

**Local Authority
Pension Fund
Forum**

**Labour Standards in China
Best practice guidelines**

***Final Report of the
Local Authority Pension Fund Forum
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PREFACE

The Forum has a longstanding interest in overseas employment standards and between 1999 and 2003 it ran a successful campaign to persuade UK companies, particularly in the retail sector, to adopt and implement Codes of Conduct in relation to their overseas supply chains. The Forum's second benchmark study in 2003 demonstrated that the FTSE 100 retailers covered by its survey were making genuine efforts, predominately amongst their direct suppliers, to translate their codes into business practice.¹

Following from that study the Forum decided that investment by UK companies in the rapidly expanding economy of the People's Republic of China provided an obvious progression of its work on labour standards. An Interim Report was published in November 2005 which presented the results of a survey commissioned from PIRC on a range of knowledge-based industries – banks, pharmaceuticals and chemicals – that investigated how they are addressing and managing the risks related to operating in China, particularly with respect to labour standards. The five interviews conducted with senior managers and advisers in FTSE100 companies provided a unique insight into what methods are being adopted to protect and enhance shareholder value. These findings helped inform the Forum's initial best practice guidelines.

This Final Report follows a LAPFF consultation with stakeholders, especially with respect to the best practice guidelines, which raised no factual challenge to the findings from the previous survey of knowledge-based industries. However, the comments from stakeholders have certainly helped the Forum develop its best practice guidelines. The Forum intends to publish these guidelines as a separate Trustee Guide for Funds in assessing the employment risks and opportunities of investee companies in China. I anticipate that it will be very useful for Trustees in engaging with their Fund Managers on this issue or directly with the companies concerned. I commend its use by all Funds.

Acknowledgements

We extend our sincere appreciation to the stakeholders and China experts who responded to the Forum's invitation for comments on the interim report. We are particularly grateful to Stuart Bell of Ergon Associates Limited and Daniella Gould of Impactt Limited for their detailed observations. Naturally, though, responsibility for the final report rests solely with the Forum and PIRC, its Research and Engagement Partner.

This report was written by Laura Aarnio and edited by Peter Southwood, Consultancy Services Manager.

Councillor Darrell Pulk
Chair, Local Authority Pension Fund Forum

¹ LAPFF (December 2003), *Overseas Employment Standards: Second Benchmark Study*, Report of the Local Authority Pension Fund Forum, p. 2.

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EXECUTIVE SUMMARY

The Forum had identified China as a special case in terms of corporate social responsibility risks to institutional investors because of concerns over the lack of democratic or human rights, including the right of workers to join a trade union of their choice. The contravention of certain international labour standards may rebound on foreign companies operating in mainland China, in particular.

The LAPFF best practice guidelines have been developed as a framework for regular monitoring of companies to detect emerging concerns about risk and value destruction due to poor labour standards.

Background to the Trustee Guide

The principal objective of this LAPFF study was:

- To ascertain how UK FTSE 100 companies are addressing and managing the risks related to operating in China, particularly with respect to labour standards.

This Final Report and Trustee Guide is based, inter alia, on the LAPFF Interim Report published in November 2005, which contained a study of five FTSE 100 companies in knowledge-based industries and the Forum's initial best practice guidelines. Although the five firms differ from those in the low-cost export-manufacturing sector, that have been the main focus of other Western studies on China, the LAPFF Report showed that the companies concerned are engaged in many positive practices in China. The Interim Report was the subject of consultation with stakeholders and China experts in 2006.

While evidence from the LAPFF survey was based only on research into knowledge-based industries the best practice guidelines are structured to suit all industry sectors by taking into account the wider literature on this topic.

LAPFF Trustee Guide

Set against the background of China's labour market and economic transformation and associated corporate responsibility issues (in chapter 2), the initial best practice guidelines have been shortened and simplified in their final version (chapter 3) while more detailed questions have now been placed in the Appendix. Each section of the Guide offers a concise background to the issue, an authoritative benchmark for judging best practice and examples of criteria for assessment or how action might be taken on the issues. This is followed by a set of questions to put to fund managers or companies.

Recommendations on LAPFF Engagement

This report outlines a process by which the Forum can now engage with companies in the Chemicals, Food Producers, Retail and Oil & Gas sectors in particular, on the basis of the LAPFF Trustee Guide (chapter 4). It is recommended that the proposed engagement programme be undertaken jointly with other investors, whenever possible (chapter 5).

1. INTRODUCTION

The promotion of overseas employment standards at investee companies is not only consistent with LAPFF's mission statement, but also reflects the Funds' long term investment interest. Trustees have an active role to play in promoting good practice in corporate governance and social, ethical and environmental (SEE) matters, which is why the Forum has a longstanding interest in overseas employment standards and recognises the impact of good working conditions on productivity and efficiency.²

The Forum had identified China as a special case in terms of corporate social responsibility (CSR) and risks to institutional investors because of the country's complex web of laws, politics and culture. Foreign companies in China operate in an unusual business environment with distinctive labour conditions, where a gradual series of economic reforms and economic liberalisation has not so far been accompanied by a similar transformation of political and civil rights. A key area of concern is the lack of democratic or human rights, including the right of workers to join a trade union of their choice, as well as the contravention of certain international labour standards and how this may rebound on foreign companies operating in China.

These guidelines have been developed as a framework for regular monitoring of companies to detect emerging concerns about risk and value destruction due to poor labour standards. They aim to provide an independent mechanism for assessing labour standards as well as indicators for measuring the effectiveness of managing employment risks and opportunities in investee companies with major operations in China.

Background to the Trustee Guide

This Final Report and Trustee Guide is based, inter alia, on the LAPFF Interim Report published in November 2005 and a subsequent consultation with stakeholders and China experts on its findings and the initial best practice guidelines.

The objectives of this LAPFF study were to:

- Ascertain how UK FTSE 100 companies are addressing and managing the risks related to operating in China, particularly with respect to labour standards.
- Publish a report on the study and its findings.
- Produce an investor guide to best practice in assessing the employment risks and opportunities of investee companies in China.

² . See background in LAPFF (December 2003) *Overseas Employment Standards: Second Benchmark Study*, Report of the Local Authority Pension Fund Forum.

It was decided that the optimum method of ascertaining how FTSE 100 companies were addressing risks in China was through a semi-structured interview with corporate representatives. The Interim Report provides details of the five companies including two banks, two pharmaceutical companies and one chemicals firm which agreed to be interviewed on the basis of a questionnaire to find out how they are managing risks and implementing employment policies and practices in mainland China³. In order to assess whether the structure and content of the questionnaire were appropriate, stakeholder organisations including Trades Union Congress, Impactt Limited and Pricewaterhouse Coopers were consulted for their views.

