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ISSUE BRIEF

# ENVIRONMENTAL AND SOCIAL POLICIES IN OVERSEAS INVESTMENTS: PROGRESS AND CHALLENGES FOR CHINA

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## EXECUTIVE SUMMARY

China is rapidly evolving into one of the world's largest overseas investors measured by the amount of money it directs overseas. Like other countries that invest overseas, China—through the projects it finances and executes—can bring great benefit to the countries and communities in which it invests (“host countries”). However, investments can pose challenges and risks to host and investor countries. Effectively tailored environmental and social policies can identify and mitigate not only unanticipated environmental and social harm, but also some of the investment risks that can undermine the long-term financial success of a project.

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Even in the midst of the 2008–09 global financial crisis, China’s outward foreign direct investment (OFDI) continued to grow.<sup>1</sup> Between 2008 and 2009, China’s OFDI flows grew nearly 8 percent, while total world OFDI flows during the same period decreased nearly 40 percent (Unctad-Stat 2012). In both 2009 and 2010, the Export-Import Bank of China and the China Development Bank together lent more than the World Bank did to developing countries (Dyer, Anderlini and Sender 2011).

*Environmental and Social Policies in Overseas Investments: Progress and Challenges for China* examines trends in China’s overseas investments and considers how social and environmental policies can reduce

investment risks and enhance the positive impacts of China’s OFDI. We focus on three major forces in China’s OFDI: the central government, financial institutions, and centrally owned state-owned enterprises (SOEs). Although a variety of institutions are involved in overseas investments, the majority of Chinese OFDI originates from centrally owned SOEs, and its OFDI growth is fueled largely by the strong lending capacity of its financial institutions, especially the China Development Bank and the Export Import Bank of China. Aid, trade, and other types of financial interest that may be associated with overseas economic interests are not addressed here, nor are overseas investments by collectively or privately owned companies.

As China continues to expand overseas investments, understanding and managing the environmental and social impact of these investments in host countries can help it build mutually beneficial relationships with host countries. Already, methods to address environmental and social issues in overseas investments are emerging in China. Chinese regulatory authorities are creating guidelines in their areas of jurisdiction, and individual financial institutions are developing and refining their own policies. International experience with environmental and social risk mitigation offers a useful context for Chinese investors and policymakers to consider as they continue to develop these overseas investment policies.

Moving forward, China faces several challenges, not the least of which is a lack of understanding of the regulatory and legal environment in host countries. Attention to host countries’ regulatory and

legal environments must be ratcheted up if investment risks are to be reduced. Supervisory challenges and coordination among ministries should also be prioritized. Finally, even though governments, financial institutions, and corporations have produced multiple guidelines and policies to guide more sustainable overseas investments, implementation remains a major challenge. Sufficient resources should be directed toward implementation to overcome barriers such as cost, coordination of resources, and time.

While these challenges are real, China’s rapid economic growth and global presence also create opportunities that offer insight for a global audience. China can shape the direction and return of its OFDI to maximize positive impact and achieve “win-win” relationships with host countries. As an experienced recipient of OFDI, China can now apply those lessons as it invests abroad. In addition, China can step into facilitator and leadership roles in the international agenda of promoting sustainable cross-border investment, especially in developing countries.

This issue brief is the first in a series of WRI publications by the International Financial Flows and the Environment (IFFE) project that examine the role of environmental and social policies in overseas investments. Future publications will look at the “business case” for adopting stronger environmental and social policies, and will include case studies of overseas investments from China and other countries.

## KEY TERMS

**Environmental and social policies:** A range of tools—including standards, guidelines, safeguards, and regulations—aimed at improving the social and environmental performance of investments.

**Overseas investment:** Capital outflow, including, but not limited to, foreign direct investment and cross-border bank lending.<sup>a</sup>

**Foreign direct investment (FDI):** Investment category in which an enterprise resident in one economy invests in an enterprise resident in another economy with the objective of establishing long-term interest and control, and holds at least 10 percent, or the equivalent, of the voting stock or ordinary shares of the enterprise.<sup>b</sup>

**Outward foreign direct investment (OFDI):** Direct investment from one country going outward to another country.

**FDI flows:** Capital provided (either directly or through other related enterprises) by a foreign direct investor to an enterprise, or capital received from an investing enterprise by a foreign direct investor. Flows are measured over a period of time, for example, during the year 2012.

**FDI stocks:** The value of the share of a direct investment's capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise. Stocks can only be reported at a certain point in time, for example, at the end of 2012.

**Capital in transit:** Inward and outward direct investment passing through entities in jurisdictions that may offer advantages, for example, for tax purposes (Davies 2012; OECD 2008).

**Round-tripping:** Investments to foreign destinations that are then channeled back to the original investing country. The purpose is usually to obtain favorable tax treatment (UNCTAD 2010).

**Financial institutions:** An organization such as a bank where people, companies, or governments put their money, which the organization then invests to make a profit (Financial Times Lexicon 2012).

**Policy banks:** In China, this term refers to three policy banks: the Agricultural Development Bank of China, China Development Bank (CDB), and the Export-Import Bank of China (China ExIm). China ExIm was created in 1994 to take over the government-directed spending functions of the four state-owned commercial banks.<sup>c</sup> CDB underwent commercialization in 2008 but still carries out the function of a policy bank. China's policy banks are charged with policy lending in areas such as infrastructure projects, and with promoting foreign trade and diplomacy

**Export credit agencies:** Public agencies and entities that provide government-backed loans, guarantees, and insurance to corporations from their home country that seek to do business overseas in developing countries and emerging markets (ECA Watch 2012).

**Development finance:** Provision of financial support to a developing country to permit it to undertake development projects that it could not otherwise afford (Deardorff). This is different from official development finance as defined by the OECD to include only bilateral aid, multilateral development bank lending, and other official flows (OECD Glossary of Statistical Terms 2012).

**Development finance institutions:** A governmental or intergovernmental body that provides development finance (Deardorff 2012),<sup>d</sup> such as the China Development Bank, the World Bank, or the European Investment Bank.

**Development projects:** A project intended to increase a developing country's ability to produce in the future. Such projects are most commonly additions to the country's capital stock, but they may involve improvements in infrastructure, educational facilities, discovery or development of natural resources, and so on (Deardorff 2012).

a. Based on concepts of "international investment" and the common definition of "capital accounts" on Deardorff (2012).

b. OFDI and FDI related definitions are based on OECD (2008) and UNCTAD Statistics on FDI, <http://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx>.

c. For categories of Chinese banks, see KPMG 2011 and the financial services section of the "Doing Business in China" guide on [export.gov](http://export.gov), managed by the U.S. International Trade Administration.

d. Also see descriptions on European Development Finance Institutions, <http://www.edfi.be/activities.html>.

## INTRODUCTION

As China increases the amount of money it invests overseas, scholars inside and outside China are trying to better understand the environmental and social risks faced by China and countries hosting Chinese investments. By learning from and avoiding the mistakes of other countries, China can better manage the investment risks associated with environmental and social issues while simultaneously becoming a leader in integrating sustainability into overseas investments.

This issue brief provides an overview of the rapidly evolving landscape of Chinese overseas investments and lays a foundation for future research. It discusses Chinese overseas investment trends and the function of environmental and social policies applied to overseas investments, including their use in reducing investment risk. It then explores international experiences in environmental and social policymaking before turning to an analysis of current Chinese efforts to reduce the environmental and social impacts of its overseas investments. The brief focuses on the three groups that largely drive Chinese outward foreign direct investment (OFDI): centrally owned state-owned enterprises (SOEs) (business entities), policy banks (financial institutions), and the government. The relationships among, and the activities of, these institutions are explained in Box 2.

In preparing this brief, WRI analyzed the challenges and opportunities affecting Chinese overseas investments. We interviewed representatives from industry, government, and civil society organizations; reviewed relevant literature; and analyzed sta-

tistics from both Chinese and international sources. Our research reveals that China is facing both great challenges and promising opportunities, and Chinese overseas investments are attracting significant international attention. We also found multiple risks associated with overseas investments, including environmental and social risks, some of which can affect the long-term success of investments. Actively identifying, mitigating, and preventing risk can help prevent negative impacts. These risk-reduction strategies can be achieved through the design and implementation of robust policies.

By increasing their knowledge of risk mitigation and engaging in appropriately tailored policymaking, Chinese institutions can create the next generation of environmental and social policies. These actions can improve the performance of China's overseas investments and at the same time, lead an international policy race to the top among both developed and emerging economies. Leading such an effort would improve China's international reputation and foreign relations, and reduce the social and environmental impacts of Chinese companies abroad. In this way, Chinese foreign investment can bring mutual benefit and "win-win" development.

