4).

### 4.3 Initiatives by Companies operating in China to reduce Social Risks

#### Main social challenges to deal with

Based on the discussion of social problems in China (see section 3.2) companies with manufacturing sites in China have to deal with the following major challenges:

- ◆ Labour rights and labour unions
- ◆ Occupational health and safety
- ◆ Wages and labour conditions
- ◆ Employment agencies

#### Labour rights: Most companies do not have stated policies to apply core standards

As opposed to environmental standards, most sample companies with manufacturing sites in China do not have social codes or policies, nor special programs based on core labour standards (the Core ILO Conventions). Clear provisions to ensure "freedom of association" and "collective bargaining", especially, are lacking. Few sample companies have integrated adherence to the Core ILO Conventions into their social policies.

Companies with supply chains in China have been more proactive in integrating compliance with core labour standards into their supplier policies (see section 4.4).

#### ABB's commitment to core labour standards and present situation in China

In 2001 ABB established a group-wide "Social Policy" which requires it to comply with basic international and local social standards, including among others Core ILO Conventions and legal minimum wages. ABB has a group-wide organisation of sustainability managers who are responsible for environment, health & safety and social programs, including implementation of the Social Policy. However, as in most sample cases, ABB does not fully comply with the Core ILO Conventions in China. Two-thirds of employees working at the ABB companies in China are members of the official ACFTU trade union. For the rest, ABB has voluntarily established so-called Employee Recreation Committees which are elected by the workers. Their main function is to organise recreational activities, while systematic collective bargaining procedures are not in place. To involve workers aside from the official unions, ABB holds factory meetings and conducts employee satisfaction surveys regularly to allow its workers to express their opinion.

#### Labour unions: Many companies don't have any ...

Under Chinese law, all workers have the right to join a trade union. However, a number of multinational companies operating in China have no labour unions at all. The US Department of State estimates that union membership in private and foreign-invested companies is less than 20% in China (US Department of State 2004). For a number of multinational companies this is, however, not a measure to restrict labour rights, but reflects their cultural background (industry sector, country of origin) of not working with unions. One example is the information technology sector.

#### Intel works in a "non-union environment"

Intel, the U.S. microchip manufacturer, does not consider freedom of association a priority problem for them in China. Intel workers are not organised either in China or anywhere else in the world. Intel employs predominately skilled workers. Involvement of employees is traditionally organised via flat hierarchies or an open communication culture rather than formalised labour committees (Ethical Corporation, March 2004).

**... many have official labour unions ...**

Most of the companies we contacted have labour unions which belong to the official ACFTU organisation. They have established worker committees, but in many cases their function is not to represent the interests of employees vis-à-vis the management, but rather to consult employees and organise social events. There are some cases where human resources managers have the function of labour union representatives at the same time. This reflects the traditional role of the official trade unions in China, which is mainly to ensure peaceful labour relations.

**... few are looking for alternative ways to involve workers**

In order to approximate companies' internal practices to the intention of the Core ILO Conventions on freedom of association and collective bargaining, it is necessary to establish mechanisms to involve employees, aside from the official ACFTU trade unions. Employees should be given the opportunity to raise their concerns about labour conditions and remuneration. Generally speaking, there have been only few efforts by companies to establish such solutions. There have been some initiatives to establish independent worker committees in supplier companies (see section 4.4). Initiatives by the companies in their own manufacturing sites are rarer. They include, for example, the introduction of complaint mechanisms or regular factory meetings. Some companies have health and safety committees consisting of elected employee representatives. They discuss health and safety related issues together with other topics in regular meetings between managers and workers. Such a committee seems to be a good basis for promoting independent worker committees in the next step.

**Adidas: Promotion of worker involvement**

Adidas is promoting communication between workers and management at its own factories as well as at its suppliers. Adidas established welfare and health, safety and environmental committees composed of worker representatives, and internal complaint mechanisms (suggestion boxes). Workers can address complaints to the internal Social and Environmental Affairs team at Adidas. Furthermore, Adidas has supported the distribution of pamphlets within Southern China, which provide workers with contact information on agencies and organisations which can be approached for advice or help on labour rights.

**Health and safety: Many companies have management systems and high standards ...**

Among the different social issues in China, companies have paid most attention to occupational health and safety. Many companies have company-wide health and safety organisations, partially integrated into their environmental management systems, with health and safety committees as the responsible local bodies in their operations in China (see above). Some companies have their operations in China certified to an international standard such as OHSAS 18001, which requires legal compliance, regular health and safety audits, monitoring and reporting systems of health and safety performance indicators. For applicable health and safety standards, companies require at least compliance with the local Chinese standards. This can be regarded as sufficient, as China has recently established a quite comprehensive health and safety legislation, which is sometimes even stricter than the relevant laws in the U.S. or Europe. Health and safety is the one area that increasingly does have government and labour authorities' support, in contrast to issues such as unionization. However, enforcement is still weak. Most companies have annual health checks, safety and emergency training programs in place.

**... H&S performance in China unclear**

It is not possible, however, to make statements about the actual health and safety performance of the companies in China, as they did not provide data on occupational accidents and illnesses. Some companies were not able to, as they had no comprehensive monitoring system for health and safety at their Chinese facilities. Taking into account the high accident rates in Chinese factories overall, a good performance for a company's operations in China would be accident rates in the range of their US, European and Japanese sites. A single company stated that they attained this.

**Labour conditions: Above local standards, according to the companies**

Poor labour conditions are more an issue for companies relying on unskilled workers (e.g. factory workers at assembly lines) than skilled workers. Although company statements cannot be verified, labour conditions in most companies seem to be above the actual local standards:

- ◆ Most companies stated that they paid basic wages above the legal minimum, with wage deductions restricted to special cases, no or reduced charges for using canteens and dormitories (if any) and additional benefits in some cases.
- ◆ For social security contributions and working hours, compliance with the relevant legal requirements is the rule. This would be an advantage over the local practice of frequent overtime above legal limits and non-payment of social security contributions.