The Forum recognised, in its Interim Report, that the knowledge-based industries in its survey differ greatly from the experiences of the low-cost export-manufacturing sector (like textiles) that have been the main focus of other Western studies on China. However, its study demonstrated that the companies concerned are engaged in many positive and encouraging practices in China, which show what foreign firms can achieve. It also revealed that, having well-developed global corporate responsibility policies, companies in the sample did not see the necessity or desirability for China-specific CSR objectives. Therefore engagement with FTSE 100 companies in China needs to be based on an assessment of the effectiveness of their management of employment risks rather than requiring the development of China-specific policies, unless a convincing need for special treatment can be established. Migrant labour may be such a case.

Stakeholder Consultation

The Interim Report recognised that a limitation of the study was that evidence of working practices in China was solely obtained from a management perspective as interviewees were senior corporate representatives. Consequently a stakeholder consultation has been conducted in order to seek further evidence on the findings and suggestions for improvements to the Trustee Guide from both stakeholders and also experts with direct experience and knowledge of labour issues, especially in China.

The Interim Report was the subject of presentations to a workshop at the 2005 LAPFF Conference and to an international seminar organised by Dexia Insurance Services in Brussels on 21 April 2006. Then in July and August this year letters were sent to about two dozen stakeholders including China experts inviting comments on the issues raised by the research and, in particular, on the draft best practice guidelines.

The Final Report and best practice guidelines have been written taking into account feedback from this consultation, in particular, Daniella Gould at Impactt and Stuart Bell at Ergon Associates. Moreover, it is important to note that while evidence from the Interim Report was based only on research into knowledge based industries the best practice guidelines in this Final Report are structured to suit all UK industry sectors with operations or supply chains in China. It does so by drawing on the wider literature on this topic.

³ Two banks, HSBC and Standard Chartered, and two pharmaceutical companies, Astrazeneca and GSK, agreed to speak on the record and the one chemicals firm gave evidence on a non-attributable basis.

2.0 THE PEOPLE'S REPUBLIC OF CHINA

The Labour Market and Economic Transformation

China's labour market has witnessed significant changes since 1978, which marked the start of a gradual series of economic reforms transforming the state planned economy towards a market system. The economic reform programme has been judged as an overwhelming success as it has encouraged successfully the formation of rural enterprises and private businesses, liberalised foreign trade and investment, relaxed state control over some prices, and invested in industrial production. Additionally, following liberalisation, China has witnessed average real growth of more than 9 percent a year and per capita income has nearly quadrupled in the last three decades.⁴

China's increasing openness to foreign direct investment (FDI) has also contributed to its exceptional growth performance. Collectively, foreign companies have benefited from China's cheap and abundant labour force. However, FDI has been directed towards coastal areas and cities, creating large scale disparities in term of growth and industrialisation between the coastal and urban areas and inland regions. Furthermore, aggregated figures measuring China's prosperity conceal the uneven distribution of this wealth between rural and urban areas (Figure 1) as well as between men and women.⁵

Additionally, China has been witnessing an increasing gap between labour supply and demand due to regional disparities and has experienced a mass migration of rural workers to its industrialising cities and export centres. Because of fixed residency permits, these migrant workers are considered by many permanent workers to be inferior and face institutionalised discrimination in the workplace. Also as temporary permits are difficult to secure and the system is open to corruption, most migrant workers are employed illegally and are often paid below minimum wage and made to work excessively long hours.⁶

Economic liberalisation and the subsequent privatisation and restructuring of the previous state owned enterprises, has been followed by the enormous task of transforming China's labour force to accommodate the new capitalist system. This has involved reforming soft budget constraints characterising the state controlled system and gearing work force incentives towards a competitive and profit driven market system.⁷ Because the former system was designed to suppress individual initiative and effort, this has had severe implications for adapting to a new competitive environment, which in turn has led to a shortage of appropriate managerial talent and skilled labour. After a legacy of central planning, which was characterised by a lack of private ownership and especially of small and medium-sized firms, Chinese companies tended to remain very hierarchical and rigid

⁴ IMF (2006), *Economic Issues 8: Why is China Growing so Fast*, p. 1.

⁵ Human rights in China (2006), *Implementation of the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW) in the People's Republic of China*, p.1.

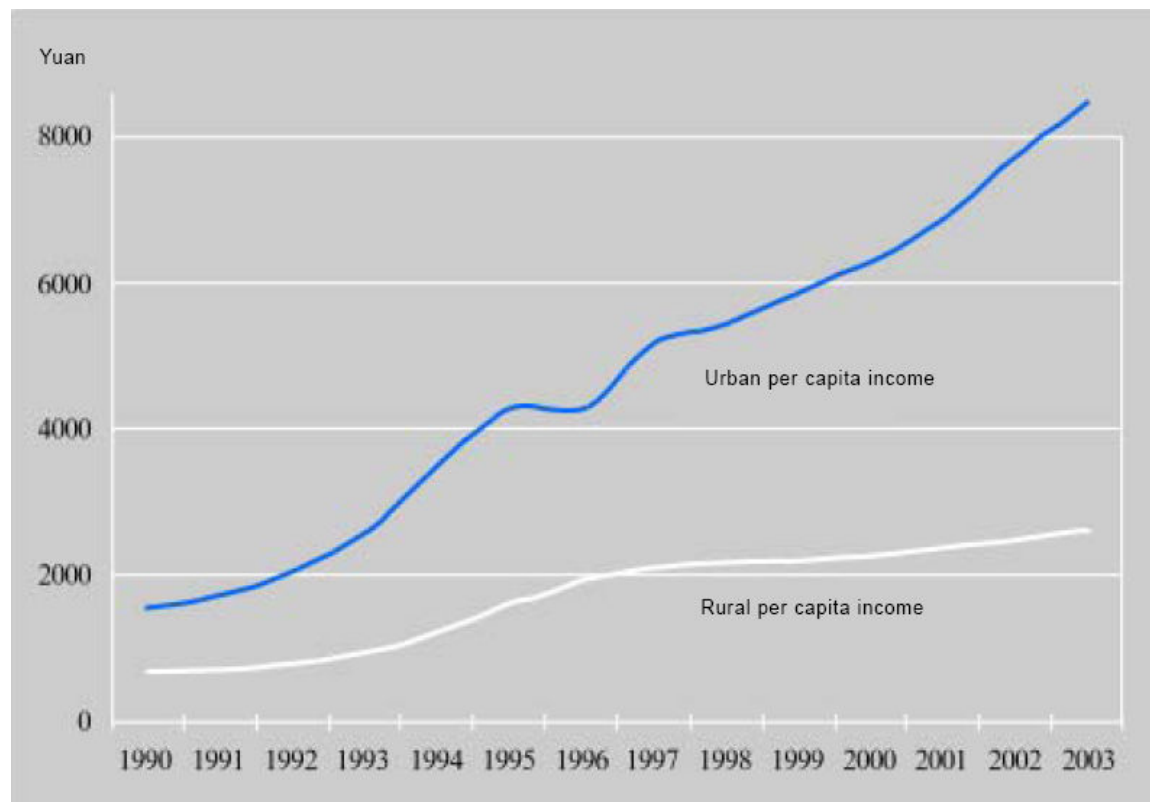
⁶ UNDP (2005), *Human Development Report: China 2005*, p.49.