### The Rapidly Changing Context of Chinese Overseas Investments

Major emerging economies such as China and Brazil are fueling a growing trend of South-South development finance flows by channeling investments to other emerging or developing countries (te Velde 2006). Figure 1 illustrates the OFDI stock from four emerging econo-

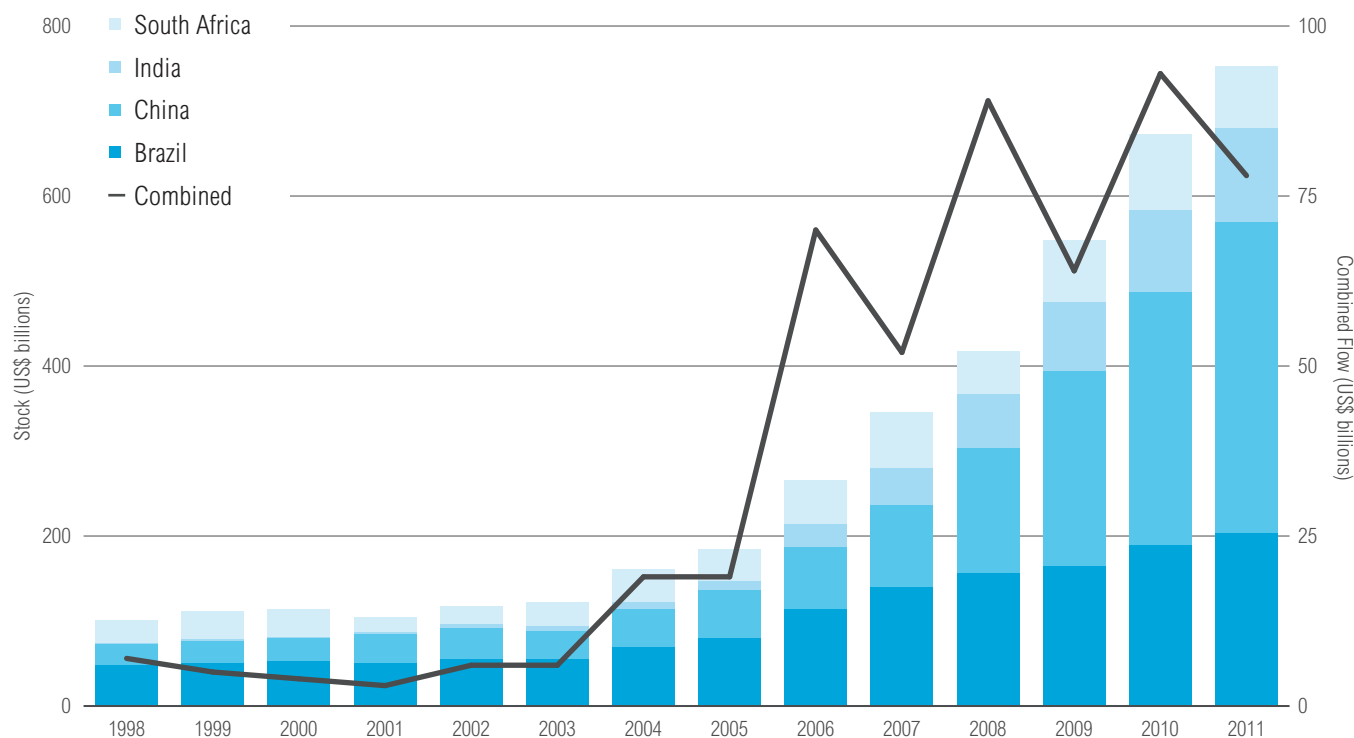
By increasing their knowledge of risk mitigation and engaging in appropriately tailored policymaking, Chinese institutions can create the next generation of environmental and social policies.

mies, as well as the combined annual flows. The fact that 56 percent of the world's state-owned transnational corporations (TNCs) are based in developing or emerging economies points to the significance of finance that is currently or potentially flowing from these economies. Among these economies, China has the second highest number (50) of state-owned TNCs (UNCTAD 2011 29).<sup>2</sup> The growing trend of South-South financial flows highlights the importance of ensuring that strong environmental and social policies are in place to guide these investments.

One way to gauge the direction and amount of overseas investment is to examine OFDI. In 2010, China's annual OFDI flows were more than

FIGURE 1

## STOCK OF OUTWARD FOREIGN DIRECT INVESTMENT (OFDI) FROM FOUR EMERGING ECONOMIES AND COMBINED OFDI FLOWS, 1998–2011



Source: WRI IFFE, based on data from UnctadStat (2012).

70 times greater than its 2000 flows.<sup>3</sup> China's 10th Five-Year Plan (a plan that outlines the country's economic and social planning initiatives and goals), covering 2001–2005, encouraged the country to “go global” and promotes investment abroad to increase international competitiveness (Government of China 2001). The “go global” strategy is one of the main drivers of China's dramatic increase in investment over the past decade as the country seeks to access natural resources, stimulate exports, and build markets abroad.

### Scale and Direction of Chinese Overseas Investments

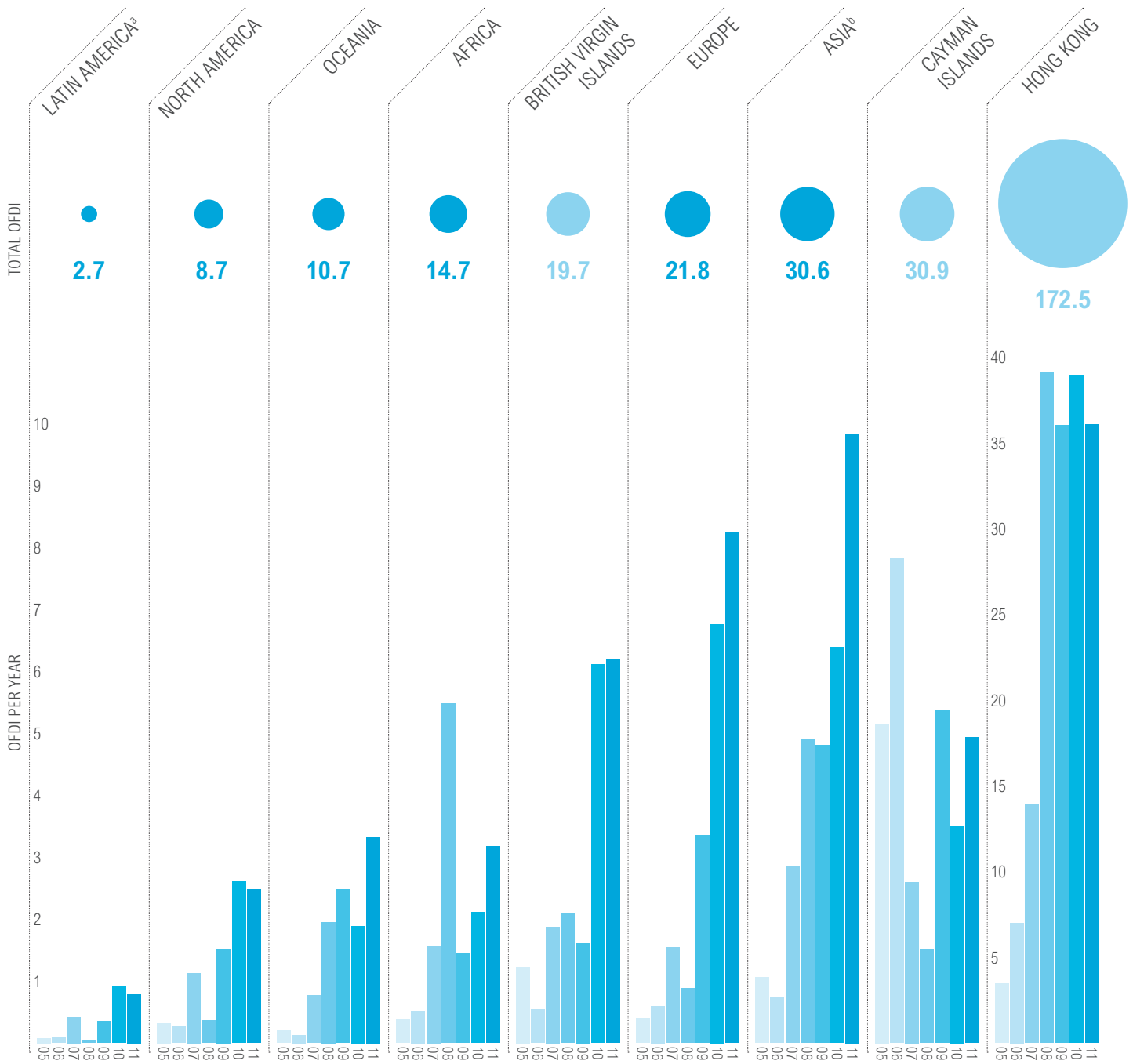
China was one of the few countries that saw consistent increases in OFDI during the 2008 global financial crisis. While China's OFDI flows between 2008 and 2009 grew from US\$52.1 billion to \$56.5 billion, total world OFDI flows during the same period decreased by 42 percent, from US\$1.9 trillion to \$1.1 trillion. In 2010, Chinese OFDI flows jumped to a new high of US\$68.8 billion, while

the world total only slightly recovered (UnctadStat 2012). According to the Chinese Ministry of Commerce (MOFCOM), total Chinese OFDI stock at the end of 2011 was more than US\$424 billion (MOFCOM, NBS and SAFE 2012). According to one estimate, Chinese OFDI stock could total US\$1–2 trillion by 2020 (Rosen and Hanemann 2011).