**Labour conditions in the sample companies with manufacturing sites in China**

Company	Basic wages	Wage deductions	Social security/ benefits <sup>a)</sup>	Working hours and overtime <sup>b)</sup>	Holidays <sup>c)</sup>	Dormitories/ Facilities
ABB	About double the legal minimum	No	Legal	Legal	10-30 days <sup>e)</sup>	No dormitories <sup>g)</sup>
Canon	Higher than legal minimum	Penalty scheme <sup>d)</sup>	Legal; organised transport for commuting	Legal	5-24 days <sup>e)</sup>	Free of charge <sup>h)</sup>
Geberit	About 1/3 higher than legal minimum	No	Legal	Legal	n/a	No dormitories; canteen with reduced prices
Kyocera (Shanghai)	Higher than legal minimum	No	Legal; support for mortgage plan	Legal	Japanese standard <sup>f)</sup>	No dormitories
Ricoh	Higher than legal minimum	No	Legal; support for housing, commuting and food	Legal	5-14 days <sup>e)</sup>	Free of charge
Sulzer (Chemtech)	About triple the legal minimum	Penalty scheme <sup>d)</sup>	Legal; support for housing	Legal	10	No dormitories; canteen free of charge

- a) Mandatory insurance for employees with more than 1 year's service, according to Chinese labour laws: injury, medical, pension, unemployment, maternity  
b) Legal: regular working hours 40 hrs/week; overtime max. 36 hrs/month  
c) Legal minimum: 5 days (after service time of more than 1 year), in addition to 10 days for national holidays; paid leave: maternity, illness, and bereavement.  
d) Penalty scheme for serious violations of quality and safety rules  
e) Depending on years of service and position  
f) Close to Chinese legal minimum standards  
g) Offering housing allowances for employees from abroad  
h) Modest charge for using dormitories for managers but free of charge for migrant workers

**Employment agencies:  
Useful for the companies ...**

Many multinational companies make use of employment agencies to hire contract workers. One reason is that the agencies have better access to local labour markets than companies, in terms of knowledge of the language and networks in local communities and authorities. Another reason is flexibility: Under Chinese labour laws, laying off workers is not easy once they are hired. Using contract workers enables companies to adjust the workforce to market fluctuations very flexibly. Furthermore, according to one company, a comparatively large number of migrant workers are not used to industrial work and their qualifications are inadequate. So frequently they do not meet the expectations of the company, which can then fire them more easily.

**Use of employment agencies by sample companies**

Company	% of contract workers (hired by employment agencies)
ABB	4%
Adidas	0%
Canon <sup>a)</sup>	0% - 16%
Geberit	approx. 25%
Kyocera (Shanghai)	approx. 25%
Ricoh	0%
Sulzer (Chemtech)	5%

a) depending on site

**... but employment conditions are critical**

However, employment agencies are often criticised by NGOs due to their low payment to workers and discrimination practices. The companies that use them do not have direct control over the contract terms, as they do not act as the direct employer. Some companies control the employment terms of contract workers, aiming at ensuring the same standards as their internal staff. Others discourage their factories in China from using employment agencies. However, in most cases control over the agencies is rather weak.

**Sulzer Chemtech: Better conditions for workers hired by employment agencies**

Sulzer (Chemtech) uses employment agencies to a limited extent. Wages and benefits for contract workers are fixed by the agencies. Sulzer compares them with their internal conditions and, in case of significant discrepancies, provides supplementary benefits from their own pockets to fill the gap. The contract terms provided by the agencies are often worse than Sulzer's internal ones (e.g. no meal allowance, and low pay and bonuses).

**4.4 Initiatives by Companies operating in China to reduce Supply Chain Risks**

**Supply chain issues are most challenging for consumer goods companies and retailers**

The criticism of NGOs against poor labour conditions in China concerns local Chinese companies producing mainly for multinational companies. Retailers and companies that outsource manufacturing to local suppliers are most affected. Among the latter, the challenge for consumer goods and some consumer electronics companies is highest, as their market success depends on their brands, which are most vulnerable to reputation risk. The retailers and the consumer goods companies have thus developed the most detailed and elaborate ethical supplier codes. These companies are also most advanced in implementing programs and initiatives to improve labour standards in their supply chains.

**Other companies have focused on the environment**

Other companies have focused their supplier management on environmental aspects. Companies like Geberit or Sulzer, which do not have diversified supply chains in China, have not established formalised supplier codes. Consumer electronics and electronics companies have established specific "green procurement standards", which typically focus on elimination of hazardous substances in purchased products (driven by legal requirements), and require their suppliers to introduce environmen-

tal management systems. Some consumer electronics companies, especially those having outsourced significantly to local suppliers, have started to tackle labour conditions in their supply chains as well. Most of them have focused on health and safety issues, within the framework of their environmental management systems. Very few of these companies have special requirements related to labour rights.

**Implementing supplier codes: Focus on "auditing approach"**

The majority of companies with environmental and social requirements for suppliers have established supplier audit programs and organisations. Retailers and apparel companies have well-organised audit systems for key suppliers, focusing on labour conditions. Electronics companies with own manufacturing sites and outsourced manufacturing in China have established environmental audit systems for suppliers. Some of them work with simple supplier self-assessments based upon questionnaires. Some have started to integrate social aspects into their supplier selection and audit processes.