⁷ UNDP (2005), *Human Development Report: China 2005*, p.32.

in which few had the incentive or power to change the structure and diversify their activities.

FIGURE 1

Trends in per Capita Income of Urban and Rural Residents 1990-2003



Source: *UNDP Human Development Report: China 2005* (based on data of National Bureau of Statistics, 2004: 357.)

Additionally, with the restructuring of state owned enterprises, workers have not only been faced by a new profit driven economic environment, but also have been deprived of a system of lifetime benefits. With rising levels of unemployment and poverty and no welfare state to support them, workers have often been demoralised by the changing circumstances.

The Labour Market and Corporate Responsibility

Labour Laws and Human Rights

Throughout the reform era China has remained a one party state under the control of the Chinese Communist party. Although the economic reform process has been accompanied by the introduction of a new legal and regulatory framework to attract foreign investment to the country, this is marred by corruption as well as a lack of clarity and enforcement measures. Additionally, economic liberalisation has not been accompanied by a similar transformation of civil and political rights⁸. Weak and corrupt legal institutions mean that workers remain unaware of their rights and are reluctant to speak out and demand their legal entitlements⁹. Moreover, the continuation of the communist state has had serious implications in terms of the slow development of civil reforms and a social security system and has allowed policymakers to delay addressing major problems such as rising unemployment and the growing number of migrant workers.

A key area of concern is China's contravention of certain international labour standards and how this may rebound on foreign companies operating in China. The country is a member of the International Labour Organisation, however, it has not signed all of the conventions such as those governing freedom of association or collective bargaining and occupational safety and health.¹⁰

China has also enacted a relatively comprehensive regulatory regime, such as through the 1994 Labour Law, and amended the constitution in 2004 to incorporate human rights.¹¹ However, significant human and labour rights issues exist particularly with regard to wages, working hours and social security entitlements. Additionally, disciplinary measures are not uncommon under managerial regimes that continue to be hierarchical and repressive.¹²

Trade Unions

The Chinese Trade Union Law (1992) spells out the organisational structure of trade unions and defines their rights and obligations, however it does not grant workers the right to join a union of their own choosing and the right to strike.¹³ While the right to strike is not specifically mentioned in the ILO Conventions 87 (Freedom of Association) and 98 (Right to Organise and Collective Bargaining), neither of which have been signed by China, the deletion of the right to strike from the revised 1982 Chinese Constitution has

⁸ Serena Lillywhite (2002), *Sustainable Foreign Direct Investment- Supply Chain Management and Labour Rights in China*, OECD, Global Forum on International Investment, p. 6.

⁹ Thomas Lum (2003), *Workplace Codes of Conduct in China and Related Labor Conditions*, Congressional Research Service, The Library of Congress, p. 2.

¹⁰ Tony Fung Kam Lam (2000), *Occupational Safety and Health in China*, p. 1.

¹¹ Human Rights Watch (January 2005), *Country Report: China, Human Rights Overview*, p.1.

¹² Human Rights in China (2001), *Promoting Human Rights in China*, p. 5.

¹³ Ying Zhang-White (1999), *An Unsafe Playing Field: Labor Relations in Foreign Enterprises in China*, Harvard Asia Quarterly, p. 1

been criticised in successive trade union complaints to the ILO against the Chinese government.¹⁴

In 2001 the Trade Union Law was amended resulting in some significant gains to employees. For instance, women were guaranteed representation in the workplace and consultation rights of trade unions were reinforced.¹⁵ Nonetheless, independent trade unions continue to be prohibited in China as all unions must be affiliated and subordinate to the All China Federation of Trade Unions – a body controlled by the Chinese Communist party. Consequently, trade unions occupy a paradoxical position in Chinese industrial relations. On the one hand, they represent workers' interests, and on the other, they keep in check union activism.¹⁶ Lack of independent trade unions signifies that there are no means of bargaining for better employment standards or formal channels of communication and reporting of labour issues. Additionally, due to the trade union appointment and promotion system, unions are also connected to the management as senior executives can be union members or even hold high level union positions. Channels of information are therefore limited as unions fail to reflect workers' views to the management and act as reporting mechanisms for any violations of labour laws. With these legal, structural and cultural constraints, unions do not provide workers with an effective machinery to bargain for better pay and working conditions.

Health and Safety

Many Chinese workers face extremely poor working conditions, including unsanitary and poorly ventilated work places and they are often exposed to dangerous chemicals or explosive materials or have to carry out other dangerous work without the necessary safeguards. As a result, industrial accidents are common. Despite the promulgation of new laws and regulations in 2002, such as the Work Safety Law, lack of enforcement and implementation are major obstacles to any improvements to occupational safety and health performance.¹⁷ Because of the speed of industrialisation, China's occupational health and safety structure has lagged behind and there is an acute shortage of work safety awareness and strict supervision as well as competent occupational health professionals. Additionally, because of backward infrastructure in many dangerous and risky sectors, such as coal mining, working conditions are below average contributing to a high frequency of health and safety incidents as well as the prevalence of occupational diseases. A full picture about health and safety performance is difficult to obtain because official statistics are not reliable due to under-reporting and low estimation.¹⁸ Resulting from the lack of independent collective organisation, worker action and information channels are limited and many incidents remain unreported.

¹⁴ John Chen (2001), *China and the ILO*, Asian Labour Update. p.1

¹⁵ Amnesty International (2002), *People's Republic of China: Labour Unrest and the Suppression of the Rights to Freedom of Association and Expression*, p.6.