In comparison with other countries, China's OFDI flows surpassed those of the United Kingdom and Japan for the first time in 2010, although

FIGURE 2

## REGIONAL COMPARISON OF CHINESE OFDI STOCK BY INITIAL DESTINATION, 2005–11 (US\$ BILLION)



Source: WRI IFFE based on data from MOFCOM, NBS and SAFE (2012).

<sup>a</sup> Excluding the British Virgin Islands and the Cayman Islands.

<sup>b</sup> Excluding Hong Kong.

China's OFDI stock is still smaller than countries that have been heavily engaged in OFDI for longer periods, such as the United Kingdom, the United States, and Germany (MOFCOM 2011).

Figure 2 presents a regional comparison of initial destinations of China's OFDI stock. Latin America, Africa, and Asia, where most of the world's developing countries are located, all received significant or growing amounts of China's OFDI between 2005 and 2011. However, these figures should be considered in context: although MOFCOM is the official source of Chinese OFDI data, its statistics do not provide a complete picture of all OFDI activity for a number of reasons. For example, the figures for Chinese OFDI may not accurately depict the final destination of the money or the exact amount invested in a specific region. This problem in accounting is generally applicable to the OFDI figures of any country. For example, round-tripping (see Box 1) may lead to an overestimate of actual OFDI that remained in a particular country. In the case of Chinese investments, Hong Kong, the British Virgin Islands, and the Cayman Islands together attracted 70 percent of China's OFDI in 2010, but it is unclear how much of this money stayed in those locations. Conversely, OFDI to the rest of the world may be underestimated since portions of the flows to these regions might fall under "capital in transit" (Box 1). There is also a risk that official OFDI figures may underestimate the actual amount of China's total OFDI due to possible underreporting and the fact that investments from privately or collectively owned smaller enterprises may not be subject to the same standard reporting process as those from the larger state-owned enter-

prises (SOEs). Regardless of these under- or over-reporting issues, China's OFDI to Asia (excluding Hong Kong), Latin America (excluding Cayman Islands and British Virgin Islands), and Africa experienced double- to triple-digit growth from 2005–11, making China a significant and growing provider of international development finance.

Most Chinese OFDI originates from centrally owned SOEs, described in Box 2. According to data collected by MOFCOM, at the end of 2011 only 11.1 percent of the 13,500 registered Chinese OFDI investors were state-owned companies, yet 62.7 percent of China's OFDI stock was held by these entities. The significance of central SOE investments is highlighted by the fact that 37 of the top 50 Chinese nonfinancial investors, as measured by OFDI stock at the end of 2010, are centrally owned SOEs (MOFCOM 2010; SASAC).

China's OFDI growth is backed by the strong lending capacity of its financial institutions. In addition to supporting Chinese companies' overseas investments, Chinese financial institutions directly finance foreign projects, companies, financial institutions, and governments. Two of China's policy banks, China Development Bank (CDB) and the Export-Import Bank of China (China ExIm), stand out among Chinese financial institutions in supporting China's "go global" strategy.

CDB is a state-owned policy bank that finances key infrastructure projects and industries in China. It also supports the "go global" strategy by facilitating China's cross-border investments (CDB 2011). In 2008, CDB was restructured into a commercial joint stock bank, but remains under state control. CDB is now the fifth largest bank in China by total assets, equal to US\$810 billion in 2010

China's OFDI to Asia, Latin America, and Africa experienced double- to triple-digit growth from 2005–11, making China a significant and growing provider of international development finance.

(KPMG 2011). Its business presence has extended to 116 economies across the globe. By the end of 2011, 15.9 percent of CDB's outstanding loans were located outside mainland China (CDB 2011). A number of large, international energy projects stand out in its portfolio (Downs 2011). China ExIm finances and implements the government's trade and overseas investment policies (China ExIm

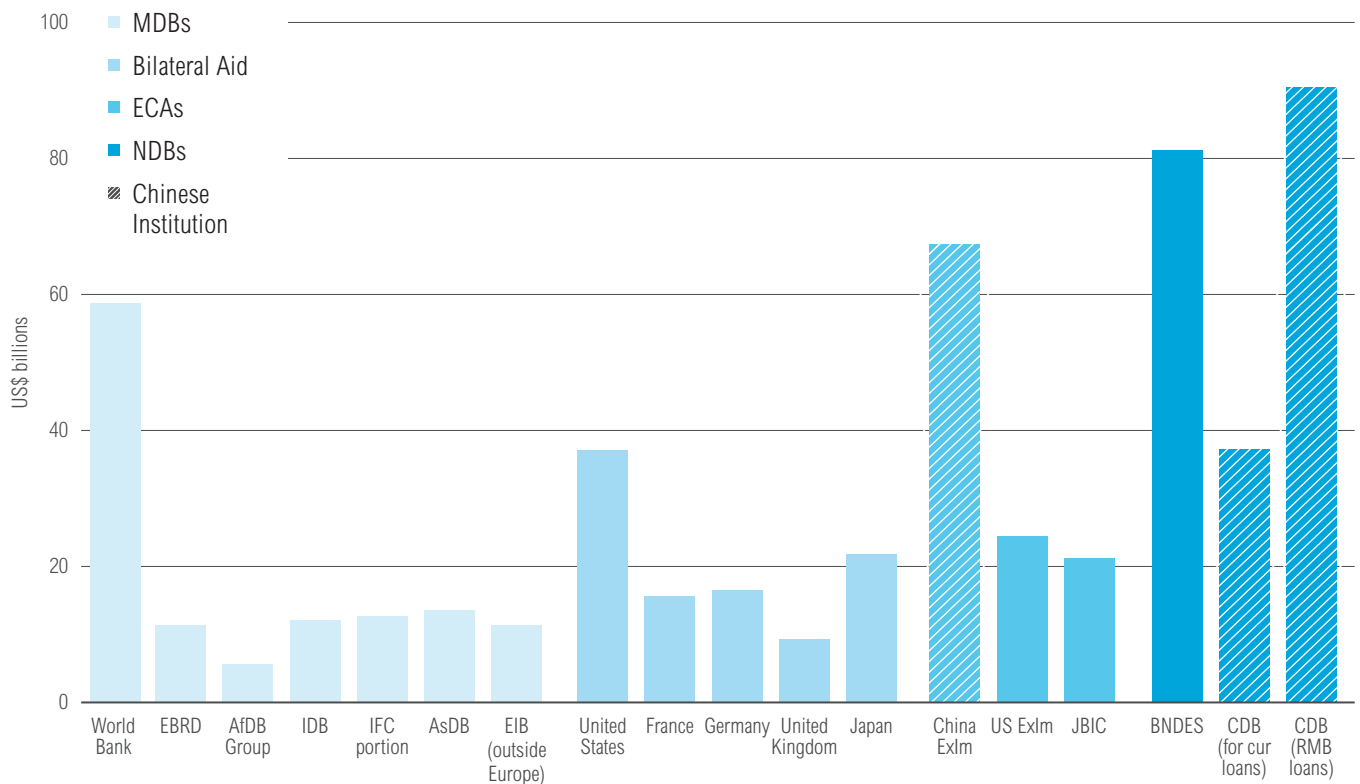
2012). It approved over US\$70 billion in new lending in 2009—more than the Export-Import Bank of the United States and the Japanese Bank for International Cooperation combined (see Figure 3).

Between 2004 and 2010, China ExIm increased its annual lending to support overseas investments from US\$1 billion to US\$8.6 billion, or in terms

of percentage of total China ExIm loan disbursements, from 9 percent to 15 percent.<sup>4</sup> In both 2009 and 2010, China ExIm and CDB together lent more to developing countries than the World Bank (Dyer, Anderlini and Sender 2011). These trends are likely to continue as Chinese policy banks continue to grow in absolute terms and continue to provide external development financing.

FIGURE 3

### LENDING BY PUBLIC FINANCIAL INSTITUTIONS BY TYPE OF INSTITUTION, 2010



Source: WRI IFFE, based on annual reports and financial statements of public financial institutions.

Notes: EBRD, European Bank for Reconstruction and Development; AfDB, African Development Bank; IDB, Inter-American Development Bank; IFC, International Finance Corporation; EIB, European Investment Bank; China ExIM, Export-Import Bank of China; US ExIm, Export-Import Bank of the United States; JBIC, Japan Bank for International Cooperation; BNDES, Brazilian Development Bank; CDB, China Development Bank. BNDES and the China Development Bank data include both domestic and international loans.



