Submission to the House of Lords: China, Human Rights, and the International Financial System

About Hong Kong Watch and this submission

Hong Kong Watch is an international non-governmental organisation which focuses on Hong Kong and wider China policy. In 2021, we published an in-depth report (Hong Kong Watch, 2021) on the effect of the influx of red capital – i.e. mainland money and assets – on the political situation in Hong Kong. One of the concluding remarks in the report is that greater scrutiny must be placed on the ties between China and the West's financial systems given the limited understanding in policy circles about these issues and the way that Beijing coopts state capital for political ends.

This submission has been written as a follow-up piece of research by the report's authors, Johnny Patterson and Sam Goodman. It considers the risks to investors, for human rights and for national security associated with deepening ties between China and international finance.

Summary

Section 1: Despite the Trade War, Ties between China and Wall Street and the City of London are growing.

- Nervous about a potential debt trap and vulnerabilities in the domestic financial system, the Chinese government has opened China's markets in unprecedented ways. Western investors have cashed in, in what has proven so far to be a win-win for the Chinese authorities and international financial firms.

Section 2: Problems with increased ties between China and Global Finance

1. The opacity of China's financial markets leaves investors exposed. While some professional financiers with years of Asia experience may have adequately factored in the risks, there are many more casual investors who may not fully appreciate the risks associated with investing in China.
2. Ethical concerns associated with institutional investment in China have not been carefully considered by institutional investors. There is currently no regulation in place to ensure that firms avoid investing in corporations complicit in the creation of the Xinjiang surveillance state. China and its human rights violations should be an ESG issue.
3. China's strategy of military-civil fusion ensures that unchecked institutional investment could directly counter Britain's national security interests if British pensions funds and other major players are funding firms in partnership with the Chinese military.

Section 3: Lessons to learn from the United States

- The United States Congress and recent American administrations are beginning to take these issues seriously and may provide lessons for Britain.

Recommendations

The British government should:

- Consider policy solutions and regulations which will ensure that complicity with the gross violations of human rights in mainland China and Hong Kong is viewed as an Environmental, Sustainability and Governance (ESG) issue by investors.
- Apply financial sanctions on firms complicit in the creation of the Xinjiang surveillance state and gross human rights violations.
- Consider enacting legislation like the US Hong Kong Autonomy Act and Uyghur Forced Labor Protection Act.
- Ensure that no state-pension funds invest in firms complicit in gross human rights violations.
- Bar passive index-tracking funds from investing in firms complicit in gross human rights violations.
- Research and consider the financial risks associated with greater exposure to Chinese financial markets.
- Demand that institutional investors account for human rights factors in their ESG reporting relating to China with a specific focus on forced labour and Xinjiang.
- Enact legislation establishing an independent watchdog, the China Economic Data Coordination Centre, to collect and publish official and unofficial Chinese economic data and assess British exposure to risk. This could be developed along the lines laid out in the US-China Economic Security and Review Commission's (USCC) recent report to Congress (USCC, 2020: 538).

Introduction

Despite diplomatic tensions, ties between China and Global Finance are Growing.

- Despite the situation in Hong Kong, the coronavirus pandemic, and the US-China Trade War driving a growing fissure between China and the West, ties between China and Global Finance are growing, and the total value of China's stock market has hit record highs (Lockett, 2020c).
- In 2020, foreign investors snapped up more than Rmb1tn worth of Chinese stocks and bonds (Lockett and Hale, 2020).
- Over the first eight months of 2020, the amount of Chinese onshore bonds held by foreign institutional investors increased more than 20 per cent year on year to Rmb2.8tn ($421bn), according to Fitch Ratings. Foreign investors have accounted for about 12 per cent of all purchases of Chinese government and policy bank bonds this year, according to Refinitiv (Mitchell, Hale and Lockett, 2020).

Deepening ties are a result of Chinese government policy

- In recent years, anxieties have been growing about the state of China's domestic financial markets. Beijing's response to the 2008 Financial crash in Beijing, which largely averted economic downturn, catalysed a credit boom and a spike in corporate and government debt (Magnus, 2020). According to the Bank of International Settlements, China's total debt

ballooned from $6.5 trillion in 2008 to $36.8 trillion in 2019. This is the equivalent of 258.7% of GDP. Even prior to the coronavirus slowdown, Beijing was engaging with the challenge of 'an enormous debt burden, an undercapitalized banking system, high levels of nonperforming assets, and a drawdown on national savings as China's population ages' (USCC, 2020).