¹⁶ *China* (2005), International Centre for Trade Union Rights, www.ictur.labournet.org/TUWChina.htm

¹⁷ Tim E. Pringle and Stephen D. Frost (2003), "The Absence of Rigor and the Failure of Implementation": *Occupational Health and Safety in China*, p.1.

¹⁸ Tony Fung Kam Lam (2000), *Occupational Safety and Health in China*, p. 3.

Diversity

Although the Chinese Labour Law prohibits discrimination on the basis of nationality, sex, race and religion, discrimination is common in China especially among women and migrant workers.¹⁹ Apart from the violation of migrant workers' and women's rights to equal opportunity in the employment market, common violations of their labour rights include long working hours, low wages and dangerous working conditions.

There are arguments that economic liberalisation has not worked to women's advantage in terms of economic benefits and that a disproportionate number of women workers in the state-owned enterprises have lost their jobs and have found it difficult to find new ones.²⁰ It is estimated that women constitute between 60-70% of those laid off.²¹ Women are generally disadvantaged because of their lack of education and/or necessary skills as well as their lower social status than men. Additionally, although maternity benefits are guaranteed under different laws and regulations, there is no dependable national welfare system and employers are reluctant to hire women of reproductive age. The majority of female jobs are occupied by rural women, who work in township and village enterprises (TVEs), or rural single women who work in coastal, export oriented industries for short periods of time.²²

Because migrant workers are required to have a temporary residency permit in order to legally work outside their place of birth, which must be renewed annually,²³ they are often subject to discrimination or work illegally in factories. Migrant employees are also disadvantaged because it is difficult for the employer to provide all statutory benefits (e.g. pension, health, housing and education) to them, as they are not registered to work in the region.²⁴ They often live at work sites where conditions in the dormitories are overcrowded and lack basic facilities like showers. Also, in many cases they have very strict rules in the factory compounds and severe restrictions on movement.²⁵ This renders them particularly vulnerable to abuse and penalties for violating such rules include dismissal, fines, and even physical ill-treatment.

¹⁹ UNDP (2005), *Human Development Report: China 2005*, p. 38.

²⁰ Scott Rozelle, Xiao-Yuan Dong, Linxiu Zhang, Andrew Mason (2002), *Gender Wage Gaps in Post-Reform Rural China*, World Bank, p. 4.

²¹ Elaine Zuckerman, Alf Blikberg and Menglin Cao (2000), *China Country Gender Review*, World Bank, p. 5.

²² Elaine Zuckerman, Alf Blikberg and Menglin Cao (2000), *China Country Gender Review*, World Bank, p. 5. And also see Serena Lillywhite (2002), *Sustainable Foreign Direct Investment- Supply Chain Management and Labour Rights in China*, OECD, Global Forum on International Investment, p. 4.

²³ <http://www.amrc.org.hk/5305.htm>

²⁴ UNDP (2005), *Human Development Report: China 2005*, p.10.

²⁵ Thomas Lum (2003), *Workplace Codes of Conduct in China and Related Labor Conditions*, Congressional Research Service, The Library of Congress, p. 3.

Wages and Working Hours

Although the Labour Law (1994) sets a minimum wage and stipulates the number of hours that employees should work, weak enforcement and implementation renders the system open to abuse. China's provinces and cities individually legislate for minimum wage standards, which vary widely across the nation and are geared to prevailing income levels and market conditions. Consequently, there are a number of ambiguities and disparities associated with minimum wages, making it even more difficult to monitor compliance.

High levels of unemployment and excess supply of labour migrating from the rural areas have contributed to the low level of wages. There is evidence that many people, despite working far in excess of the maximum number of working hours, do not receive a living wage and cannot afford to keep a family above the poverty line.²⁶ Low pay has been traditionally associated with the export oriented manufacturing industries, which are labour intensive and are characterised by low skilled labour. The manufacturing sector is a very competitive industry and, given the low prices paid for its goods, profit margins are low and the market rate for wages is driven down by continuous attempts to cut costs. Additionally, many workers are paid on a piece rate basis and under such a quota system minimum wage requirements are very difficult to enforce as pay is calculated according to the number of items produced.

Sectors such as the financial industry face a reverse of the situation of the export-manufacturing sectors. The primary risks and challenges experienced by firms in these sectors are recruiting, retaining and developing personnel because of a shortage of skilled and experienced labour in China.

However, the issue of long working hours and unpaid overtime is one that applies to a range of industries. In the export factories, there is a culture of long working hours, which exceed legal maximum hours. There appears to be a number of reasons for this problem, often related to the nature of export markets. There is evidence that long hours are not only associated with low productivity and quality of products, but in many factories with hazardous working conditions, excessive hours are one of the most common labour abuses and causes of sickness and accidents.²⁷

²⁶ UNDP (2005), *Human Development Report: China 2005*, p.91.

²⁷ Thomas Lum (2003), *Workplace Codes of Conduct in China and Related Labor Conditions*, Congressional Research Service, The Library of Congress, p. 10.

3. FORUM BEST PRACTICE GUIDELINES

Who the Guidelines Are For

The initial best practice guidelines in the Interim Report constituted ‘a very useful and comprehensive set of questions’, in the view of one stakeholder, before highlighting a dilemma: ‘Maybe too comprehensive for Trustees to use to check up on their manager, though appropriate for direct engagement with companies either by Trustees, managers or PIRC [as the Forum’s Research and Engagement Partner].’

In reviewing the evidence from the stakeholder consultation, some of which produced more detailed questions about key labour issues in China, it was decided that the main Trustee Guide (as the LAPFF best practice guidelines are now called) should be shorter and simpler. This could be used to help Trustees ensure that their fund managers are on top of the issues. The more detailed questions would be put in an Appendix to this Final Report for use by larger Funds and by LAPFF itself for engagement in specific cases where labour issues have to be probed in depth.

How to Use this Trustee Guide

This Guide aims to assist Trustees of Funds to seek and evaluate evidence from their fund managers, or directly, on whether investee companies are objectively assessing the employment risks and opportunities of doing business in China. The ultimate purpose of this engagement is to protect or enhance long term shareholder value.

These best practice guidelines are intended to give Trustees an insight into material issues for each aspect and set out relevant questions to ask fund managers or investee companies themselves. While many UK listed companies will do business with mainland China, the Forum Trustee Guide is likely to be most appropriate for those whose investment there, either directly or through supply chains, is significant enough to merit reference in their voluntary OFRs or mandatory Business Reviews.²⁸ Trustees may wish to focus on any such investee company (referred to simply as ‘the company’ in this Guide) whose assessment of employment risks and opportunities in China appears to lack transparency and accountability in objective terms. This is discussed further in the next chapter on engagement.