## IMPORTANT INSTITUTIONS IN CHINESE OVERSEAS INVESTMENT

Overseas investment involves many institutions, including business entities (e.g., project sponsors; engineering, procurement, and construction companies; and suppliers), financial institutions, government institutions, intermediaries, and consultants (Ning 2009). This issue brief focuses on centrally owned SOEs (business entities), policy banks (financial institutions), and the central government. The relationship between the groups involved in overseas investment decisions is illustrated in Figure 4. The specific institutions—business, financial, and government—that we focus on in this brief are described below.

### Chinese centrally owned SOEs

Business entities in China can be public or private. Public enterprises that are majority-owned by the government are called state-owned enterprises (SOEs). Some SOEs are also publicly traded. Different levels of government may own SOEs. For example, there are local-government-owned SOEs and provincial-government-owned SOEs. The types of SOEs discussed in this brief are central-government-owned SOEs, which accounted for more than 70 percent of China's OFDI flows in 2010. These SOEs are multifaceted: they can conduct equity investment in greenfield projects; act as project sponsors in project financing, mergers and acquisitions; and invest through their foreign subsidiaries.

### Chinese policy banks

China's three policy banks, which include China ExIm and CDB, were created in 1994 and focus on different matters than traditional commercial banks. They are charged with China's policy lending in areas such as infrastructure projects, and with promoting foreign trade and diplomacy.<sup>a</sup> These banks participate in a variety of foreign economic activities, including lending to Chinese SOEs to finance projects abroad and lending directly to foreign governments or projects (Downs 2011). Debt financing is the most prevalent financing mode used in international projects. For Chinese companies, this mainly consists of bank loans because bond issuance is tightly controlled (Ning 2009).

### Chinese national government

Government bodies from both investing countries (where the investment originates) and host countries (that receive the investment) are involved in overseas investment. Government bodies involved in overseas financial activities include ministries, commissions, and oversight bodies. The bodies with the most significant roles in China's overseas investments are:

*Ministry of Commerce (MOFCOM):* Responsible for administering China's foreign trade, economic cooperation, and foreign investment.

*Ministry of Environmental Protection (MEP):* Responsible for developing and implementing national policies, laws, and regulations for environmental protection.

*National Development and Reform Commission (NDRC):* Responsible for formulating and implementing national economic and social development and for analyzing domestic and international economics, including overseas investments.

*China Banking Regulatory Commission (CBRC):* Responsible for formulating supervisory rules and regulations governing banking institutions and for administering the supervisory boards of the major state-owned banking institutions.

*State-owned Assets Supervision and Administration Commission (SASAC):* Responsible for managing SOEs, appointing top officials, creating laws governing SOEs, and guiding the reform and restructuring of SOEs.

a. One interpretation of "policy lending" is "when banks in a command economy lend money to state-owned enterprises according to instructions from state authorities, without regard for the quality of the borrower and their ability to repay." (Financial Times Lexicon 2012).

Source: Descriptions compiled from organizations' websites.

# Environmental and social policies, either at the national or international level, can help mitigate risks to both the investor and host countries.

Like many other countries' overseas investments, a significant portion of China's investments go to the energy and natural resources sectors (Harsch 2003). According to MOF-COM data, in 2010, 8.3 percent of China's OFDI went to the extractives sector, which commanded the third highest amount of Chinese OFDI after the business services and financial sectors.<sup>5</sup> Even more resources could have flowed into the extractive sector from intermediaries in the business services sector. A substantial part of China's OFDI is directed toward the global South (IMF 2011), where many Chinese companies have found opportunities in resource-rich developing countries (Lum et al. 2009). China's overseas interests range from natural resources like minerals and oil in Africa to hydro-power in Southeast Asia. As China's economy continues to grow, so will its demand for natural resources and new markets.<sup>6</sup>

## THE FUNCTION OF ENVIRONMENTAL AND SOCIAL POLICIES

Environmental and social policies influence the effects of an investment on environmental and social well-being (see Box 3). One consideration for any country or institution investing abroad is how to reduce the negative, and increase the positive, environmental and social impacts of their investments. Examples of positive impacts are pollution prevention, waste management, and poverty reduction. Investments, particularly large-scale investments in the natural resource sector, can cause major negative environmental and social impacts in the host country, including water pollution, land degradation, and violation of local communities' rights and livelihoods (World Bank 2013).

In addition to protecting the environment and the interests of local communities, environmental and social

policies can help reduce multiple investment risk factors. International investment involves a variety of risks for the investor and host countries that can jeopardize the long-term financial success of a project. Environmental and social policies, either at the national or international level, can help mitigate risks to both the investor and host countries. Box 4 provides examples of risks to an investment that can result from environmental and social harms.

### BOX 3

## WHAT ARE SOCIAL AND ENVIRONMENTAL "POLICIES"?

In this issue brief, the word "policy" describes a range of tools—including standards, guidelines, safeguards, and regulations—aimed at improving the social and environmental performance of investments. It refers to any principle or rule influencing the actions of an institution. Some policies have the strength of law and are complemented by institutions capable of ensuring that they are followed.<sup>7</sup> Other policies provide general guidance, without clear details on how they will be implemented. Some policies, such as the World Bank's Safeguard Policies, establish minimum social and environmental standards for investments. Other policies proactively encourage or require investment in environmentally or socially beneficial projects.

## RISKS ARISING FROM ENVIRONMENTAL AND SOCIAL HARM BY A FOREIGN INVESTMENT

Type of Risk	Description	Example
<b>IN THE HOST COUNTRY, THE INVESTING COMPANY CAN FACE:</b>		
Host country government sanction risk	Host governments can withdraw permits and licenses, commence enforcement actions, impose civil or criminal penalties on the proponent, or tighten requirements.	The Zimbabwean government ordered a Chinese energy company to stop exploration after the company failed the environmental impact assessment conducted by Zimbabwe's Environmental Management Agency (The Zimbabwean 2012).
Host country political risk	Political forces in the host country can threaten the project based on potential environmental and social harms.	Despite continued government support for the mining industry, Peru's political culture has become demonstrably less accommodating to mining projects in the wake of multiple high-profile conflicts between mines and their host communities (Herz 2007).
<b>IN THE HOME COUNTRY, THE INVESTING COMPANY CAN FACE:</b>		
Financing risk	Company financiers and investors can delay financing, require more conditions, or decide not to participate.	Intense local opposition to a proposed US\$1.7 billion paper mill on the Argentina-Uruguay border prompted the ING Group to withdraw its interest in financing the project (Herz 2007).
Home country management risk	Investing country governmental bodies can deny approval of the project because of potential environmental and social impacts.	The United States, United Kingdom, Netherlands, and Italy abstained from voting on a World Bank plan to provide loans to coal power plants in South Africa because of environmental concerns (Patel 2013).
Home country political risk	Political forces in the home country can threaten the project based on political considerations.	Widespread resistance and protests in Europe against multiple banks' investment in Turkey's controversial Ilisu Dam led to several major financiers withdrawing support (IR 2013, Banktrack 2013).
<b>IN BOTH HOST AND HOME COUNTRIES, THE INVESTING COMPANY MAY FACE:</b>		
Project construction risk	The company's ability to complete the project on time or on budget can be affected.	The construction of an oil and gas project, an international cooperation project between Russian and foreign companies, was suspended due to a violation of the Equator Principles (see section 6) and subsequent public interference (Feng 2011).
Project operation risk	The company's ability to access necessary inputs, produce sufficient output, or sell at a sufficient price (which can disrupt operations) can be affected.	Rio Tinto's Panguana copper mine in Papua New Guinea was forced to close in 1989 after accumulated local grievances with the mine helped ignite a secessionist civil war. The mine was never reopened (McIntosh 1990).
Reputational risk	The project can harm the company's brand identity and image, which can translate into loss of market value in the long term.	In the early 1990s the threat of an international consumer boycott forced Scott Paper to abandon its plans for a US\$635 million Indonesian eucalyptus plantation and pulp mill that may have displaced thousands of local residents (Stern 2003).
Business risk	Delays or interruptions to a project can reduce the company's profitability and asset value, thus decreasing the company's stock value, lowering its credit rating, and raising the cost of borrowing.	Manhattan Minerals suffered a huge decline in its stock market valuation after the Peruvian Government terminated its option to develop the Tambogrande mine. The company did not qualify since it could not find a major partner in the prevailing antimining social conditions (Business News Americas 2005).

Source: WRI IFFE compilation.