- The potential of falling into a debt trap (Magnus, 2018) has led policy makers in Beijing to consider the possibility that foreign capital may provide some of the answers and be able to help mitigate the risks. Simultaneously, pushing for market access concessions was a priority for US negotiators in the US-China trade talks.
- The Chinese government has taken a range of steps to open up their financial markets to foreign investors. This has included (USCC, 2020: 265):
    - Increasing market access in banking, securities and insurance industries;
    - Granting foreign institutions equal treatment in credit and payment sectors;
    - Opening domestic bond market to investors.

The opening of Chinese markets has brought dividends for both Western firms and Chinese capital markets

- The result of these steps to open-up has been that several foreign firms have been allowed to buy-out their partners in joint ventures and become controlling owners of their Chinese securities ventures.
    - Since the signing of the phase-one trade deal between the US and China in 2018, JPMorgan will get full control of a futures venture in which it had a minority stake. Goldman Sachs and Morgan Stanley became controlling owners of their Chinese securities ventures. Citigroup Inc., meanwhile, won a custodian license to act as a safe keeper of securities held by funds operating in the country, and Blackrock won approval to start the first non-Chinese wholly-owned mutual-fund business in August 2020 (Lingling, Davis, Lim, 2020).
- Another consequence of the opening-up has been that major investment indices have increased the presence of Chinese stocks and bonds. In April 2018, the value that individual Hong Kong and overseas investors can trade in Chinese securities through Hong Kong was significantly increased. This led to the inclusion of A-shares in several benchmark MSCI and FTSE Russell indices in 2018-2020 (USCC, 2020: 265).
- The increased financial flows and regulatory approvals have coincided with loose central bank policies elsewhere, pushing the bond yields that underpin global portfolio allocations to historic lows, ensuring that the yields on Chinese bonds are far higher than elsewhere.
- For investors, riding the China-wave seems a no-brainer: China is increasingly profitable. It weathered the global pandemic better than most countries, it has some strong technology firms and its growth in the last ten years has been higher and more consistent than pretty much anywhere else (Ying, 2020).

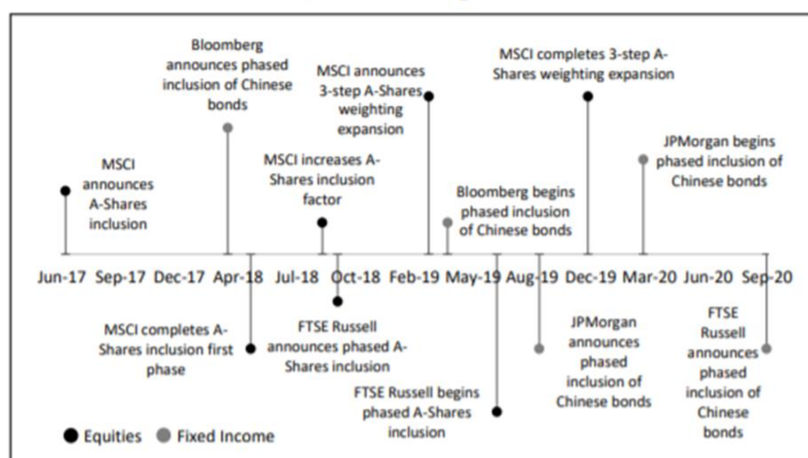
Black Rock, Global Indices and Investment Flows. The carrot offered to international financial giants carries a quid pro quo.

- The carrot offered to financial giants carries with it a quid pro quo. These firms are acting as cheerleaders for China's gradual integration into global financial markets and have helped to

spark a boom in investment in China. Leading Wall Street figures like Blackstone's Stephen Schwarzman and Blackrock's Larry Fink are increasingly important go-betweens for Beijing to the White House. British politicians like Lord Grimstone play a similar role for the City of London (Pickard, 2015).