Benefits for the Fund

The Guide has been written by PIRC with due attention to the resource and time constraints that Funds face. It will enable Trustees and officers to conduct periodic reviews of their fund managers’ engagement activities affecting China, in order to:

²⁸ . The demise of the statutory OFR but continued significance of the Business Review, based on the EU Accounts Modernisation Directive, is summarised in LAPFF (September 2006), *Holding Fund Managers to Account: Delegation of Engagement to Fund Managers*, pp. 15-16.

- Initiate a dialogue between Funds and their managers about engagement in this area;
- Develop a better understanding of how their fund managers engage on China issues;
- Enable an assessment of engagement progress along with quality and effectiveness;
- Open up opportunities for improvements to current strategy, policy and practice of companies operating in China;
- Get the most out of fund managers' and the Forum's engagement services.

Structure of the Guide

Trustees can read this Guide as a whole or refer to each relevant section separately. For example a company with health & safety issues in China may require a Trustee to read only section A on 'Corporate Objectives and Strategy' and the sub-section in B on H&S. Each section offers a concise background to the issue, an authoritative benchmark and examples of criteria for assessment or how action might be taken on the issue concerned. This is followed by a set of questions to put to fund managers or the companies concerned.

Sources for benchmarks and explanation of technical terms are contained in the glossary.

INVESTING IN CHINA: LABOUR STANDARDS

A Corporate Objectives and Strategy

Although China represents a major market offering long-term growth opportunities to many foreign enterprises, across various sectors, China is clearly more central to some firms' core business strategies than to others. Therefore, for a UK listed company, it is vital that Trustees identify what China represents in the company's strategy and whether the country is significant through direct operations or the supply chain. This is not only important for recognising any sector specific CSR objectives and issues that are relevant to the company, but also in understanding the company's operating context at the local level and/or significant relationships with local enterprises.

A listed company should include details, in its OFR or Business Review, of the main trends and factors likely to impact its future prospects and, therefore, of China if it represents one of their major potential markets. Additionally, companies should report on risks and uncertainties affecting long-term value and acknowledge any risks and opportunities associated with its operations in China. This should include recognising the distinctive features of the Chinese labour market and the company's approach to managing it. Generally, however, the findings in the LAPFF Interim Report suggest that companies will have well-developed global corporate responsibility policies but no special CR objectives in China.

Choice of criteria	<p>Trustees adopt company-specific evaluation criteria, depending on the nature of the business in China and the particular sector, when analysing the report and accounts. Also, trustees examine whether special CR issues or risks have been identified in relation to China. These could allow, for example, an assessment of how far the company is aware of relevant risks and be aimed at identifying:</p> <ul style="list-style-type: none"> • Whether the company has direct operations through production in China • Whether the company sources from Chinese partners (contracted labour) • What is the nature of business in China and risks involved (e.g. high-tech manufacturing or low-skill, labour intensive production for export; banking services)
Benchmark	<p>‘The OFR should have a forward-looking orientation, identifying those trends and factors relevant to the members’ assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives.’ [ASB, <i>Reporting Statement: OFR</i>, paragraph 8.]</p> <p>‘Directors should consider the potential future significance of issues in deciding whether or not to include an analysis of them in the OFR.’ [ASB, <i>Reporting Statement: OFR</i>, paragraph 49.]</p>
Information source	<p>Methods of assessment will be based on a number of sources:</p> <p>Principal sources:</p> <ul style="list-style-type: none"> • Annual Report and Accounts: OFR, Business Review, Directors’ Report <p>Other sources:</p> <ul style="list-style-type: none"> • Internal control statement • CSR/Sustainability Report • Company website • Direct engagement with company

1.1. Key questions to ask your fund manager or the company

1.1.a	What significance does China have in the company’s strategy? What is the company’s nature of business/operations in China?
1.1.b	Has the company provided evidence in its Report and Accounts that it has fully analysed the potential significance of the Chinese market for the long term and the associated risks and opportunities?
1.1.c	Have the company’s global CR policies been adapted appropriately in China including consideration of special policies, where necessary?

B Employment risks and opportunities

Labour Laws and Human Rights

The existence of a system of law that ensures compliance is essential to protect workers rights. The Chinese legal system and culture do not provide strong institutional support for compliance with labour law, which is also often inconsistent and ambiguous. Additionally, because of China's contravention of certain international labour standards, workers have limited safeguards under international conventions as applied by their own government. Trustees, therefore, need to ensure that companies have relevant policies addressing issues such as human rights and appropriate measures for protecting workers from abuse and safeguarding good labour standards.

Benchmark	The company is a member of the UN Global Compact ^(a) and/or supports the UN Universal Declaration on Human Rights (UDHR) ^(b) , the OECD Guidelines for Multinational Enterprises ^(c) , the ILO Core Conventions ^(d) or the Global Sullivan Principles ^(e) .
Action	Trustees need to ensure that that the company has a policy on human rights and relevant reporting on human rights issues. These could be aimed, for example, at identifying <ul style="list-style-type: none"> • Whether the company refers to international conventions • Whether the company is certified to standards such as the SA8000^(f), which provides guidelines defining basic human rights of workers • Whether the company has a policy or code of conduct on labour standards for suppliers

2.1 Key questions to ask your fund manager or the company

2.1.a	Has the company signed up to one or more of the international Codes of Conduct?
2.1.b	Does the company have a group wide human resources/human rights policy covering wage and benefits, worker rights, procedures on recruitment, discipline, promotion and grievance etc?
2.1.c	Which board director, if any, has ultimate responsibility for labour rights or human rights (as distinct from human resources)? Also do the Chinese subsidiaries have an adequate HR function?
2.1.d	Has the company undertaken a review of its purchasing practices, particularly with respect to supply chains in China, to determine its main employment risks and if it is contributing to good or poor labour standards?
2.1.e	Is regular training provided to all employees in China at every level on labour rights and group policies on employment standards?

Trade Unions

Freedom of association is a constitutional right in China but workers cannot join a union of their own choosing, effectively negating this right. Because freedom of association in the workplace, outside the only recognised trade union (ACFTU),⁽⁹⁾ is not possible collective bargaining for better pay and labour conditions is limited. Additionally trade union representatives usually also hold senior or management positions, indicating that labour conditions are set by unilateral management decisions. As trade unions in China are generally ineffective in protecting labour rights, Trustees should be examining whether companies encourage worker participation and opportunity for dialogue through other channels of communication such as forums and relevant committees.