## INTERNATIONAL EXPERIENCE IN ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT

There is no single way to address environmental and social concerns in overseas investments. As described in Box 2 and illustrated in Figure 4, many institutions—including companies, financing institutions, and governments—are involved in foreign investments. Similarly, a multitude of options exist for mitigating risk in ways that benefit the host country and the investing country and institution, while ensuring the long-term success of investments. The Chinese approach is evolving, as are the approaches of other countries and international institutions. This section reviews several approaches

that international institutions employ to govern overseas projects. It also discusses voluntary individual initiatives not prescribed by law that banks and companies take to address environmental and social issues. Finally, it describes efforts in other emerging economies to introduce environmental and social policies into their lending.

### International Financial Institutions and Other International Institutions' Approaches to Risk Management

International financial institutions now recognize that poor environmental and social performance can create risks for a project's success. In response to public criticism of its involvement in controversial projects in the 1980s and 1990s, such as

the Narmada Dam in India, which displaced over 300,000 people, the World Bank developed "safeguard" policies to help identify, avoid, and minimize harm to people and the environment. Borrowers must now meet certain environmental and social requirements as a condition of lending,<sup>8</sup> including requirements to conduct an environmental and social impact assessment, consult with local communities, and restore the livelihoods of displaced people.<sup>9</sup> In 2006, the International Finance Corporation (IFC)—the private-sector financing arm of the World Bank Group—released its "Performance Standards on Environmental and Social Sustainability," (Box 5) which have become a benchmark for many other institutions. IFC has also consulted with Chinese agencies (Box 6). Other international financial institutions have adopted similar policies.<sup>10</sup>

#### BOX 5

## INTERNATIONAL FINANCE CORPORATION'S PERFORMANCE STANDARDS

In 2006, the International Finance Corporation (IFC)—the private-sector financing arm of the World Bank Group—released its "Performance Standards on Environmental and Social Sustainability," which updated its previous safeguard policies. In May 2011, the IFC's board of directors—which includes the Chinese, Indian, and Brazilian governments—adopted a revised version of the performance standards, which became effective on January 1, 2012. These performance standards for environmental and social risk management define the role and responsibilities of those receiving financing for projects supported by the IFC.

Over the past few years, IFC has emerged as a leading standard-setter for banks and companies. Its performance standards are now used by IFC clients, as well as over 60 private banks, including export credit agencies, and multinational companies worldwide.

The IFC performance standards address eight topics: (1) assessment and management of environmental and social risks and impacts; (2) labor and working conditions; (3) resource efficiency and pollution prevention; (4) community health, safety, and security; (5) land acquisition and involuntary resettlement; (6) biodiversity conservation

and sustainable management of living natural resources; (7) indigenous peoples; and (8) cultural heritage. The IFC also requires companies to consult extensively with communities, establish a grievance mechanism whereby communities can raise concerns, and allow communities to bring concerns directly to IFC.

Source: IFC 2012a.

## IFC WORK IN CHINA

In recent years, Chinese officials have worked closely with international financial institutions, particularly IFC, to build the capacity of Chinese financial institutions to manage environmental and social risks (Aizawa and Yang 2010). For example, the IFC plans to work with the CBRC and MEP to strengthen green credit lending and help banks understand the environmental and social business-related costs in certain high risk sectors, such as energy (Aizawa 2011). IFC also plans to work with CBRC to ensure consistent implementation of the guidelines, and improve evaluation through the creation of key performance indicators (IFC 2012b). More generally, IFC's own investment practices serve as a model for emerging markets to support the growth of sustainable capital flows by encouraging capital market stakeholders to integrate environmental, social, and governance factors into their investments (IFC Advisory Services in Sustainable Business 2011).

Source: See IFC in China. [http://www1.ifc.org/wps/wcm/connect/region\\_ext\\_content/regions/east+asia+and+the+pacific/countries/ifc+in+china](http://www1.ifc.org/wps/wcm/connect/region_ext_content/regions/east+asia+and+the+pacific/countries/ifc+in+china).

Multilateral institutions also have environmental and social requirements. The Asian Development Bank (ADB)'s Safeguard Policy Statement (SPS) (ADB 2012) includes environmental safeguards, involuntary resettlement safeguards, and indigenous people's safeguards. When the ADB updated and consolidated

its environmental and social safeguard policies into the SPS in 2008, it consulted with multiple Chinese stakeholders. Chinese government agencies, including the State Environmental Protection Agency (the predecessor to MEP), presented their safeguard experiences. The ADB's SPS promotes sustainable project outcomes by avoiding potential negative impacts on people and the environment. It also focuses on helping clients strengthen and improve their own safeguard systems, and building client capacity to effectively manage environmental and social risk (ADB 2009). The ADB supports governments in developing their own national safeguard policies in order to reduce project transaction costs, increase local ownership of safeguards, and enhance development outcomes. However, ADB stipulates that "in order for projects financed by ADB to use a country's own safeguards, those policies must be equivalent to ADB's own environmental and social protection measures and there must be sufficient capacity in place" (ADB 2008).

Bilateral export credit agencies also have environmental and social policies to manage risk. For example, the Organisation for Economic Co-operation and Development (OECD) issued the "Recommendation on Common Approaches on Environment and Officially Supported Export Credits" that applies to national export credit agencies based in OECD member states. Although the recommendations are not binding, "there is an expectation that member countries will do their utmost to fully implement a Recommendation." (OECD 2003) France's Compagnie Francaise d'Assurance pour le Commerce Extérieur (Coface), for example, is

subject to the OECD recommendations that member governments assess potential impacts of projects, increase transparency, and require adherence to internationally recognized standards, such as those of the World Bank Group (OECD 2007). In response, Coface developed an environmental commitment based on the principles outlined in the OECD recommendations (Coface 2012).

Various development finance institutions, such as the U.S. Overseas Private Investment Corporation (OPIC), have also developed environmental and social policies. In 2010, OPIC released an updated version of its Environmental and Social Policy Statement, applicable to projects it finances. The statement draws on a variety of policy sources, including relevant U.S. laws, IFC's performance standards and industry sector guidelines, and OPIC environmental and social policy commitments, including the commitment to provide information on its website about higher risk projects at least 30 days before the execution of an OPIC agreement (OPIC 2010).<sup>11</sup>

## Individual Initiatives and Policies

Individual companies and banks may institute risk-prevention initiatives that go above and beyond the scope of applicable laws. These "voluntary corporate initiatives" are policies that address circumstances that may be inadequately dealt with by laws in either the investing or host country. They may reflect an institution's desire to protect itself and prevent harm from circumstances that are not addressed by laws. They may also be motivated by the desire to enhance competitiveness through enhanced corporate reputation.

## Risk Control

Poor environmental and social performance can harm a company in a range of areas, from international reputation to financial returns. Companies can manage the complex impacts of development projects by guarding against these risks. For example, engaging local communities in a project's design can build community support and avoid conflict later in the project cycle (Herz et al. 2007).

Companies that fail to improve their environmental and social governance beyond what is required by law can harm their market value and long-term performance (UNEP Finance Initiative 2004) (see Box 7). A recent study by Deutsche Bank argues that corporate commitment to governance, environmental, and social issues in investment has a positive

impact on both corporate financial performance and the cost of capital (DB Climate Change Advisors 2012). According to the study, academic literature on sustainability and the corporate cost of capital demonstrates that a sound commitment to good governance, corporate social responsibility (CSR), environmental, and social issues is positively correlated with a lower cost of capital (DB Climate Change Advisors 2012). The market identifies these companies as lower risk, and consequently lowers their cost of capital in terms of debt and equity. The correlation is consistent with the findings of a report by the United Nations Global Compact Initiative, which was endorsed by 22 leading financial institutions, including Banco do Brasil and Goldman Sachs. The report found that attention to sound environmental and social governance contributes

to a company's success in a global market (The Global Compact 2004). Companies attuned to environmental and social issues are better equipped to manage risks, enter new markets, and anticipate legal action—all of which can help boost shareholder value. Effective management of social and environmental issues also correlates strongly with a company's reputation, which, as the UN Global Compact report notes, is an increasingly important factor in a company's success.

In 2003, several private-sector banks established a set of standards to identify, mitigate, and manage environmental and social risk. They used the IFC's environmental and social policies (Box 5) to develop the Equator Principles—a voluntary set of principles to manage environmental and social risk in project finance.

### BOX 7

## BUSINESS REPERCUSSIONS OF POORLY MANAGED RISKS

The actions of financial institutions, shareholders, government entities, and local communities may affect the balance sheet of a project or project sponsor. Financial institutions can withdraw financing if they detect poorly managed environmental and social risks. For example, Landsvirkjun, sponsor of the Karahnjúkar Hydropower Project in Iceland, arranged to receive US\$4 billion from a lending consortium of 19 banks in 2003. An environmental impact assessment found that the project had failed to adequately minimize environmental and social impacts, lacked pollution control, and would negatively affect regions with high conservation value. As a result, nine banks in the consortium refused to provide financing.