- Blackrock's role is worth considering in greater depth. Their index-mirroring passive investment funds increasingly offer easy ways of fund managers to tap into China. "I continue to firmly believe China will be one of the biggest opportunities for BlackRock over the long term, both for asset managers and investors," Mr. Fink said in a March letter to shareholders, "despite the uncertainty and decoupling of global systems we're seeing today" (Lingling, Davis, Lim, 2020).
- Blackrock played an important role in lobbying the index provider MSCI Inc to introduce and then increase the number of Chinese A-shares in the MSCI Emerging Market index Exchange Traded Fund (ETF). This index is now weighted so that nearly 40% of the index is made up of Chinese equities. Blackrock, Vanguard and other investment funds have built financial products which then passively track this index, helping funnel tens of billions of US Dollars into the Chinese stock market.
- USCC (2020) have documented a timeline of Chinese Securities' inclusion into Global Investment Indices and laid out a graph of the rise in investment. See below.

Figure 5: Timeline of Chinese Securities' Inclusion into Global Investment Indices, June 2017–September 2020



Source: Created by Commission staff.

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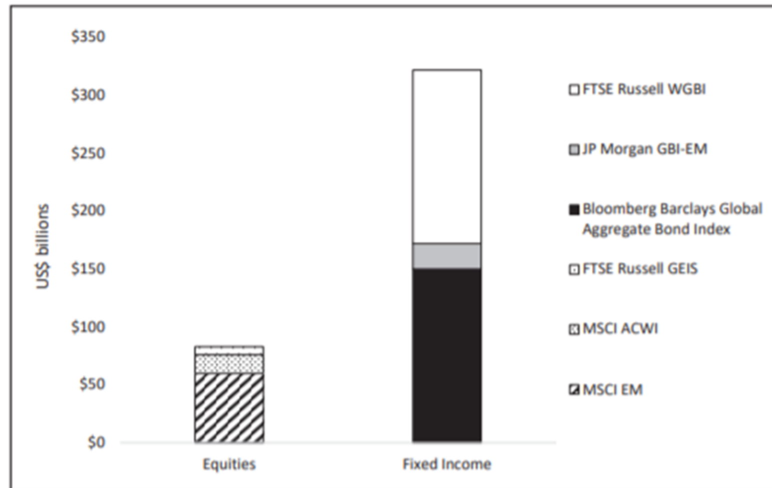
Figure 6: Estimated Foreign Portfolio Investment Inflows to China from Index Inclusion of Chinese Securities



Source: Various.[125]

Problems with increased ties between China and Global Finance

Investor exposure

- The Chinese government have partially chosen to open-up to international capital because of systemic internal problems. Recognising that there are dangers of exposing oneself to these risks must be a policy priority. The opaque political structure combined with no free information flows and ad hoc state market intervention ensures that price signals are unreliable, and transparency is inhibited.
- Poor corporate governance standards of many Chinese issuers, which file misleading corporate financial disclosures, compound these risks and undermine efficiency in China's financial markets as investors cannot accurately ascertain the value of securities USCC (2020: 268).
- Of course, many of the actors who are investing actively in China have accounted for these risks. However, those investing via passive ETFS are unlikely to have sufficiently considered the differences between the quality of the pricing of Chinese stocks when compared with others. These risks may not have been fully factored in.

Inadvertent support for problematic Chinese companies.

- The Financial Times calculated in September 2020 that roughly Rmb875bn in foreign investment has flowed into Chinese equities through stock connect programmes linking Hong Kong with onshore bourses in Shanghai and Shenzhen since the policy change was enacted (Lockett, 2020). Those investing via these passive ETFs have little to no leverage over the behaviour of the firms they invest in, and little effort has been taken to monitor the human rights standards or environmental practices of the firms.
- Even when these firms do have leverage, they tend not to use it. In 2017, when Hong Kong-traded Chinese companies—including Industrial & Commercial Bank of China and oil-and-gas

giant China Petroleum & Chemical Corp. —proposed charter changes requiring their boards to seek advice on major decisions from Communist Party committees, BlackRock funds voted in support, as did many other U.S. asset managers.