Benchmark	Businesses should uphold freedom of association and the effective recognition of the right to collective bargaining [UN Global Compact, principle three].
Action	Trustees need to ensure that the company has a policy on freedom of association as well as mechanisms providing opportunities for dialogue for Chinese workers.

2.2 Key questions to ask your fund manager or the company

2.2.a	Does a union organisation exist within the company? If not, do any alternative mechanisms for employee negotiation and consultation exist in the company?
2.2.b	Where there is a trade union, was the union representative elected by employees through a secret ballot or nominated by the ACFTU or management of the company?

Health and Safety

The Chinese Labour Law (1994) is very broad, in terms of health and safety, and states that working conditions must be safe and workers should be provided with appropriate health and safety training. If hazardous materials are used, there should be controls and emergency plans in place and supervision provided. Workers must also be advised of any areas of their work that involves hazards.²⁹

Implementation and enforcement of the law is not only poor, but also because of the lack of independent trade unions and effective channels of information, it is difficult to assess the nature and frequency of occupational accidents or diseases and many incidents remain unreported. Consequently, Trustees need to ensure that appropriate policies are in place and question how workplace conditions are monitored. Trustees should also be asking whether companies encourage worker participation through other channels such as health and safety committees.

²⁹ . Adapted from Global Alliance, Appendix 2 'Summary of Chinese Labor Law and Other Relevant Regulations, esp. 82-4.

Benchmark	A safe and hygienic working environment shall be provided, bearing in mind the prevailing knowledge of the industry and of any specific hazards. Adequate steps shall be taken to prevent accidents and injury to health arising out of, associated with, or occurring in the course of work, by minimising, so far as is reasonably practicable, the causes of hazards inherent in the working environment. Workers shall receive regular and recorded health and safety training, and such training shall be repeated for new or reassigned workers. Access to clean toilet facilities and to potable water, and, if appropriate, sanitary facilities for food storage shall be provided. Accommodation, where provided, shall be clean, safe, and meet the basic needs of the workers. The company observing the code shall assign responsibility for health and safety to a senior management representative. [ETI Base Code, 3.1 – 3.5.] ^(h)
Action	Trustees need to ensure that the company has a policy on health and safety and that it has relevant reporting on health and safety issues in China.

2.3 Key questions to ask your fund manager or the company

2.3.a	Have the Chinese operations or supply chains established H&S policies, H&S committees or a relevant system of regular H&S risk assessments?
2.3.b	How is relevant data on H&S provided? Does the company monitor H&S performance in China?
2.3.c	Have there been any serious H&S incidents in the company or, where appropriate, its supply chain in the last three years? Has the company undertaken to improve the safety record of its Chinese operations or supply chains?

Diversity

Migrant workers are one of the most vulnerable groups in China due to discrimination and their subordinate social status. Although migrant labour is a distinctive feature of the Chinese labour market, it is important to note that other forms of discrimination also exist against minority groups and women. Trustees therefore should be considering whether companies place importance on equal opportunities and diversity and disclose relevant policies and procedures to promote them.

Migrant workers not only occupy most of the time all the dirty, difficult and dangerous jobs, they are also most vulnerable to disciplinary action. Furthermore, because of their subordinate or sometimes even illegal status, it is often difficult for them to raise grievances and have disputes resolved without risking reprisal. For this reason, monitoring as well as providing relevant training should be a key part of managing risks concerning disciplinary and diversity issues. This might include management training or workshops for providing information on disciplinary measures and on the elimination of discrimination in the workforce.

Benchmark	There is no discrimination in hiring, compensation, access to training, promotion, termination or retirement based on race, caste, national origin, religion, age, disability, gender, marital status, sexual orientation, union membership or political affiliation [ETI Base Code, 7.1].
Action	Trustees need to assess that the company has a detailed policy on the equal opportunities covering all relevant aspects and that it has relevant reporting on diversity issues. Monitoring diversity performance should be considered paramount.

2.4 Key questions to ask your fund manager or the company

2.4.a	Does the company have a policy on equal opportunities and does it monitor diversity within its Chinese operations?
2.4.b	How many Chinese employees in the company are migrants, i.e. persons originally from another region of China but now living and working near their place of work?
2.4.c	What policies, systems and training are in place at the company to manage the issue of discipline?
2.4.d	Has the company encountered any unreasonable disciplinary measures taken against employees in China or supply chain workers?

Wages and Working Hours

The Chinese law provides that the maximum number of hours to be worked in a week is 40, excluding overtime, and that there should be a rest period of 24 hours each week. Overtime in excess of three hours per day or 36 hours per month is prohibited. Any work done as overtime must be paid at an additional rate.³⁰ Due to ambiguities concerning the labour law, and weak enforcement, Trustees should be seeking to ensure that companies are committed to a set maximum hours of work per 24-hour period and per week as well as to complying with applicable laws and industry standards on working hours.

Chinese labour law requires local governments to set minimum wages with resulting regional variations. This is another area of the law that is ambiguous since it is unclear if the minimum wage includes all deductions.³¹ Recently, the number of companies required to pay the minimum wage was increased so that now enterprises with fewer than eight employees must adhere to the minimum wage and part-time workers must receive an hourly minimum wage.³² Wages, however, are pushed down by high unemployment in many regions and the growing number of migrant workers, and arguably also by the absence of any widespread system of collective bargaining. Trustees need to ensure that companies have relevant policies and are committed to paying salaries that comply with local laws or match prevailing industry standards.

³⁰ Global Alliance (2004), p.86

³¹ Global Alliance, p.84.

