The Association for Sustainable & Responsible Investment in Asia

SRI MARKETS IN ASIA

CHINA

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Contents

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1. Executive Summary

The financial industry in China is in its early stage of growth. There is every opportunity for China to leapfrog in areas such as corporate governance because it does not have the baggage of family-owned enterprises, as has been the case with many overseas Chinese companies. State-owned enterprises dominate the business scene. Once the state is determined to change, reform is unstoppable. The Green Olympic Games of 2008 is also an important incentive for China to gear towards environmental friendly practices. SRI has a long way to go before it establishes itself in China. Nonetheless prospects are bright.

CARING GROUPS ARE POORLY PAID

Caring professionals in the West have the financial means to promote SRI. This advantage is not presently shared by their Chinese counterparts.

A GROWING FUND INDUSTRY BOLSTERED BY GOVERNMENT BLESSING

At the end of 2000, China's 33 securities investment funds had total net assets valued at Rmb84.6bn (US$10.37 billion), up 35% from year-end 1999. Mutual funds are aimed strictly at the retail investor. There are 33 closed-end funds managed by 15 local asset management companies. Open-ended funds made their debut in September.

CORPORATE GOVERNANCE AND ENVIRONMENTAL ISSUES GAIN PROMINENCE

China has made continuous efforts to plant good corporate governance into its state-owned enterprises restructuring drive. Much reform is needed. This issue has powerful sponsorship from senior government officials. The Hong Kong-based 'Political and Economic Risk Consultancy' gave China a score of 8.22 points on its quality of corporate governance (on a scale of zero to ten, with ten being the worst). Environmental issues, too, are topical. Chinese cities are some of the dirtiest in the world and polls show that the populace is more than concerned.

2. Caring Groups are Poorly Paid

Caring professionals in the West have the financial means to promote and purchase SRI funds. This is an advantage not shared with their Chinese counterparts.

The total population of China stands at about 1.2 billion according to state estimates. There are 8.68 million people employed in social services, 4.78 million people in health care, sports and social welfare, and 15.73 million people in the education, culture, radio, film and television industries, according to categories listed in the 1999 National Statistics Yearbook. The figures may be staggering but the average wage for those people is below 5,300 yuan (US$650), 5,000 yuan (US$613) and 7,000 yuan (US$858) respectively, which is less than half that of their peers in Hong Kong and Taiwan. No detailed breakdown of the numbers and wages of private sector professionals in those sectors are available.

3. A Growing Mutual Fund Industry Bolstered by Government Blessing

At the end of 2000, China's 33 securities investment funds had total net assets valued at Rmb84.6bn (US$10.37 billion), up 35% from year-end 1999. Mutual funds are aimed strictly at retail investors. The 33 funds, all closed-ended funds, are managed by 15 local asset management companies.

List of 15 Local Asset Management Companies

(A full list of China's financial institutions can be obtained from China Financial Guide 2002)

Nanfang Asset Management Company
Guotai Asset Management Company
Huaxia Asset Management Company
Hua'an Asset Management Company
Buoshi Asset Management Company
Penghua Asset Management Company
Jiashi Asset Management Company
Fu Guo Asset Management Company
Changsheng Asset Management Company
Dacheng Asset Management Company
Yianda Asset Management Company
Baoyin Asset Management Company
Yinhua Asset Management Company
Rongtong Asset Management Company
Changcheng Asset Management Company

Foreign ventures are not presently allowed to own or operate funds in China. However many partnerships, phrased in written contracts as technology transfer or business exchanges, are being formed with local companies. These co-operative partnerships mainly have the intention of progressing to joint venture status after China enters the WTO. In its bilateral agreement with the United States over WTO accession, China has pledged to allow foreign ownership in domestic securities investment fund management businesses to be set at less than one-third upon accession; and the ownership ceiling is to rise to 49% within three years of accession.

Nonetheless, it is preferable if SRI initiatives are endorsed by local fund managers. Their understanding of local values, which is essential for SRI, is unbeatable.