USCC (2020: 268) note that:

> *"The passive investment management style associated with index funds can preclude investors from being fully aware of the constituent securities in which they are investing, raising the risk that they may unintentionally provide material support to Beijing's industrial policy goals or problematic companies. For example, several constituent A-shares in the MSCI All Country World Index (ACWI) are subsidiaries of state-owned defense conglomerate Aviation Industry Corporation of China, which has advanced China's military-civil fusion strategy* through the acquisition of aerospace and engineering firms in the United States and Europe.*
>
> *"Investors may also be inadvertently supporting companies whose operations are antithetical to U.S. national security and foreign policy interests. In testimony before the Commission, Nazak Nikakhtar, assistant secretary for industry and analysis at the U.S. Depart ment of Commerce, noted that several Chinese companies on the department's Entity List are also included in the MSCI ACWI Index against which the Thrift Savings Plan's (TSP) † International Stock Fund ("I Fund") is scheduled to be tracked. These companies include iFlytek, Zhejiang Dahua, and Hikvision Technology."*

The Listing of Chinese firms on international stock exchanges

- There has, in recent years, been a spike in the number of firms from mainland China which have chosen to list internationally. This carries with it certain risks. For instance, the Chinese government insists that Chinese firms do not divulge their accounting information to American auditors for review. The result has been cases such as that of Luckin Coffee which defrauded US investors by inflating sales by more than $300 million in its 2019 financial reports and inflated costs from April 2019 to January 2020.
- Luckin Coffee's stock had to be halted on the Nasdaq after it plunged by 83 percent over three days, leaving bond holders deeply out of pocket. In response, US regulators delisted the company in July 2020 and fined the company $180 million for accounting fraud in December 2020.
- Several steps have been taken in response to the Luckin Coffee case and others in the United States. In August 2020, the US Treasury and the Securities and Exchange Commission issued recommendations to ban Chinese companies from American exchanges unless they complied with US auditing requirements.
- The United States signed the Holding Foreign Companies Accountable Act (HFCAA) into law on December 18, 2020 (Lexology, 2021). This introduces requirements auditors of foreign public companies allow the Public Company Accounting Oversight Board (PCAOB) to inspect their audit work papers for audits of non-US operations (HLS, 2021). If they fail to comply for

three consecutive years, then the company's shares are prohibited from trading in the United States.

- With listing increasingly difficult in the United States, many of the firms which would have chosen the New York Stock Exchange may now pick London. Regulators and the government must decide whether the lack of transparency afforded by Beijing's strict control of the audits of Chinese companies in foreign jurisdictions is acceptable. The behaviour of Chinese firms on the London Stock Exchange's Alternative Investment Market should serve as a cautionary tale about poor auditing standards (Burgess, 2015).

UK national security and foreign policy risks

- Some UK investment is directly funding companies that are destabilising the South East Asia region and the UK's foreign policy interests. The Burma Campaign's 'Dirty List' shows that several Chinese companies which receive UK institutional investment are heavily involved in arming and funding the military in Myanmar, which has just launched a coup and is the process of an extremely violent crackdown on protests (Burma Campaign, 2021). This demonstrates clearly that some UK investment is indirectly funding companies that are destabilising the region and the UK's foreign policy interests which support Myanmar's transition toward a democracy.

- Increased western investment has driven a substantial amount of China's economic growth in the last few years. The Chinese Government in turn has used this growth to build up and expand its military and cyber capabilities. This expansion of the Chinese military is being used to threaten neighbours in the South China Sea, the security and freedom of Taiwan, to peddle fake news in Europe, and launch cyber-attacks against Western companies.

- There is a more direct risk associated with China's strategy of military-civil fusion. This has been written about copiously (CFR, 2018; State, 2020; CNAS, 2021), but in short civil-military fusion is the Chinese government's strategy to harness civilian enterprises, particularly dual-use technologies, for military ends. In the words of the Council for Foreign Relations: "Since Xi Jinping ascended to power in 2012, civil-military fusion has been part of nearly every major strategic initiative, including Made in China 2025 and Next Generation Artificial Intelligence Plan. The goal is to bolster the country's innovation system for dual-use technologies in various key industries like aviation, aerospace, automation, and information technology through "integrated development"." The result of this is that the provision of funding for Chinese firms in a number of key industries may be inadvertently funding the upgrading of the Chinese military. Questions ought to be asked whether this is in Britain's long-run strategic interests.

- There is a danger that some institutional investors are funding Chinese firms which are buying out key strategic British infrastructure. UK-based investment funds run by Mathews Asia, Baillie Gifford, and Fidelity China are investing huge sums in Chinese state-owned banks like the China Construction Bank and China's Merchant Bank (Citywire, 2020). These firms, in turn, fund Chinese-state owned enterprises like the China National Oil Corporation, China General Nuclear Power Group or Beijing Construction Engineering Group who are heavily invested in the UK's energy and construction sectors.