³² <http://www.state.gov/g/drl/rls/hrrpt/2004/41640.htm>

<p>Benchmark for working hours</p>	<p>Working hours comply with national laws and benchmark industry standards, whichever affords greater protection. In any event, workers shall not on a regular basis be required to work in excess of 48 hours per week and shall be provided with at least one day off for every 7-day period on average. Overtime shall be voluntary, shall not exceed 12 hours per week, shall not be demanded on a regular basis and shall always be compensated at a premium rate [ETI Base Code, 6.1 – 6.2].</p> <p>Many company codes prescribe a maximum of 60 hours per week, including a maximum of 48 hours regular time and voluntary overtime not exceeding 12 hours. All codes should allow for a day off per week. The SA8000 allows for mandatory overtime if this is part of a collective agreement.</p>
<p>Benchmark for minimum wages</p>	<p>Wages and benefits paid for a standard working week meet, at a minimum, national legal standards or industry benchmark standards, whichever is higher. Wages should always be enough to meet basic needs and to provide some discretionary income. All workers shall be provided with written and understandable information about their employment conditions in respect to wages before they enter employment and about the particulars of their wages for the pay period concerned each time that they are paid. Deductions from wages as a disciplinary measure shall not be permitted nor shall any deductions from wages not provided for by national law be permitted without the expressed permission of the worker concerned. [ETI Base Code, 5.1-5.3].</p>
<p>Action</p>	<p>Trustees need to ensure that the company acknowledges it has relevant policies on working hours and wages and is committed to reporting on performance. Questions could be aimed, for example, at identifying</p> <ul style="list-style-type: none"> • Whether the company has a policy concerning long hours • Whether the company has a policy concerning minimum wages • Whether the company monitors performance and conducts surveys • Whether the company monitors performance and conducts surveys of suppliers

2.5 Key questions to ask your fund manager or the company

<p>2.5.a</p>	<p>Does the company have a policy on minimum wages and maximum working hours?</p>
<p>2.5.b</p>	<p>Does the company monitor low pay and long working hours within its Chinese operations and, where appropriate, at least its first-tier suppliers?</p>
<p>2.5.c</p>	<p>Does the company require its Chinese suppliers to issue their workers with written contracts, which clearly define their terms and conditions of employment?</p>

Annex - Glossary

- (a) **UN Global Compact** This is a voluntary initiative launched by the UN Secretary-General Kofi Annan in 1999. Corporate signatories signed up to the Compact's 10 principles which cover human rights, labour rights, the environment and anti-corruption. Corporations are expected to uphold these principles within their sphere of influence. In order to participate in the Global Compact, companies' chief executives must give their commitment. Participating companies are requested to disclose in their annual reports how they are supporting the 10 principles. The Compact is the world's largest corporate citizen initiative.
- (b) **Universal Declaration of Human Rights** The Universal Declaration of Human Rights (also UDHR) is a declaration adopted by the United Nations General Assembly (A/RES/217, December 10 1948), outlining a view on basic human rights. There are a total of thirty articles outlining people's human rights although there is no enforcement mechanism.
- (c) **OECD guidelines for multinational enterprises** The OECD Guidelines for Multinational Enterprises are non-binding recommendations addressed by governments to multinational enterprises. They provide voluntary principles and standards for responsible business conduct consistent with applicable laws. The Guidelines are part of the OECD Declaration on International Investment and Multinational Enterprises.
- (d) **International Labour Organisation (ILO)** Founded in 1919, the ILO is the UN specialised agency which seeks the promotion of social justice and internationally recognised human and labour rights. The ILO formulates international labour standards in the form of Conventions and Recommendations setting minimum standards of basic labour rights. It promotes the development of independent employers' and workers' organisations and provides training and advisory services to those organisations.
- (e) **Global Sullivan Principles** The principles are a code of conduct, which include key labour rights and a commitment to work with stakeholders, including governments and communities. Endorsers of the Principles commit to work towards the aspiration that all of the Principles represent, including the implementation of internal policies, procedures, training and reporting structures. There is annual reporting of progress made by companies.
- (f) **SA8000** SA8000 is a certification standard for international labour standards to ensure ethical sourcing of goods and services. SA8000 is a voluntary standard and can be applied to any size of organisation or business across all industries. It is based largely on ILO conventions and sets basic standards for: child labour, forced labour, health and safety, freedom of association and the right to collective bargaining, discrimination, disciplinary practices, working hours, compensation.
- (g) **All China Federation of Trade Unions (ACFTU)** ACFTU has a monopoly over trade union activity in China and is an arm of the state. All trade unions must be affiliated to this body and those that do not are considered to be illegal in China. As ACFTU is part of the state it is not deemed to be an independent organisation. Its main purpose is to control union activity, although it also carries out a representative function for its members. However, given that it is not independent, it cannot effectively represent its members' interests when these are in conflict with the state.

^(h) **Ethical Trading Initiative (ETI)**

This is a tripartite organisation established by the UK government in 1999. Its members consist of corporations, trade unions and NGOs. The ETI takes an experimental approach to implementing codes of conduct. The ultimate aim of the ETI is to ensure that the working conditions of workers producing for the UK market meet or exceed international labour standards.

4. LAPFF ENGAGEMENT WITH FTSE 100 COMPANIES

Introduction

The dissemination of the LAPFF Interim Report and the extensive consultation exercise undertaken did not produce any material challenge to the findings from the interviews with the five respondent companies: two banks, HSBC and Standard Chartered; two pharmaceutical companies, Astrazeneca and GSK; and the one chemicals firm which gave its evidence on a non-attributable basis. Consequently, the standards they have set may be taken as good practice at the time and even as best practice, where they met the benchmarks now proposed.

The best practice guidelines, it should be emphasised, are intended to be applied to any UK listed company whatever the sector but they are likely to be especially useful to the Forum in relation to industries from which most supporting evidence was derived. Concerns in some low-cost export-manufacturing sectors in China, like textiles and toys, are already being addressed by various stakeholder groups and it is less likely that the Forum could add value there. However, there are other sectors like the retail sector with which LAPFF has had a long running involvement on labour standards. The China project survey has already suggested, by omission, that some companies in both the knowledge-based sectors and in export-manufacturing in China may be below best practice. It would appear to make good sense to engage with these sectors and companies first, as much of the knowledge and expertise to do so has already been acquired.

Selection

Within each sector below there are potential concerns in China (the list is not exhaustive):

- Chemicals (effective worker representation; migrant labour);
- Food producers (low pay and long working hours);
- Retail (Code of Conduct for supply chain management);
- Oil & gas (health & safety).

The process for identifying the specific companies with which the Forum may wish to engage would be based on the following process:

- (i) Review company OFR or Business Review and other information on the extent of corporate involvement in China;
- (ii) Prioritise seriousness of employment issues concerned;
- (iii) Decide objectives for engagement and criteria for judging successful outcomes.

If this *recommendation* for engagement with companies is accepted then the newly adopted Trustee Guide would form the basis of a programme of engagement with a small selection of companies in some or all of the above sectors from the autumn 2006. Depending on how effective this is, it could become, as outlined in the LAPFF Work Plan, the basis for engagement on employment issues in other South East Asian countries.