Major Sino-foreign asset management partnerships

COMPANY	PARTNER
China Southern Fund Management	HSBC Asset Management (Hong Kong)
Dacheng Fund Management	Deutsche
Full Goal Fund Management	Bank of Montreal
Huaan Fund Management	Jardine Fleming
Penghua Fund Management	INVESCO
Guotai Junan Securities	Dresdner (for fund management)
China Galaxy Securities	Schroders (for fund management)
Haitong Securities	Fortis (for fund management)
CITIC Securities	AIG
Xiangcai Securities	Credit Lyonnais (for fund management)
China Southern Securities	Commerzbank (for fund management)

3.1 LIMITED INVESTMENT CHOICES

Investors have little investment choice at present other than gathering meagre interest in bank accounts and buying into A and B share markets in Shenzhen and Shanghai. A plan to launch a NASDAQ-like second board has been postponed. A tiny percentage of the population is familiar with the concept of mutual funds. It will take a lot of public discussion and promotion to introduce SRI. The positive news is that the fund industry is growing and it has the government's blessing. Forthcoming developments, such as the introduction of open-ended funds and allowing national social security funds to invest in stocks, are conducive to the development of SRI as the market matures.

3.2 INVESTORS ARE ENTHUSIASTIC ABOUT OPEN-END FUNDS

At present, mutual funds are aimed strictly at the retail investors. Companies and government entities are prohibited from subscribing. A key task for the Chinese government in developing the financial market is to foster growth in institutional investment. The introduction of open-ended funds is essential for the eventual development of SRI funds in China.

Market regulators have pushed for open-ended funds, which have no limit in size, because they are expected to boost market liquidity by encouraging institutional investment. It is the first step towards allowing institutional investors to pour money into A-share markets which are otherwise reserved for domestic investors. Foreign financial houses have been allowed to sign co-operation agreements with local fund management companies. Also more money will flow to better managed funds, pressing fund management companies into improving their performances.

China issued guidelines for open-ended funds last year and stated that at least 100 investors must subscribe to fund units with a net worth of at least 200 million yuan (US$24.5 million). They also allow fund management companies to charge a fee of up to 5% on purchases and 3% on redemptions. The first batch of open-ended funds were launched in September 2000.

Chinese investors are eager for more investment choices as well. More than 70% of investors are interested in open-ended funds and nearly 50% of investors will buy them when they are available in the market, according to a survey released by the China Construction Bank in May this year.

Survey results indicated that 74% of institutions and 62% of individuals consider a fee rate of 1% to 3% reasonable, while 22% of institutions and 33% of individuals consider a rate of 3% to 5% reasonable. Only 4%of institutions and 5% of individuals push the "reasonable" line up to 5% or above.

3.3 CHINA'S PENSION FUND

China has been reforming its pension system since the mid-1980s and so far there have been more problems than successes. With the breakdown of rural communes and traditional filial structures, longer life expectancies, exacerbated by the one-child policy, the Chinese population is ageing rapidly. The World Bank has forecast that by 2050 China will have an elderly population (aged over 65) of 300 million. The country's pension fund assets are expected to reach US$1.3 trillion by 2030, making it one of the biggest markets. The potential for SRI is enormous.

If China is to levy a tax to sustain its retirement system, three workers will have to support one retiree. The present ratio is about 10 to 1. At present, the population aged 15 to 65 is 11% more than the population aged over 65. The situation is going to get worse in the next three decades.

The pension system has evolved from one purely funded by the state to one requiring contributions from both employers and employees. Under the present national system, employers are required to pay 20% of their employees' salary into government-run schemes. Employees must pay about 5%. All of China's urban working population of about 200 million people are required to join the pension schemes. While the scheme is mandatory, it is not well-enforced.

The system works fine for the existing young workforce as they will have a long working life to save for retirement. However for those well into their fifties, they have only a few more years to work and cannot save enough for a safety net. Also many of the now-defunct state-owned enterprises have defaulted on their payments. Workers have little savings to rely on. The situation is so dire that many unionists have predicted massive social unrest if no improvement is in sight.

3.4 STEEP PENSION DEBT

The present pension liability is about US$600 billion to US$800 billion, with assets at US$15 billion. The discrepancy is a perennial concern to the government. Officials have proposed getting more money for the national social security fund from taking 10% from company's initial public offerings, selling state assets, lotteries, raising a special tax or through a Chinese-style Tracker Fund, in which the state can raise money by unloading shares to Chinese investors.