**Environmental and social supplier management in the sample companies**

Company	Ethical Supplier Code		Implementation	
	Environmental	Social	Environmental	Social
<b>Retailers:</b>				
<b>B&amp;Q (Kingfisher)</b>	Yes	Yes	Supplier assessments, audits, Promotion of environmentally friendly products	Supplier assessments, audits Cooperative programs
<b>J Sainsbury</b>	Yes	Yes	Supplier self-assessments Promotion of sustainable farming and timber	Supplier assessments, audits, Joint projects
<b>Marks &amp; Spencer</b>	Yes	Yes	Promotion of sustainable food	Supplier assessments, audits, Cooperative programs, Joint projects
<b>Outsourcing Consumer Goods and Electronics Companies:</b>				
<b>Adidas</b>	Yes	Yes	Supplier assessments, audits Supplier training	Supplier assessments, audits, Cooperative programs (w orker dialogue), Joint initiatives
<b>HP</b>	Yes	Yes	Supplier assessments	Supplier assessments
<b>IBM</b>	Yes	Yes	Supplier assessments	Supplier assessments
<b>Manufacturing Companies:</b>				
<b>Canon</b>	Yes	No	Supplier assessments	Part of supplier assessments (not formalised)
<b>Geberit</b>	No	No	Part of supplier assessments (not formalised)	Part of supplier assessments (not formalised)
<b>Kyocera</b>	Yes	No	Supplier assessments, audits	(not formalised)
<b>Ricoh</b>	Yes	No	Supplier assessments, audits	(not formalised)
<b>Sulzer</b>	Partially (under development)	Partially (under development)	Planned	Planned

**Limitations of the "auditing approach" ...**

The "auditing approach" can be based on existing supply chain management structures and is useful for making compliance of suppliers with specified standards "visible" (e.g. certification, number of audited sites, etc.). However, environmental and social requirements usually appear as "added-on" to the general purchasing requirements (cost, quality, lead time). Suppliers are mainly interested in passing the audits, rather than in long-term improvements in labour conditions. It was observed, for example, that factory managers simply falsified documents or implemented short-term improvements, just for the audits (Oxfam 2004b, Ethical Trading Initiative 2003). Furthermore, factory managers often do not have the technical knowledge and information to fully implement action plans developed during audits. Given these limitations, it is questionable whether long-term environmental and social improvements can be achieved in the supply chains by applying a pure "auditing approach".

**... cooperative approaches can be more effective**

Some companies do not conduct audits any longer, but promote cooperation with factory managers and joint initiatives with other multinational companies, such as the apparel manufacturer Pentland (Ethical Corporation, March 2004). The general trend is for companies to turn away from a pure audit approach by starting more cooperative programs to supplement the audits. Examples include training and information of suppliers, sharing best practice cases, direct dialogue with workers in the supplier factories, and others. The aim is to develop knowledge about legal requirements and labour standards and to improve self-governance skills of supplier factory managers, as well as to increase awareness of the workers in supplier factories about labour rights.

**B&Q's "Factory Book"**

B&Q distributes an illustrated handbook to factory managers of their supplier companies in China. It explains B&Q's supplier standards and gives concrete examples for their implementation. The standards are separated into three levels, "critical points" (e.g. child labour) which must be fully met before starting business with B&Q, "operational standards" which must be met within two years and "improvement targets" which are recommendations of B&Q for their suppliers. The handbook provides information on China's labour law as well. B&Q is also organising workshops for factory managers to explain their standards and find practical solutions to health and safety issues.

**Conflict between ethical and commercial purchasing requirements**

Ethical supply chain management is often separated from the purchasing organisation in companies. The former requires high labour standards from their suppliers, the latter low prices, high quality and short lead times. These requirements are contradictory and they have to be balanced to achieve viable solutions long-term. On one side, a full integration of ethical supply chain management into the general purchasing practices is needed to avoid high additional burdens for suppliers, which are just regarded as a nuisance by both suppliers and purchasing managers. On the other side, the ethical

**Adidas terminates contracts with suppliers which do not comply with ethical standards**

Adidas assigns equal authority to the head of Sourcing and the head of Social and Environmental Affairs to terminate contracts with non-performing suppliers. In this way, non-compliance with environmental and social standards can be sanctioned effectively. In 2003, there was one case of a contract being terminated with a supplier in China for ethical reasons, especially poor health, safety and environmental standards, excessive overtime, incorrect payment of wages and benefits, evidence of misleading and dishonest practices and interference with worker interviews.

standards need to be effectively enforced, i.e. non-compliance with ethical standards must result in sanctions just like non-compliance with commercial standards.

**Cross-sector initiatives are more effective than individual efforts**

Even if a company has integrated high ethical standards into its purchasing practices, the possibilities of enforcing these standards are still limited, as in many cases one supplier works for several multinational companies at once. Suppliers can thus cancel business contracts with a "demanding" partner and move to a competitor with lower requirements. Therefore, joint initiatives of companies of the same industry sector are more effective in enforcing higher environmental and labour standards in the supply chains. Such joint initiatives could consist in developing common environmental and social standards for suppliers, organising common auditing processes, launching "fair labour labels", or organising common information and education programs for suppliers, local authorities and the companies themselves. A number of such joint initiatives exist in the retail and consumer goods sectors especially, such as the Ethical Trading Initiative (British retailers and consumer goods companies) or the Fair Labor Organisation (sports goods and clothing companies).

**Ethical Trading Initiative (ETI)**

ETI is a voluntary initiative of a number of British retailers and consumer goods companies, NGOs and trade unions, in partnership with the UK government, to promote good practice in supply chains, based on a common ETI Base Code. China has been one of the focal points of ETI's activities, which included providing information for their members about the challenges in China, and conducting pilot projects to implement the ETI Base Code. The current ETI China Project is an engagement program aiming at improving health and safety conditions by installing elected health and safety committees in supplier factories. In a second phase of the project, ETI plans to promote the installation of independent worker committees, based upon the experiences with the health and safety committees.

**Environment and health and safety have been the focus so far ...**

Across the different companies, the focus of supply chain initiatives has been on the implementation of environmental standards. The implementation of better labour standards has been limited to some industry sectors only (retail and consumer goods). When it comes to labour standards, the focus of the initiatives has been on health and safety up to now. This is understandable, as health and safety is a priority issue in China, the labour authorities have been supportive of organised efforts to improve health and safety, and companies often have related management systems in place.