Government intervention and construction delays can result in huge financial losses for project sponsors. The Russian government intervened in the Sakhalin-2 oil and gas extraction project in Russia after strong objections from local community and civil society. The Ministry of Natural Resources and Environment halted construction of the project though it was 90 percent complete. Shareholders Investec Henderson and Mo Lei 莫雷 investment fund sold their shares in one of the project-sponsoring companies to oppose its lack of social responsibility.

The cost of local community consent is more difficult, but possible, to quantify. A

quantitative analysis by Shell shows that for its US\$4.5 billion Malampaya project in the Philippines, the cost of gaining local consent was approximately US\$6 million. Shell reaped several benefits from this consent; in addition to avoiding anticipated delays and saving US\$50–72 million, it developed a better relationship with the Philippine Government and improved the poor reputation it had earned from projects in other parts of the world.

Source: Examples are compiled from research, including: Feng, 2011, 82 and Herz et al. 2007. Note that WRI plans a publication analyzing the business case of environmental and social risk management.

As of 2012, 76 major financial institutions, including four export credit agencies, representing every region of the globe, have adopted the Equator Principles. The Equator Principles Association is in the process updating the principles for the second time since their adoption to reflect the IFC's revised 2012 standards. A draft of the updated Equator Principles was released in August 2012 for stakeholder consultation and public comment (Equator Principles Secretariat 2012).

### Initiatives and Policies from Other Emerging Economies

Other emerging economies are finding their own solutions to environmental and social issues as they invest abroad, address their countries' needs, and learn more about the importance of such policies. For example, CBRC and IFC jointly launched the first International Green Credit Forum in Beijing, facilitating the exchange of learning among financial institutions and regulatory bodies from 12 emerging economies, including Brazil (Box 8), Bangladesh, and Indonesia (IFC 2012c).

Some developments in emerging economies are based on national law, while others result from individual corporate initiatives. For example, Vietnam's Law on Environmental

Protection requires strategic environmental assessments (SEAs) pertaining to regional and sector planning. These SEAs must include environmental, social, and economic impacts (DAC Network on Environment and Development Cooperation 2008). In Korea, banks, insurers, securities firms, and the government together formed a green finance council (King 2009). The Financial Service Commission of Korea is

Bank Indonesia, the central bank of Indonesia, is trying to increase global awareness of sustainable development principles, and in 2010 signed a green banking agreement with the Ministry of Environment to balance economic development, social issues, and the environment (Bank Indonesia 2010). In 2012, Bank Indonesia took a further step and announced plans to sanction banks that lend to companies that harm the environ-

ment. The bank now requires lenders to assess clients based not only on their financial standards, but also environmental and social policies (Indonesia Today 2012, Bisara 2012). The proposed sanctions are intended to lower the risk of risk-weighted assets. In 2012, the Nigerian Bankers Committee published a voluntary set of sustainable banking principles relating to banks' impact on the environment and local communities. These overarching principles offer sector-specific guidelines and a commitment to developing local capacity to manage environmental and social risks (Bohjanen 2012).

Brazil's nationally owned development bank,

Banco Nacional de Desenvolvimento Economico e Social (BNDES) has taken major steps toward incorporating environmental and social policies into its overseas lending, as further illustrated in Box 8.

Financial institutions in many emerging economies are rapidly developing methods to incorporate environmental and social practices into their lending.

building a database to encourage and capture corporate disclosure of environmental information.

More specifically, financial institutions in many emerging economies are rapidly developing methods to incorporate environmental and social practices into their lending.

## SPOTLIGHT ON BRAZIL

Like China, Brazil is an emerging economy in development finance whose OFDI flows have dramatically increased in recent years. The largest development bank in Latin America is Brazil's BNDES. In 2010, BNDES replaced its previous environmental policy with a new socioenvironmental policy that applies to all institutions and projects it finances, regardless of whether the intended projects are based in Brazil or abroad. This policy promotes sustainable development in all of BNDES' projects and investments, and requires measures such as risk analysis and the verification of compliance with environmental legislation. It also highlights the importance of transparency and the link between economic development and environmental and social considerations.

Also in 2010, BNDES adopted a social and environmental responsibility policy based on its 2009-14 strategic plan. The policy references ISO 26000—an international set of standards for social responsibility. The BNDES “Social and Environmental Responsibility Policy” aims to value and integrate social and environmental dimensions into BNDES' strategy, policies, practices, and procedures in all its activities and interactions with stakeholders. BNDES has started developing a series of “socioenvironmental instruments” for the economic sectors it supports.

BNDES also has multiple initiatives and programs designed to support environmental and social preservation, such as the

BNDES forestry credit line, which promotes recovery, conservation, and reforestation of degraded and converted forest areas. The bank also offers several finance lines to help industries—such as agriculture, plastic, and cattle—to green their production and reduce the associated negative impacts. Though BNDES has established an ombudsman office where people can voice concerns about investments, it has no grievance mechanism.

Source: For BNDES social and environmental policy and guidelines, see [http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_en/Institucional/Social\\_and\\_Environmental\\_Responsibility/](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_en/Institucional/Social_and_Environmental_Responsibility/) and the website sections on socioenvironmental policy and support for social and environmental projects. See also BNDES 2009 and 2010 Annual Reports.

## DEVELOPMENT OF CHINESE ENVIRONMENTAL AND SOCIAL POLICIES FOR OVERSEAS INVESTMENTS

### Relevance of Environmental and Social Policies to Chinese Overseas Investments

As China's economy continues to grow, it is working to create mutually beneficial, cooperative relationships with other countries. China's 12th five-year plan (2011–2015) acknowledges the importance of environmental and social factors in its own development (Government of China 2011). The plan addresses the challenge of promoting economic development without sacrificing the environment, and states that it will seek methods to promote economic development while protecting the

environment. In addition, the plan discusses social development and strengthening social systems in multiple places, such as the “action plan for improving people's livelihoods” in chapter 36.

As China looks for opportunities to invest overseas, its relationship with host countries would benefit from examining the environmental and social impact of its investments. Mutually beneficial relationships, environmental sustainability, and social development are entwined and, as discussed in the next section, the success or failure of one factor can affect the others.

The application of environmental and social policies to overseas investments would clarify the role of these factors in an investment and provide both investor and host a clearer picture of what is expected and

required. As illustrated in the next section, these policies can outline expectations, mitigate risk, and provide additional support to projects. The existence and implementation of these policies would also send a message of forward, sustainable thinking, which could open doors to further overseas investment opportunities for China.

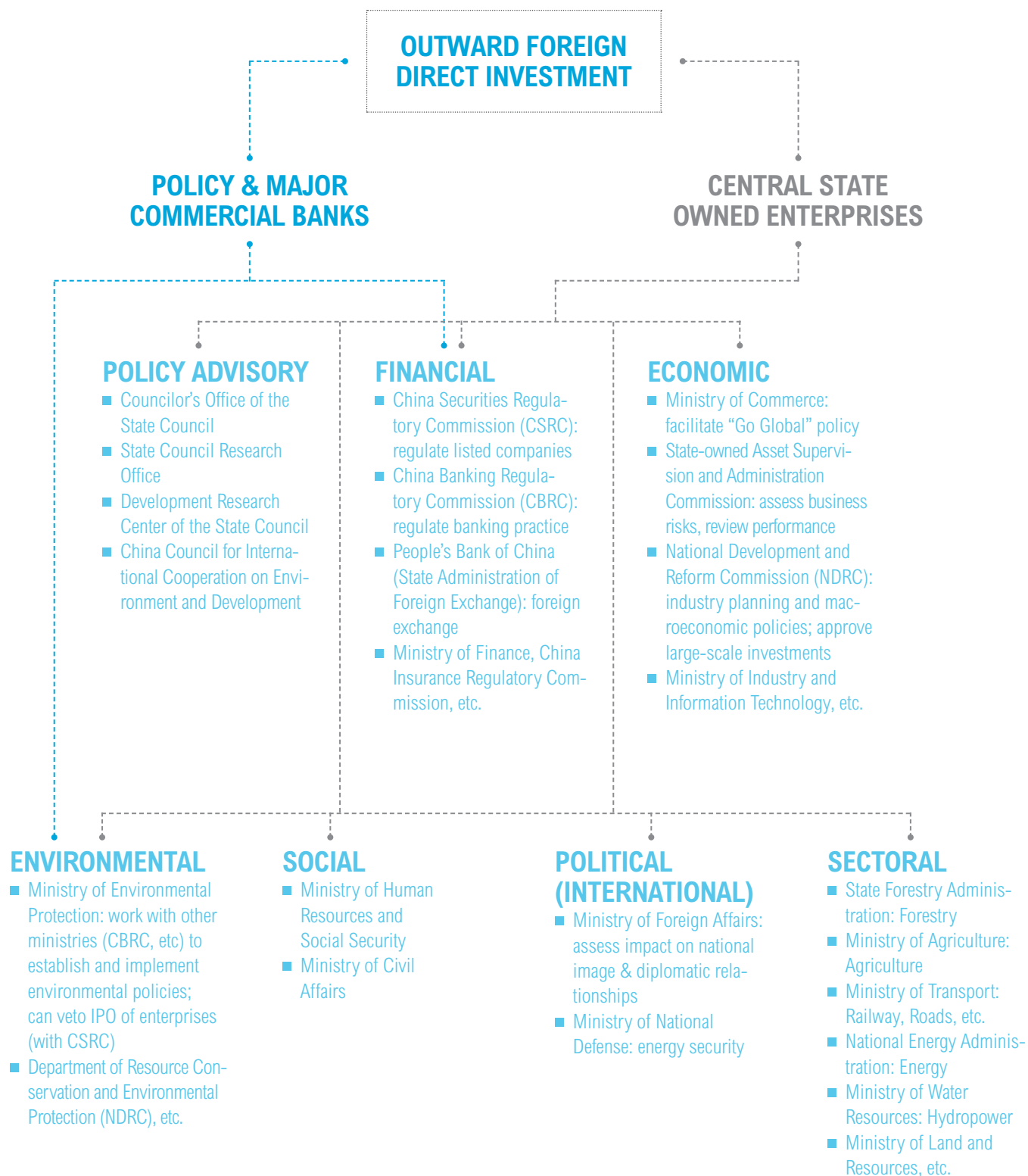
### Environmental and Social Policies in China