The State Council started setting up a national social security foundation to supervise the operation of the fund in September 2000. So far, the foundation has collected about 30 billion yuan (US$3.6 billion) of funds, mostly from funds gathered through selling part of the state holdings in Chinese companies during their overseas initial public offerings (IPOs) as well as some fiscal income. The State Council announced in June rules that require all listed companies to conduct similar selling during IPOs or secondary share issue. The funds raised will go to the national social security foundation. It is estimated about 200 billion RMB in capital (US$24.5 billion) would be raised every year from IPOs, about 10% of which goes to the national social security fund. However, in late October 2001, the CSRC eased its pressure on SOEs selling state assets because of worries of overly upsetting and swamping the market with shares. The pension liability is far from redeemed.

3.5 A LARGE POOL OF FUNDS WAITING TO BE INVESTED

The social security fund thus represents a large pool of money waiting to be invested. So far, most of China's pension funds are in cash earning abysmal interest rates and invested in closed-end funds. The government is expected to unveil regulations that formally allow social security funds to be invested in stocks before October 2001, a draft of which has been submitted to the State Council for final approval. This measure will further boost the market.

As an experiment, pension funds are allowed to buy shares in Sinopec, an oil company listed on the New York Stock Exchange. The restriction is going to be relaxed to allow buying shares in other Chinese listed companies. SRI criteria can be applied to companies when investing in pension funds.

3.6 TOO EARLY TO THINK ABOUT SRI?

Before we see the emergence of different investment channels and management styles in China, it is still too early to think about SRI. The country has too many fundamental financial problems that need to be tackled at this stage. SRI, to many Chinese, is at the top of the intellectual pyramid. Nonetheless prospects are on the bright side. Educating Chinese investors about SRI while they are still learning how to invest is the most effective way.

4. Corporate Governance and Environmental Issues Gain Prominence

As SRI issues such as environmental protection and corporate governance gain prominence in public debate, China will become more prepared to be attuned to the concept of SRI itself. The Green Games of 2008, a much-coveted gain, is an important incentive for China to clean up its capital and major cities. It also serves as an educational and awareness-raising exercise.

China's unique culture and political situation suggests that SRI is going to be selective and engagement driven. It is still highly sensitive to mention any human rights violations and labour exploitation.

4.1 CORPORATE GOVERNANCE

The Bank of China (BOC) President, Liu Ming Kang, told the Second Asia Development Forum that the Chinese government has made unremitting efforts to plant good corporate governance into its state-owned enterprise (SOE) restructuring. Much reform is needed. In May, Hong Kong-based 'Political and Economic Risk Consultancy' gave China a score of 8.22 points for its quality of corporate governance (on a scale of zero to ten, with ten being the worst).

The definition of corporate governance included the countries' willingness to make concrete steps to reduce corruption and improve corporate reporting. For example, the Consultancy report noted the importance of appointing independent outside directors, as well as the employment of professional disinterested auditors and the application of international accounting standards.

4.2 REFORM IS AT THE TOP OF THE OFFICIAL AGENDA

Laura Cha, Vice Chairperson of the China Securities Regulatory Commission (CSRC), was formerly Deputy Chairperson of Hong Kong's Securities and Futures Commission. A lawyer by training, she has established a reputation as a determined reformer with years of experience in regulating the securities market. At an international symposium on mutual fund development in April this year, Cha said that China will allow the establishment of joint venture securities and fund management companies in the near future, and institutional investment is encouraged. CSRC's top agenda this year is to improve corporate governance.

4.3 ENVIRONMENT

The Nature Conservancy, a US-based environmental protection organisation, conducted a Green Gauge Study on Greater China (China, Hong Kong, Taiwan and Singapore) in mid 1998. Encouragingly some of the findings indicated a growing interest in purchasing environmentally friendly products in mainland China.