**Reebok: Promotion of a union election in a supplier factory**

Reebok conducted a project to establish elected workers' committees and unions in two Chinese footwear factories of suppliers in 2002. The factories had unions with ACFTU-endorsed officials. Their role was mainly taking care of family planning, social insurance and social events. Before organising elections, Reebok carried out seminars for factory workers about labour rights under the Chinese trade union law and explained the process to elect worker representatives. In the first pilot factory 3,300 out of 3,500 workers participated in the election. The election was observed by a Hong Kong-based NGO to make sure it was fair and independent. As a result of the election, many ACFTU-endorsed officials lost their seats. This case must be regarded as exceptional, since approximately 90% of the factories' business was with Reebok, resulting in a high level of control and leverage of Reebok. Usually, one supplier works for several multinational companies (ASrIA 2002).

**...labour rights remain a major challenge**

Just like in the companies' own manufacturing sites, only few initiatives have been started to tackle the issue of labour rights, especially the installation of independent

labour unions. Examples include a project of the Ethical Trading Initiative to promote the installation of independent worker committees by starting with elected health and safety committees and a pilot project conducted by the sports goods company Reebok in 2002 (see box).

#### **4.5 Summary: "Good Practice" and remaining Challenges**

What represents "good practice" for a company to act in a socially responsible way in China can be different, depending on the specific sector or business activities. The sample companies have focused on the following areas of "good practice":

##### **Supply chain management**

- ◆ Supply chain standards: Besides retailers, the sectors consumer goods and to some extent consumer electronics have been most proactive in improving labour standards in their supply chains, since they have outsourced a major part of production and are most vulnerable to reputation risks. Many companies have established ethical supplier codes and started audit programs to monitor and improve labour standards in their supply chains. Some have started cooperative programs (e.g. supplier training) and cross-sector joint initiatives to apply common standards for suppliers. The main focus of these activities up to now has been on health and safety improvements. Health and safety is one area that increasingly does have government support.

##### **Managing labour conditions in own factories**

- ◆ Companies with own manufacturing factories in China are generally less exposed to the "China challenges" than consumer goods and retail companies. Nevertheless, most of them have company-wide environmental management systems in place, which include their sites in China. Most of them have environmental programs in China, which go beyond local environmental regulations. Many companies have also implemented occupational health and safety programs as part of their environmental management. However, statements about the actual health and safety performance of the companies are not possible, since they do not provide the relevant data. Ideally it should be on a par with the performance of the manufacturing sites in Europe, North America and Japan. Most sample companies stated that they paid basic wages above the legal minimum and that their social security payments and working hours comply with the local legal regulations as a minimum requirement. This is likely to be satisfactory, since Chinese labour law sets reasonable standards here (the problem is the poor enforcement of the law). Some companies provide extra benefits for employees, such as housing subsidies and additional holidays.

**... and remaining challenges**

The following challenges have not yet been addressed by the "good practice" companies sufficiently:

- ◆ Labour rights: Independent trade unions are prohibited in China<sup>4</sup>. Whether in their own manufacturing sites or their supply chains, companies have made little effort to find solutions to involve workers more in decision-making processes independently from the official trade unions. Many sample companies have trade unions belonging to the official ACFTU. Workers' committees, however, often do not represent the interests of employees vis-à-vis the management, but merely organise social activities. Some companies do not have any unions, partly because of the industry culture, for example, technology companies used to have no trade unions company-wide. Many ethical supplier codes require compliance with the Core ILO Conventions<sup>5</sup>, however, only a few companies have started to improve labour conditions in their supply chains.
- ◆ Employment agencies: Many companies manufacturing in China hire workers via local employment agencies. In most cases, they do not have direct control over the contract terms provided by the agencies. Their contract conditions tend to be worse than those of directly hired workers.
- ◆ Supply chain standards: Up to now, the initiatives to improve labour standards in the supply chains have been limited to specific industries (consumer goods and retailers), which are highly exposed to the "China challenges". The majority focus on key suppliers and selected issues such as health and safety. Notably companies impose conflicting demands on their suppliers: Better labour standards and general purchasing standards (price, lead time and quality). Cross-sector joint initiatives can be useful for integrating ethical criteria into purchasing policy without sacrificing competitiveness for individual companies.

**"Cultural" differences between companies**

Environmental protection is more standardised globally than the management of labour conditions and other social issues. Companies have different approaches to work on social issues depending on their cultural background. For example, many Japanese companies operating in China have high environmental standards and management systems. However, they lack "visible" evidence of their labour conditions and social commitment. In general, they have a broad corporate philosophy which determines the way the company works with their employees and suppliers. In contrast to US companies for example, it is not documented in the form of policies or internal guidelines. This makes it difficult to assess Japanese companies properly.

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4) Under Chinese law, independent trade unions are prohibited. All unions must be organised under the umbrella of the All-China Confederation of Free Trade Union (ACFTU), which is controlled by the state.

5) The Core ILO (International Labour Organisation) Conventions: forced labour, child labour, freedom of association, right to collective bargaining, and discrimination.

## 5 How does Socially Responsible Investment deal with the Issues?

### **SRI involves positive and negative screening of companies**

Socially Responsible Investment (SRI) looks for companies demonstrating an above-average involvement with the environmental and social aspects of their business ("positive screening"). In addition, certain business activities can be excluded from investment by negative criteria from the outset ("negative screening").

### **Best practice examples existing ...**

Based on the previous discussion about companies operating in China, a number of "best practice examples" can be found, against which companies can be benchmarked in a "positive screening".

### **... but unresolved problems too ...**

However, it also became apparent that some challenges have not yet been tackled comprehensively:

- ◆ A few companies have started initiatives to involve workers, but full compliance with the Core ILO Conventions about freedom of association and right to collective bargaining is not possible in China, due to the restrictive legal environment.
- ◆ Labour rights and labour conditions are an issue with suppliers. Some companies have launched major initiatives to establish sustainable supply chain management practices. However, all in all most of them are still in their infancy.