5. CONCLUSION AND RECOMMENDATIONS

The Forum's study of how FTSE 100 companies are addressing and managing the risks related to operating in China, particularly with respect to labour standards, has cut new ground in its focus on knowledge-based industries. The significance of this development is that through the use of Trustee Guide it is possible to assess how companies in similar sectors to those in the LAPFF survey are doing in comparison with their standards of good practice. Even for companies outside the banking, pharmaceutical and chemical sectors in the LAPFF sample, or in the low-cost export manufacturing sectors, the wealth of information in the Interim Report is still likely to be useful despite the differing contexts.

Whereas the Forum embarked on this study with the view that China was a special case, the evidence from its survey suggests that few FTSE 100 companies are likely to treat the country in that way. This need not be a difficulty provided global policies are implemented in an appropriate manner and the special features of mainland China, like migrant labour, can be addressed effectively through such adaptation.

For this purpose the Forum's Trustee Guide, which is the practical outcome of the survey and subsequent stakeholder consultation, provides the tool for Funds to assess the employment risks and opportunities of investee companies with major subsidiaries or supply chains in China. While in practice, except for the largest Funds, the Forum may often be asked to carry out this evaluation on their behalf, it is essential that the process for doing so commands widespread support amongst LAPFF members. This will give it legitimacy amongst investors and also with the FTSE 100 companies that the Forum decides to engage with regarding employment issues in China.

In essence, once again the opportunities presented by the drive for enhanced narrative reporting in the UK, whether through the Business Review or voluntary OFR, have helped the Forum develop a Guide to enable Trustees to monitor their fund managers' engagement activities on labour standards or intervene themselves when necessary.

Recommendations

The next stage, as set out in the LAPFF Work Plan for 2006/07, is the development of an engagement programme on overseas employment standards focused on UK FTSE 100 companies with significant operations or supply chains in mainland China. As proposed in Chapter 4, this would apply the Trustee Guide to the chemicals, food producers, retail and oil & gas sectors following identification of companies where there are concerns on such issues as: effective worker representation; migrant labour, low pay and long working hours, supply chain management or health and safety.

In carrying forward any such engagement it is also recommended that the prospects for joint action with other investors and stakeholders be considered.³³ Such collaboration could be expected to increase the likelihood for timely and successful outcomes.

³³ . See, in particular, Impactt (2005), *Changing Over Time: Tackling Supply Chain Labour Issues Through Business Practice*, The Impactt Overtime Project sponsored by The Co-operative Insurance Society (CIS) and The Association for Sustainable & Responsible Investment in Asia (AsRIA)

APPENDIX – SUPPLEMENTARY QUESTIONS FOR LAPFF TRUSTEE GUIDE

The more detailed questions in this Appendix are intended for those cases where a more in-depth analysis of a particular FTSE 100 company is required either through the Fund’s manager or directly with the firm concerned. They are not intended for more general use.

Most of the questions are taken from the Forum’s Interim Report (November 2005) or from a consultation response helpfully provided by Impactt Limited.

A Corporate Objectives and Strategy: Supply Chain and Risk Management

1.1 Supplementary questions to ask your fund manager or the company

1.1.d	How have the company’s global CR policies been adapted in China to ensure effective supply chain management?
1.1.e	Do the company’s contracts with suppliers incorporate labour standards?
1.1.f	What are the costs and benefits of the company’s risk management system in relation to labour standards? Has the company worked with a third party to assess how the company’s understanding of its risks compares with that of the third party? Does the third party consider that the company is adequately addressing its risks?
1.1g	Does the company monitor its joint venture and other major business contracts in relation to labour standards?

B Employment risks and opportunities

Labour Laws and Human Rights

2.1 Supplementary questions to ask your fund manager or the company

2.1.f	Does the company disclose its own code of conduct, if any? Is the code applicable to suppliers in China? Are such codes translated into local languages?
2.1.g	How does the company ascertain compliance with international, and its own, codes of conduct for its Chinese operations or suppliers? How does the company respond to any material non-compliance with these codes?
2.1h	Do buyers purchase solely on price or do they take labour standards into consideration when selecting a supplier? Does the company solicit feedback from its suppliers about its buying practices? Is the company aware of how its buying practices may affect labour standards?

Trade Unions

2.2 Supplementary questions to ask your fund manager or the company

2.2.c	Is the union involved in bargaining for better pay and conditions for employees? If not in what ways has the company sought to involve the union in employment related issues?
2.2.d	Where alternative mechanisms of negotiation or consultation take place in the company (e.g. collective contracts), what employment issues are covered in such cases (e.g. training, remuneration, health, welfare, terms of contract etc.)?
2.2.e	Has there been any industrial action in the company or within its main suppliers in the last three years?

Health and Safety

2.3 Supplementary questions to ask your fund manager or the company

2.3.d	Are employees included in health and safety committees?
2.3.e	Does the company disclose the results of any H&S risk assessments or corrective actions?

Diversity and the Use of Disciplinary Measures

2.4 Supplementary questions to ask your fund manager or the company

2.4e	Do the company's hiring practices specify the age and sex of applicants? (This may indicate age or gender discrimination.) What is the male/female ratio of management and other grades of employee? Are managers predominantly from one region of China? (If so, there may be discrimination in recruitment or promotions.)
2.4.f	How is the company addressing issues related to migrant workers (inc. remuneration, housing, welfare, workshops and training issues)?
2.4.g	Does the company provide grievance or whistle-blowing procedures to enable employees to raise concerns, about discrimination or excessive disciplinary measures, without fear of victimisation?
2.4.h	How does the company respond to any non-compliance with its disciplinary policies? How are such issues investigated and resolved?
2.4i	Are copies of the disciplinary procedures of the company's main suppliers available? Are workers aware of the disciplinary policies? Do the policies have a system of fines or another system in place? Do fines constitute a maximum of 20% of workers' take home salaries (as Chinese law stipulates)? What steps are being taken by the company to discourage the use of fines as a disciplinary measure?

Wages and Working Hours

2.5 Supplementary questions to ask your fund manager or the company

2.5d	Is the company confident that pay and hours documents shown to the company by its suppliers are true and accurate? (Note that double bookkeeping is a significant problem in China.)
2.5.e	Is the company using contract labour hired through an agency? Where this is the case, does the company or the agency set their terms and conditions of employment?
2.5.f	Where pay falls below the legal minimum or industry benchmark standards amongst its own employees or its suppliers, how is the company seeking to address this issue?
2.5.g	Where excessive working hours have been identified amongst its own employees or its suppliers, how is the company seeking to address this issue and the related one of overtime payments?