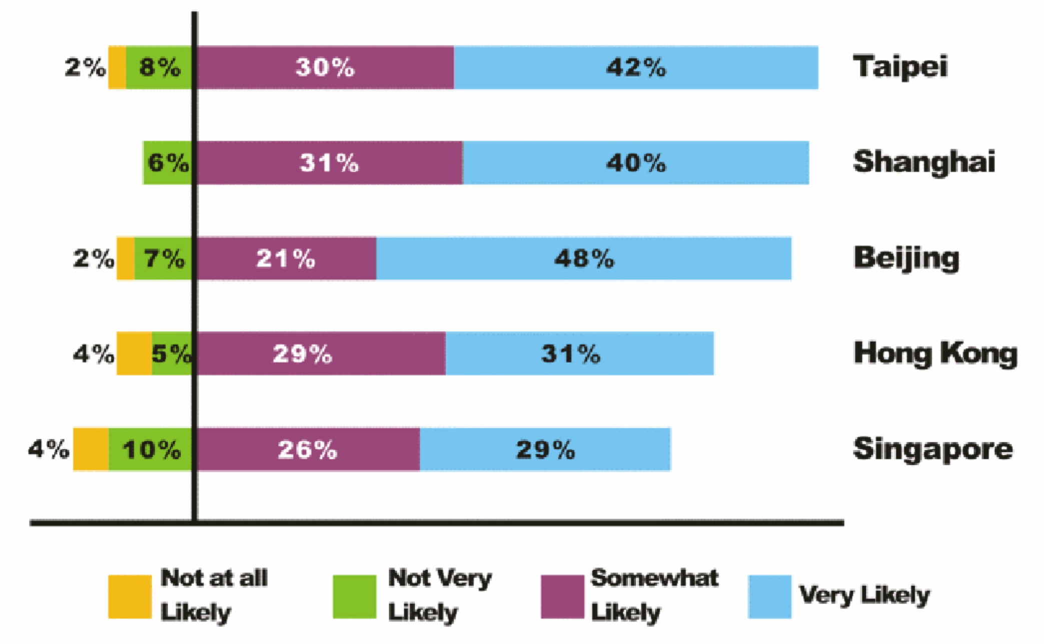
For the two major cities in China, Beijing and Shanghai, the survey found that residents in Beijing claim to be most knowledgeable when asked "how much you know about environmental issues", with 59% claiming to know "a fair amount". Shanghai ranked 49% for that category. In mainland China, women are considerably less likely than men to claim knowledge about the environment.

About 40% of Shanghai respondents said that it is "very likely" for them to switch over to buying products from environmentally friendly companies, while 48% from Beijing said the same. The figures are among the highest in Asian cities with Hong Kong (31%), Singapore (29%), Taipei (42%). See chart below.

The survey also found that 42% of Shanghai respondents favoured protecting the environment even at the expense of economic growth, while the figure for Beijing residents was 37%. The figure is higher than that of Taipei (32%), Hong Kong (23%), and Singapore (19%). This suggests that the Chinese have intensified concerns about the environmental impact of industrialisation and development over the past few decades.

According to the State Environmental Protection Administration of China, there are 15 environmental protection NGOs in China; and by end of August 2000, 125 universities were involved in environmental education.

How Likely Would Consumers Switch to Environmentally-Friendly Products if They Are of the Same Quality and Price to the Current One They Are using?



Source: The Nature Conservancy, 1998

4.4 GOVERNMENT ACTION

During the Ninth Five - Year Plan period (1997-2001), pollution control cost RMB 450 billion (US$55.2 billion). The government has realised that preventive action to reduce pollution is more cost-effective than cleaning up later.

The Distribution for Environmental Protection Expenditure (1997-2001)

Project	Expenditure (100 million yuan)	Proportion
Prevention and Control of Air Pollution	2,080	46%
Prevention and Control of Water Pollution	1,820	40%
Prevention and Control of Solid Waste Pollution	500	11%
Others	100	3%
Total	4,500	100%

4.5 HEALTH - A LARGE POPULATION OF SMOKERS

About two-thirds of China's male population, or 320 million people, are smokers. A study by the University of Hong Kong, the Department of Health and the University of Oxford in England predicted that smoking would kill three million a year in China by 2050. Smoking now kills about one million people a year, and unless habits change, the figure would double by 2025 and climb to three million a year by 2050. The figures are astounding - about 100 million people in China will be killed by tobacco over the next 50 years at this projected rate.

The Chinese government has launched a few anti-smoking campaigns in the past to no avail. However the topic is bound to get more heated in the future.