### **... as well as limited information**

Furthermore, independent information about the actual on-site conditions in the factories of a specific company is usually quite limited. SRI must rely on information provided by the companies to a large extent, which can not be verified in most cases.

### **Exclusion of companies operating in China?**

Taking into account the unresolved problems as well as the limitations on independent information, it is a question for SRI as to whether companies operating in China should be excluded from investment altogether ("negative screening").

### **Relevance of the "China challenges" varies among companies**

However SRI investors deal with the "China challenges", it must be taken into account that the issues are of different relevance depending on the company (See section 4.1):

- ◆ First, it matters whether the company's activities in China form an important part of the business or not (in terms of proportion of employees, sales or purchases in China).
- ◆ Secondly, the exposure of companies to the different environmental and social challenges is different depending on the business model and the industry sector

respectively (e.g. commodity consumer products vs. specialised products, outsourcing vs. in-sourcing).

- ◆ Thirdly, there are significant regional differences in the state of the environment and natural resources in China, and in environmental pressures emanating from industrial and urban development. Thus companies are exposed to the environmental challenges differently, depending on their locations.

As SRI involves an overall assessment of the sustainability of a company, the company's exposure to the "China challenges" must be weighted depending on its actual relevance.

### **5.1 Sarasin Sustainability Rating**

Sarasin applies a systematic approach to identify socially responsible companies. Every company is assessed based upon a system of environmental and social criteria ("positive screening"), resulting in a sustainability rating. This rating determines the eligibility for the SRI funds. On top of the rating, a set of exclusion criteria is applied ("negative screening"), for example nuclear energy, armament or tobacco, depending on the individual fund.

Sarasin does not apply exclusion criteria related to the "China challenges", such as exclusion of all companies with a significant China business or of companies which do not comply with basic labour rights or labour standards.

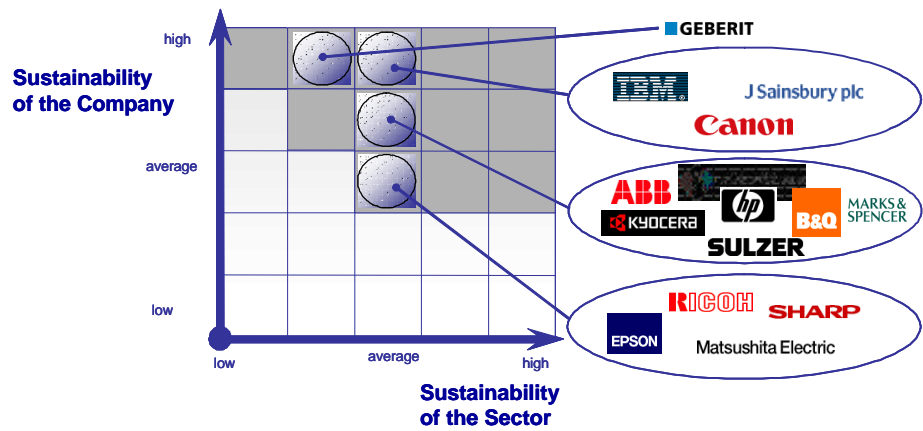
**Exposure to "China challenges" is an integral part of the sustainability rating**

The Sarasin rating system includes several criteria to assess the commitment of companies in dealing with the "China challenges". However, as the system is meant to draw a complete picture of a company, this is just one among various other sustainability criteria. "Non-sustainable business practices" in China result in a reduction of the sustainability rating score, but the rating may still be good enough to qualify for investment.

**Sarasin Sustainability Matrix®**

Sarasin's sustainability rating of companies is two-dimensional. Every company is positioned in the Sarasin Sustainability Matrix® depending on the sector rating and the company rating. Companies positioned in the shaded area qualify for Sarasin's sustainability funds.

**Rating of the sample companies with the Sarasin Sustainability Matrix®**



**Sector Rating** The Sector Rating is an assessment of the specific environmental and social risks of each industry, in comparison with other industries. All sample companies highlighted in this study have "average" sector ratings (consumer electronics, consumer goods, trade and retail, electrical engineering and electronics, machinery and engineering), except for Geberit which belongs to the building products industry (rating "below average").

Outsourcing and relocation of production sites to China and other emerging countries are to some extent sector-specific. The sector rating of these industries (consumer electronics, consumer goods, electrical engineering and electronics especially) takes into account the associated social risks as a constituent of the assessment.

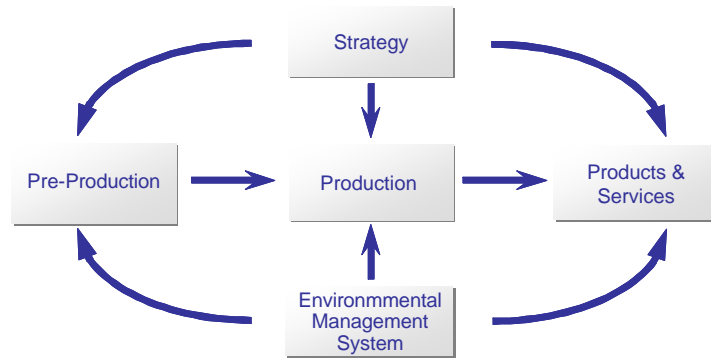
**Company Rating** The Company Rating, the second dimension of the Sustainability Rating, measures how well a company deals with the sector-specific risks compared with other companies in the same sector. This assessment is based upon a number of environmental and social criteria.

The assessment model takes into account whether a certain criterion applies for all operations of the company or just part of them. The assessment of the company's business in China is therefore part of the overall evaluation of the company. This is true for all criteria. With this approach, business activities in China may constitute a smaller or bigger part of the overall assessment, depending on their importance for the company as a whole (e.g. in terms of percentage of employees).