Numerous bodies and institutions are involved in the regulation, decision-making, and project approval processes of overseas investments. The involvement of so many entities requires significant coordination. Figure 4 illustrates the intricate links and relationships among government, banks, SOEs, and the resulting overseas investments. For further clarification of the roles and functions of these bodies, see Box 2.



FIGURE 4

## MANAGEMENT OF OUTWARD FOREIGN DIRECT INVESTMENT



## POLICIES AND INSTITUTIONS GOVERNING CHINA'S OVERSEAS FINANCIAL ACTIVITIES, 2012

Date	Institution	Policy Description	Applicable to Relevant Body
2007	State Forestry Administration	The "Guide on Sustainable Overseas Silviculture by Chinese Enterprises" (State Forestry Administration, 2007) governs the overseas practices of Chinese logging companies. It requires preservation of high-value forests and endangered species, monitoring systems, and consultations with local communities.	Any company engaging in logging/silviculture
2008	China ExIm	"Guidelines for Environmental and Social Impact Assessments of the China Export and Import Bank's Loan Projects" (CCICED 2011) is an environmental policy requiring environmental impact assessments, monitoring, and review of project impacts for all projects. When deemed necessary, environmental and social responsibilities may be included in the loan contract.	Projects receiving loans from China ExIm
2008	State Council	The State Council (MOFCOM 2008) issued a regulation allowing the government to fine companies up to Y1 million if they commence a project without official approval, which includes requirements to abide by host country laws.	Chinese companies operating overseas
2008	National Audit Office department on overseas assets	The Audit Office recently announced this new department focusing on state-owned or central-capital controlled companies and overseas national assets (Lin 2008). The department will seek to uncover any potential misuse of funds, with special attention to overseas state-owned assets. This oversight can prevent the use of illegal payments to gain approval for environmentally or socially sensitive projects.	State-owned or central-capital-controlled companies with overseas national assets
2008	Industrial Bank of China	Industrial Bank, a joint-stock commercial bank, was the first Chinese financial institution to subscribe to the Equator Principles (Industrial Bank of China 2008).	Projects receiving Industrial Bank financing
2009	State Forestry Administration and MOFCOM	Written by a joint task force, the "Guide to Sustainable Overseas Forests Management and Utilization by Chinese Enterprises" <sup>a</sup> tells Chinese enterprises how to manage overseas forest resources.	Any company engaging in forest-related activities
2011	SASAC	SASAC promulgated "Interim Measures on the Supervision and Administration of the Overseas State-owned Assets of Central Enterprises" <sup>b</sup> and "Interim Measures on the Administration of the Overseas State-owned Property Rights of Central Enterprises." <sup>c</sup> This supervision system provides most direct influence over SOEs and can be expanded to cover environmental and social issues.	SOEs
2012	SASAC	SASAC's preliminary supervision system of overseas assets was completed with the promulgation of the "Interim Measure for the Supervision and Administration of Central SOEs' Overseas Assets." <sup>d</sup> This system can oversee the environmental and social issues arising from overseas investments.	SOEs
2012	CBRC	The CBRC released "Green Credit Guidelines," which establish guidance for Chinese banks financing overseas activities, including transparency, monitoring, and supervision. <sup>e</sup>	Banks financing overseas activities
2013	MOFCOM and MEP	The "Guidelines on Environmental Protection for Overseas Investment and Cooperation" require all Chinese companies operating overseas to conduct environmental impact assessments, develop mitigation measures, and work with local communities to identify potential negative impacts of the investment (MOFCOM and MEP 2013).	Chinese companies operating overseas

a. See the State Forestry Administration website. <http://www.forestry.gov.cn/portal/main/s/224/content-401396.html>

b. SASAC Order No. 26, June 24, 2011, [http://www.gov.cn/flfg/2011-06/24/content\\_1891821.htm](http://www.gov.cn/flfg/2011-06/24/content_1891821.htm)

c. SASAC Order No. 27, June 24, 2011, [http://www.gov.cn/flfg/2011-06/27/content\\_1893993.htm](http://www.gov.cn/flfg/2011-06/27/content_1893993.htm).

d. SASAC website, <http://www.sasac.gov.cn/n1180/n1566/n11183/n11244/13624758.html>

e. CBRC website, <http://www.cbrc.gov.cn/EngdocView.do?docID=3CE646AB629B46B9B533B1D8D9FF8C4A>

Methods to address environmental and social issues in overseas investments are emerging in China. For example, MOFCOM requires SOEs operating abroad to follow the laws of the host country, respect local customs and habits, observe ecological and environmental protection requirements, and promote local economic and social development (State Council 2008). The State Council has

issued a regulation stating that companies working on overseas projects that do not receive official approval from the appropriate Chinese commerce authority (centrally owned SOEs must gain approval from MOFCOM) can be fined up to Y1 million (equivalent to US\$ 161,012) (MOFCOM 2008). This regulation allows commerce authorities to complete a risk assessment and warn Chinese

contractors against any risks, including environmental and social risks, in host countries. In addition, some development banks (such as China ExIm), oversight bodies (such as SASAC), and industry-specific bodies (such as the State Forestry Administration) have developed guidelines. Numerous institutions now publish annual sustainability reports, as described in Box 10.

## BOX 10

## SUSTAINABILITY REPORTING IN CHINA

Companies can publish sustainability reports highlighting the benefits they have provided to host countries and communities. In contrast to the West, where the pressure for CSR is driven mainly by civil society, in China, pressure for CSR is driven by the government and shareholders (Forstater et al., 2010). In 2008, President Hu Jintao announced that companies “should establish the concept of global responsibility, include social responsibility in their business strategy on their own, abide by the laws in the country where the enterprises operate and international common business practices, improve their management models, and pursue unity of economic returns and social results.” (MFA 2008) In 2009, SASAC issued CSR guidelines for SOEs owned by the central government (SASAC 2009). The guidelines urged SOEs to strive for four goals: long-term business success and tax payment; ethical behavior that safeguards workers’ rights and interests; environmental protection; and contribution to social welfare through philanthropic spending.

Encouraged by the government, some Chinese banks and companies are taking an interest in environmental and social responsibility. This is particularly relevant as Chinese banks and companies increasingly interact on a global scale, enter foreign stock

exchanges, and market their products abroad. In 2007, China Construction Bank was the first state-owned Chinese bank to publish a sustainability report (China CSR 2007). In the next two years, China Development Bank, Industrial and Commercial Bank of China, Agricultural Bank of China, and Bank of China also released their first reports.<sup>a</sup>

Companies often describe their approach to stakeholder engagement in sustainability reports. For example, PetroChina, which started publishing sustainability reports in 2006, states in its 2010 report:

Trust and support from our stakeholders is the basis for PetroChina to evolve and develop. We are dedicated to improving the quality of our development and our efficiency to maximize long-term value. We are also committed to showing our gratitude to stakeholders by delivering achievements of our development to maximize the common interests of the Company and our stakeholders so as to achieve harmonious and mutually beneficial development (PetroChina 2011).

PetroChina also engages with local communities through dialogues, exchanges, and increasing information disclosure (PetroChina 2011).