- More broadly, entrenched financial links between UK investors and Chinese state-owned enterprises, which are ultimately controlled by the Chinese Communist Party, risks the co-opting of UK economic elites. This is not only a key strategy of the Chinese Communist Party's

United Front Work, but risks having UK companies and businessmen directly seeking to undermine UK economic interests and national security in pursuit of their own narrow interests. The case of HSBC, a UK based bank, which has supported the National Security Law and frozen the assets of pro-democracy activists in direct conflict with the UK's international treaty obligations to Hong Kong, is demonstrative of the risk that these trends pose (Hong Kong Watch, 2021).

Lessons to learn from recent developments in the United States

With increased acknowledgement of the importance of ESG factors in investing, and growing geopolitical tensions between the US and China, the US Congress and the White House have begun to consider ties between Wall Street and China in greater depth since 2020.

- In final weeks of his Presidency, President Trump has started to show the United States' full financial arsenal. The President had listed a range of Chinese firms as contributing to the Chinese 'military-industrial' complex earlier in the year, but in November 2020, an executive order banned American investors from holding shares in the listed companies (Lockett, 2020). The ban comes into effect on January 11, while investors with existing stakes in the targeted companies have until November 2021 to divest.
- The aim of this order is to make it more difficult for money to flow into China from the United States. It is likely to cause dislocation of portfolios, and the removal of the firms from the major investment indices such as MSCI and FTSE Russell indices.
- On 5 December 2020, FTSE Russell dropped eight Chinese companies from indices in response to the executive order (Carnevali, Platt and Sevastopulo, 2020). This was followed by similar action by S&P Dow Jones on 9 December (S&P Dow Jones, 2020). MSCI have conducted consultations with their index users, but not yet taken substantive decisions to remove constituents (Li and Sedgwick, 2020).
- The fact that indices took substantive measures in response illustrates the potential effectiveness of these kind of steps in halting passive capital flows into problematic corporations.
- As of 18 March 2021, the Biden administration has paused some of these measures as it assesses its approach towards China.

New legislation in the US Congress, summer 2021

- It appears that similar ideas maybe legislated for in a new big piece of China legislation which is set to come before Congress in the summer of 2021, led by the Senate leader Chuck Schumer who has approached the chairs of various Senate committees to craft provisions to go in the bill. This legislation looks set to receive bipartisan support in both chambers of Congress (Desiderio and Levine, 2021).
- Senator Marco Rubio, in October 2020, previously attempted to introduce legislation that would have barred U.S. investment firms, retirement funds, and insurance companies from taking stakes in Chinese companies that have been placed on a trade black list overseen by the Commerce Department or added to a list of firms backed by the Chinese military according to the Pentagon.

Conclusion

As tensions have risen between the West and China over its human rights record, its encroachment in Hong Kong, and the increasingly aggressive posturing of the Chinese Communist Party, UK investment has poured into Chinese companies as a hangover from the 'Golden Era'.

The public revelations about the participation of Chinese companies with a footprint in the UK who have been involved in the construction of China's surveillance state and the camps where over a million Uyghurs are being held, should at the very least raise concern and lead parliamentarians to investigate the involvement of UK finance.

As American lawmakers begin to move towards legislating to prevent US investment in companies complicit in human rights abuses and the EU finalises a due diligence framework, UK policymakers should follow suit. The UK has the capacity post-Brexit to be the ESG capital of the world. We can use the City of London to be a force for good, rather than a handicap towards a foreign policy which reflects our values and promotes human rights and democracy.

There are a number of steps, listed above in our recommendations, which could be taken to do this. Three headline recommendations are as follows:

First, the Committee should encourage the UK Government to create an entities list of companies where there is evidence of complicity in crimes against humanity and human rights abuse.

Second, the Committee should work to task the Financial Conduct Authority through primary legislation to design rules to restrict investment in companies with particularly egregious records of complicity in human rights abuses.

Third, the Committee should call the Government to establish a China economic data centre which will monitor accurate Chinese economic data and give British consumers a fair and balanced assessment of the risks associated with investment in China.

Finally, the Committee should ensure there is a ban on UK public pension funds being invested in Chinese companies who are complicit in the persecution and enslavement of the Uyghurs and the Tibetans.

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