Separate environmental criteria include, for example, "Environmental Management System" (see Figure) which assesses the presence of environmental management systems company-wide (including China), or "Pre-production" which assesses the presence of systematic environmental supplier assessments and audits company-wide (including China). The criterion "Production" includes an assessment of environmental programs and the actual environmental performance of the company as a

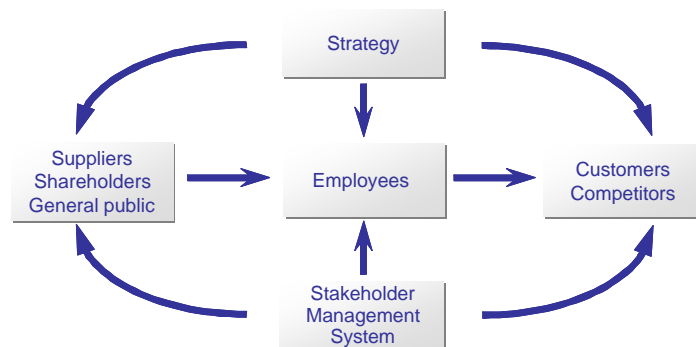
whole, including manufacturing sites in China. An example for social criteria (see Figure) is occupational health and safety (performance, programs and measures) in the company as a whole (including China), which is part of the assessment under "Employees".

**Sarasin Company Rating - Environmental Criteria**



In addition to these general criteria, the assessment model includes a set of specialised social criteria addressing the specific issues of emerging countries (including China). They include among others the presence of internal policies and guidelines related to human rights (included under the criterion "Stakeholder Management System"). Compliance with the Core ILO Conventions (e.g. freedom of association) is part of the assessment under "Employees". Working conditions (health & safety, compliance with the Core ILO Conventions) in supplier factories in emerging economies, as well as appropriate processes to assess and monitor suppliers are part of the criterion "Suppliers".

**Sarasin Company Rating - Social Criteria**



**Weighting system**

In order to arrive at an overall rating from the various single criteria, a weighting system is applied. This is sector-specific and reflects the different importance of a specific issue for different sectors. The criterion "Suppliers", for example, has a

comparatively high weight in the trade and retail sector (taking into account that working conditions in the supply chain are one of the most important challenges for these companies), while its weight is lower in the machinery sector, which does not rely on suppliers from developing countries to a large extent.

**Different relevance of "China challenges" for different companies is taken into account**

To sum up, the rating system accounts for the different relevance of the "China challenges" for different sectors and companies:

- ◆ By considering the "vertical coverage" of each criterion, for example, non-compliance of a company's operations in China with the Core ILO Conventions weights higher the more important the business operations in China are for the company as a whole.
- ◆ By assigning different weights for criteria, depending on their relevance for the environmental or social impact of the industry sector (see the above mentioned example of the criterion "Suppliers").

The rating aims at drawing a complete picture of the sustainability of a company. The "performance" of a company in dealing with the environmental and social challenges in China forms one building block of the rating, but it is just one among various others.

## **5.2 Integration into the Investment Process - the Ökoveision Approach**

**SRI Fund Ökoveision**

Ökoveision ([www.oekoveision.de](http://www.oekoveision.de)) is a sustainable investment fund of ÖkoWorld Lux. S.A., a subsidiary of the German financial services company Versiko AG. Launched in 1996, it is among the sustainability funds in Europe with the longest track record. The fund is managed by Sarasin. A criteria committee appointed by ÖkoWorld decides on the basic eligibility of companies for the fund, based on a set of environmental and social criteria and the research information provided by Sarasin. The criteria committee is independent and composed of representatives of NGOs working in the areas of environment, human rights and consumer protection, as well as individual experts in the various aspects of sustainable development.

The criteria committee has discussed the issue of the eligibility of companies operating in China repeatedly during the last years, focussing on two aspects:

- ◆ Violation of basic labour rights and minimum social standards, as well as environmental compliance.
- ◆ Lack of transparency about the actual conditions in the company's operations in China.

**Violation of basic labour rights is an exclusion criterion**

Among the different environmental and social issues in China, the criteria committee has highlighted the problem of non-compliance with basic ILO standards (in particular the right to collective bargaining and the right to unionization) as the most crucial ones. Violation of basic human rights and labour rights constitutes one of the negative criteria of Ökoviision. In principle, companies which do not comply are excluded from investment ("negative screening" approach). As a consequence, due to the restrictive political and legal framework in China, companies operating there would, under "normal conditions" (i.e. just by complying with the local legal conditions, without engaging actively into improvements) not be eligible for an investment.

**Relevance check: More than 5% of employees in China**

However, this would not only be unrealistic. Hence the criterion is limited to companies with significant activities in China. 'Significant' is a share of more than 5% of a company's global workforce in China. If that is the case, no investment is permitted.

**No exclusion of companies that are actively involved in improving labour rights**

However, the criteria committee is also keen to acknowledge and reward active attempts by companies, which try to approximate the content of the Human Rights and the ILO minimum rights, e.g. by experimenting with innovative ideas aimed at involving employees 'as if'.

In other words, it was agreed that companies can be exempted from exclusion and be considered for investment on condition that they are able to show evidence of specific activities to approximate their internal practices to minimum labour standards. As demonstrated by the discussion of the sample cases (see section 4) such "best practice examples" can be found, although unfortunately examples of companies trying out independent worker committees or similar approaches to involve workers independently from the official ACFTU trade union organisation have been very limited up to now.

**Dealing with incomplete information**

The criteria committee decides on a case-by-case basis whether a company actually meets the conditions for exemption from exclusion or not. In most cases, the decision has to rely on limited information about the actual on-site situation in a company's operations in China.

As a matter of fact, information provided by the companies is often not comprehensive, partly because corporate headquarters, which are the primary source of information, often do not have detailed information about the conditions on-site either. Independent information is even more difficult to obtain and usually it is beyond the scope of sustainability research to collect site-specific information, especially when it comes to multinational companies with a large number of sites.

In order to explore possibilities of obtaining independent on-site information about selected companies in China, the criteria committee commissioned an independent organisation to carry out a survey of the working conditions in a Chinese factory of one of the companies invested in the fund (worker interviews). Furthermore, the

committee carried out a survey of institutions with activities in China which could potentially be asked for concrete information on a case-by-case basis. The conclusion was that it was not practicable to get the desired information by engaging external independent institutions. One must rely on information provided by the companies anyway. This applies even in the case of factory inspections by independent organisations which are not possible without the cooperation of the company. Only in special cases it is possible to use supplementary independent information from press articles or NGOs (mainly in the case of "scandals").

**Engagement with the companies**

Considering the importance of information from the companies about the on-site conditions in China, the criteria committee has started to engage with the companies directly in selected cases. The goal is to improve the information base about the companies (including plausibility checks) via direct company contacts, but also to encourage companies to intensify positive approaches to respond to the different environmental and social challenges.

**Eligibility of the sample companies for the Ökoveision fund**

Based on this procedure, the criteria committee assessed some of the sample companies during recent years. Of those assessed, all companies were rated as eligible for the fund. This merely reflects the fact that the selected sample companies are those that are more active in dealing with the social and environmental challenges in China. Two companies in the sample have not achieved the highest "degree of qualification" for the fund, Geberit and Kyocera. This decision is directly linked to the China business of these companies: The criteria committee judged their efforts to deal with the "China challenges" as being not entirely satisfactory.

**Sample Companies which are invested in the Ökoveision fund:**

- ABB
- B & Q (Kingfisher)
- Canon
- Geberit
- IBM
- Kyocera
- Sulzer

as of September 2004

## 6 Conclusions for Socially Responsible Investors

### **China opens up investment opportunities**

By shifting manufacturing to China, companies can exploit the opportunities which have arisen from the development of China into the "world's workshop". The major driver has been low labour costs up to now. Therefore, opportunities for investors have been found among labour-intensive companies producing in China mainly for export, such as producers and retailers of clothing and shoes, consumer electronics products and components, or certain commodity consumer goods. Latterly more companies have started to target the Chinese domestic market, giving rise to new opportunities for investors. This will increase the interest for Chinese companies too, in addition to multinational companies.

### **Concerns about the sustainability of the "flight to China"**

Irrespective of whether they want to exploit these investment opportunities or not, socially responsible investors have to look into the "flight to China", as more and more companies have developed significant business activities there.

From a sustainable development point of view, poor labour conditions in Chinese factories, low wages, disregard of international labour rights, and environmental problems are a matter of concern. These issues constitute a challenge for companies operating in China which take their social responsibility seriously, in their factories as well as their supply chains.

The situation is all the more challenging taking into account the legal and political restrictive environment for independent trade unions in China. Provincial and municipal authorities are typically rather hostile to union activity, and state-owned enterprises, which do not uphold basic labour standards, frequently shape the competitive and regulatory realities for a range of foreign companies operating in China.

### **SRI is looking for companies acting in a socially responsible manner in China ...**

Socially responsible investors are looking for companies which succeed in meeting this challenge, not just as a matter of principle, but also to reduce investment risks. Investment risks arise from the consequences of the different environmental and social challenges associated with operating in China for the companies. They include reputation risks (poor labour conditions can create negative publicity and damage the value of brands), operational risks (e.g. quality problems and high employee turnover rates among employees due to poor labour conditions) and legal risks.

### **... bearing in mind that companies are exposed to the "China challenges" differently**

The "China challenges" affect companies differently, a fact that must be taken into account when screening companies for SRI. First, the importance of the China business for the company as a whole may be large or small. Secondly, the challenges for the companies differ depending on the business model and the industrial sector: For example, companies with complex supply chains in China (outsourcing model)

are more affected than companies manufacturing in-house in China, or producers of commodity consumer goods for export are more affected than producers of capital goods and specialised products for the domestic market.

**Different SRI approaches to assess companies with regard to their China business**

A rating system like the Sarasin Sustainability Matrix® takes into account such differences between companies. The model aims at drawing a complete picture of the sustainability of a company, including all relevant environmental and social aspects. The China business of a company forms a part of the overall assessment, which depends on its relevance for the company as a whole and the relevance of the associated environmental and social issues.

However, this approach tends to conceal the assessment of the China business in the overall assessment of a company. It could happen that a company showing little interest in managing the "China challenges" can still achieve eligibility for an SRI fund, if it performs well in other environmental and social criteria. This result is not enough for some socially responsible investors and they prefer a more stringent approach. For example, the SRI fund Ökovision applies an additional "negative screening" criterion, under which companies with significant operations in China are excluded from investment, unless they can provide evidence for specific activities to approximate minimum labour standards - but also 'rewards' attempts by companies trying to overcome the present restrictive framework.

**Socially responsible investors can find companies operating in China**

The different examples analysed in this study show that companies can be found that are suitable for SRI, depending on the SRI approach. If social responsible investors do not exclude non-compliance with international labour standards categorically, it is possible to match the goal of finding financially promising investments in companies operating in China with the goals of keeping high environmental and social investment standards and reducing investment risks, even if a more stringent "negative screening" approach is applied.

However, it needs to be pointed out again that under present circumstances (restrictions against independent trade unions) no company can comply fully with international labour standards. In particular attempts to find solutions to involve workers more in decision-making, in order to approximate to the intentions of the Core ILO Conventions about labour rights, are still uncommon. Secondly, even most of the "best practice companies" are still only just starting to improve sustainability (labour conditions especially) in their supply chains.

In supporting the companies which are most committed to acting responsibly in China, socially responsible investors can encourage the dissemination of "good practice examples" and thus to a more sustainable development in China.

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## Sustainability Rating Method

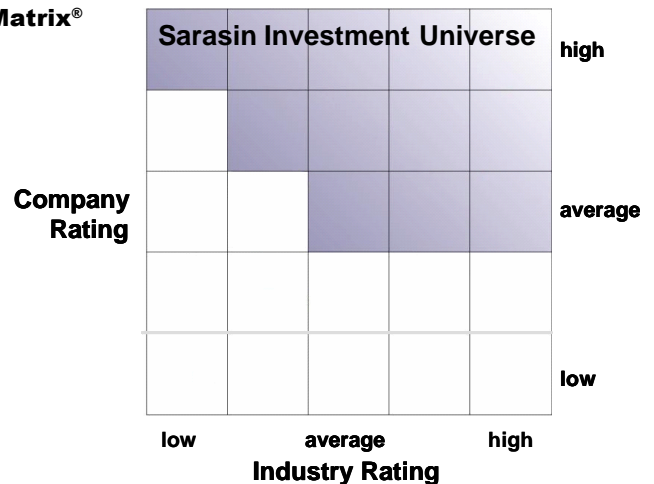
### Matrix combines industry and company rating

The environmental and social analysis of companies is based on a proprietary valuation method developed by Bank Sarasin. It covers two dimensions, which are mapped on the Sarasin Sustainability Matrix®:

- ◆ Industry rating: comparative rating of industries based on selected environmental and social criteria.
- ◆ Company rating: comparative environmental and social analysis of companies within the industry.

Bank Sarasin's retail sustainability funds are limited to those securities that are positioned in the Sarasin investment universe (shaded area).

### Sarasin Sustainability Matrix®



### Evaluation criteria

When rating individual companies, we assess how they handle sector-specific environmental and social risks and exploit the relevant opportunities. The main criteria are the same for all industries. They are set out in the company's environmental and social profile relative to the sector average, and then summarised as an overall rating. The weighting of the main criteria and the selection of the subcriteria depend on the specific features of that industry.

### Controversial activities

Certain business activities that are not considered to be compatible with sustainable development (e.g. armaments, nuclear energy, tobacco, pornography) may result in companies being excluded from Sarasin's sustainable investment universe. The fund's Advisory Council makes this selection for our retail funds ValueSar Equity and OekoSar Portfolio.

### Information sources

Our company rating is based on details from the company, press reports and information from independent institutions. We contact the companies to clarify any unresolved questions or contradictions. We do not use standardised questionnaires.

## Contacts

	<b>Andreas Knörzer</b> Head of Sarasin Sustainable Investment	Tel. +41 61 277 7477 andreas.knoerzer@sarasin.ch
<b>Portfolio Management</b>	<b>Gabriele Grewe</b> Head, Bonds and Balanced Portfolios	Tel. +41 61 277 7073 gabriele.grewe@sarasin.ch
	<b>Catrina Vaterlaus-Rieder</b> Deputy Head, Equity Portfolios	Tel. +41 61 277 7805 catrina.vaterlaus@sarasin.ch
	<b>Arthur Hoffmann</b> Equity Portfolios	Tel. +41 61 277 7322 arthur.hoffmann@sarasin.ch
	<b>Wulf Haasner</b> Bonds and Balanced Portfolios	Tel. +41 61 277 7195 wulf.haasner@sarasin.ch
	<b>Johannes Weisser</b> Equity Portfolios	Tel. +41 61 277 7267 johannes.weisser@sarasin.ch
<b>Sustainability Research</b>	<b>Dr. Eckhard Plinke</b> Head, Machinery, Electronics and Electrical Engineering	Tel. +41 61 277 7574 eckhard.plinke@sarasin.ch
	<b>Makiko Ashida</b> Insurance, Consumer Goods	Tel. +41 61 277 7470 makiko.ashida@sarasin.ch
	<b>Dr. Michaela Collins</b> Retail, Tourism, Countries, Institutions	Tel. +41 61 277 7768 michaele.collins@sarasin.ch
	<b>Dr. Matthias Fawer-Wasser</b> Energy, Food, Paper	Tel. +41 61 277 7303 matthias.fawer@sarasin.ch
	<b>Andreas Holzer</b> Chemicals, Medical & Healthcare, Water Utilities	Tel. +41 61 277 7038 andreas.holzer@sarasin.ch
	<b>Klaus Kämpf</b> Banks, Business Services, Software, Recycling & Waste Management	Tel. +41 61 277 7780 klaus.kaempf@sarasin.ch
	<b>Dr. Gabriella Ries</b> Media, Telecommunications, Building Materials, Transport/Logistics	Tel. +41 61 277 7166 gabriella.ries@sarasin.ch
<b>Marketing/Support</b>	<b>Erol Bilecen</b> Marketing Support	Tel. +41 61 277 7562 erol.bilecen@sarasin.ch
	<b>Dr. Mirjam Würth</b> Marketing Support	Tel. +41 61 277 7342 mirjam.wuerth@sarasin.ch
	<b>Gabriela Pace</b> Administrative Support/Secretariat	Tel. +41 61 277 7331 gabriela.pace@sarasin.ch
	<b>Balazs Magyar</b> Research-Assistant	
<b>Address</b>	Bank Sarasin & Co. Ltd, Sustainable Investment Gabriela Pace Elisabethenstrasse 62 CH-4002 Basel	
<b>E-Mail</b>	gabriela.pace@sarasin.ch	
<b>Website</b>	www.sarasin.ch/sustainability	

## Publications

<b>Media</b>	Corporate Social Responsibility Issues of the Media Industry. Gabriella Ries, June 2004 (only available in German)
<b>Biotechnology</b>	Will Medicinal Biotechnology sustain its promise? Delivering on potential - to patients, investors and society. Andrew DeBoo, March 2004
<b>Government Bonds</b>	Sustainability of Sovereign Bonds? Approach and results of the Sarasin country evaluation. Michaela Collins/Astrid Frey, January 2004 (only available in German)
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