These recent and rapid developments indicate an increasing awareness of the need for transparency and disclosure. Although many financial institutions’ voluntary corporate initiatives focus on their domestic lending activities, they may soon expand to overseas lending. This expansion is an important step toward creating and adopting the next generation of best practices. Furthermore, in 2008, Industrial Bank became the first private Chinese bank to adopt the Equator Principles (Industrial Bank of China 2008), a global standard for environmentally and socially responsible project finance. Industrial Bank’s actions may encourage other banks to either adopt existing standards or create their own.

a. See CDB’s Social Responsibility Report 2007, <http://www.cdb.com.cn/WebSite/cdb/UpFile/srr2007/index-en.html>, Industrial and Commercial Bank of China’s 2007 Corporate Social Responsibility Report, <http://www.icbc-ltd.com/ICBCLtd/SocialResponsibility/Corporate%20Social%20Responsibility/2007/>, Agricultural Bank of China’s 2007 CSR Report, <http://www.abchina.com/en/about-us/csr-report/> and Bank of China’s CSR Report 2008, [http://www.boc.cn/en/aboutboc/boccsr/200905/t20090506\\_690712.html](http://www.boc.cn/en/aboutboc/boccsr/200905/t20090506_690712.html)

This section discusses policies emerging from the various institutions involved in overseas investments: financial institutions, specific sectors, and regulatory bodies, as highlighted in Box 9. In addition, it introduces policies that are still developing in China. The application and enforcement of the policies described in this section is a crucial next step. The effective implementation of these policies is discussed in the next section.

### Approaches of Chinese Regulatory Bodies

Governmental regulatory bodies are creating social and environmental guidelines to regulate the activities of institutions under their jurisdiction. In February 2012, the CBRC released new “Green Credit Guidelines” that strengthen the 2007 Green Credit policy (CBRC 2012). The 2012 guidelines focus on environmental and social risk management in domestic and overseas lending and provide more specific guidance on both domestic and overseas lending. They emphasize the crucial role that financial institutions play in the development of a sustainable and environmentally friendly economy. They offer direction for green lending policies and require banks to “identify, measure, monitor, and control environmental and social risks” in their operations.<sup>12</sup> They also state that the CBRC is in charge of supervising and administering banks’ environmental and social risk management.

A section of the CBRC guidelines dedicated to overseas investments states that banks should strengthen environmental and social risk management for proposed projects, comply with local laws, and adopt international standards to ensure

they follow international best practices.<sup>13</sup> However, the remainder of the CBRC guidelines fails to specify applicability of these environmental and social risk management practices to overseas or domestic lending. As a result, it is unclear how lending institutions will ultimately interpret the guidance in relation to their international lending. Other sections of the guidelines highlight the importance of environmental and social policies in risk management, and provide details about monitoring and supervision. Regardless of whether these guidelines are applied to domestic or overseas lending, they demonstrate that the CBRC recognizes the close link between environmental and social policies and risk mitigation.

SASAC’s regulatory system governing the overseas investments of central SOEs also requires enhanced risk assessment and mitigation (see Box 9). SASAC designed and is implementing a two-year training program for central SOEs to improve key management areas, one of which is risk management in overseas investment. Although the training did not focus on environmental and social risks, after the training several companies included these types of “new risks” in their reflections and planning (SASAC 2012). In addition, SASAC promulgated “Guidelines to the State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities” in 2007, indicating that CSR is crucial for central SOEs to expand their international economic activities (SASAC 2007).

In February 2013, MOFCOM and MEP jointly issued guidelines that could revolutionize the environmental and social impacts of Chinese institutions investing abroad. The “Guide-

In February 2013, MOFCOM and MEP jointly issued guidelines that could revolutionize the environmental and social impacts of Chinese institutions investing abroad.

lines on Environmental Protection for Overseas Investment and Cooperation” require all Chinese companies operating overseas to conduct environmental impact assessments, develop mitigation measures, and work with local communities to identify potential negative impacts of the investment (MOFCOM and MEP 2013). Although these guidelines focus primarily on environmental issues and do not address many social issues, they represent an important first step toward developing a consistent approach across China’s overseas investments. As of early 2013, these policies had yet to be implemented, which, as discussed throughout this brief, is a vital second step to effect-

ing change. Thorough and systematic implementation requires resources, time, and coordination between the relevant bodies illustrated in Figure 4.

Chinese policies governing overseas investments are evolving. For example, in 2012 the National Development and Reform Commission (NDRC) announced plans to increase its jurisdiction over outward investments and streamline the approval process for both inbound and outbound investments. In late 2012, NDRC released new draft regulations updating its 2004 overseas investment regulations (Gao, Zhou, and Shaw, 2012). As of early 2013, it remained to be seen how these new policy developments would affect the approval process for overseas investments, and how they would affect NDRC's relationship with MOFCOM, which also regulates foreign direct investment.

### Approaches of Individual Chinese Financial Institutions

Some financial institutions in China have developed their own policies (see Box 9). For example, in 2004, China ExIm developed a short set of environmental and social guidelines, and in 2008 issued revised, more robust, "Guidelines for Environmental and Social Impact Assessment of the China Export Import Bank's Loan Projects" (CCICED 2011). These guidelines, which address both domestic and international lending, give China ExIm the right to require environmental and social considerations in the loan contract, and to require that companies receiving bank finance conduct environmental and social impact assessments before beginning a project. They also give the bank the right to monitor the client's implementation of the assessment. As one of China's most

influential policy banks, and one of the largest export credit agencies in the world, China ExIm's approach to environmental and social risk management could set a precedent for other investors in China.

CDB also introduced environmental policies, such as limiting access to credit to companies engaged in "high energy consumption, high pollution and excess capacity" industries, and implementing environmental impact assessment (EIA) loan veto mechanisms. In addition, CDB identifies renewable energy, energy efficiency, and environmental protection as its priority lending areas, which is reflected in CDB's first "Guidelines on Solar Power Development" and "Development Finance Cooperation Agreement" with MEP (MEP 2010). CDB's general support of low-carbon industries is also reflected in its overseas lending (Tan et al. 2013).

### Approaches of Specific Sectors

Industry sectors are also beginning to establish social and environmental guidelines. For example, in 2007 and 2009, two guides outlining sustainable overseas practices were published: "A Guide to Sustainable Overseas Silviculture by Chinese Enterprises" (State Forestry Administration) and "A Guide to Sustainable Overseas Forests Management and Utilization by Chinese Enterprises" (State Forestry Administration and MOFCOM). These guides contain basic tenets, such as observing Chinese and host country laws, and emphasize principles such as ecosystem protection. Certain associations, such as the China International Contractors Association, are also creating new guidelines (see Box 11).

## BOX 11

### GUIDE ON SOCIAL RESPONSIBILITY FOR CHINESE INTERNATIONAL CONTRACTORS

Although international contractors are distinct from overseas investors, they work in similar sectors (such as extractives and infrastructure), and are eligible for financial support from CDB and China ExIm. In 2011, international contractors completed projects worth US\$103.4 billion, while OFDI projects completed in the same period were worth US\$60 billion (MOFCOM 2012a, 2012b).

In September 2012, the China International Contractors Association released a "Guide on Social Responsibility for Chinese International Contractors" (China International Contractors Association 2012).

These guidelines, created under the direction of MOFCOM, describe requirements for social responsibility management and focus on seven issues, including environmental protection and community development.

## CHALLENGES AND OPPORTUNITIES FOR CHINA IN MANAGING OFDI

Environmental and social policies that govern overseas investments are essential for the long-term success of Chinese investments. As discussed earlier, there are multiple reasons why Chinese investors benefit from sound governance, including improved relations with host country governments, prevention of local community opposition, and risk identification and mitigation. From a business perspective, China's overseas investment approaches—including joint ventures, mergers and acquisitions, and loan-for-resource programs—are similar to those of other countries (Brautigam 2009).

However, several characteristics of Chinese OFDI are distinctive. For example, the vast majority of Chinese FDI is directly or indirectly state-owned, operated, or controlled. In addition, the Chinese government has supported companies by providing access to finance and insurance to lower the cost of doing business (The China Analyst 2010). SOEs must carefully balance their roles as profitable business entities and government policy instruments; because the government can set, coordinate, and enforce SOE policies, their actions can be assumed to reflect Chinese national interests.

### Emerging Issues and Challenges Faced by China

The international community is paying increasing attention to Chinese overseas investments.<sup>14</sup> The former president of the U.S. Export-Import Bank has noted that U.S. environ-

mental groups that previously monitored the environmental and social impacts of only Western overseas investors are now also monitoring Chinese investors (Global Environmental Institute 2010). Because China is a relatively new actor in this arena, interested groups lack details and a thorough understanding of its investors and financial institutions. A lack of information and misunderstanding about China's motivations for investing abroad can lead to fear in the United States and other Western countries; these countries may be unsure why China is increasing overseas investments. This worry resonates with Chinese experts who are concerned about how the world perceives China's economic rise. Officials from the Chinese Ministry of Foreign Affairs, the State Forestry Bureau, and the Ministry of Environmental Protection have noted that the negative environmental and social impacts of China's overseas investments invite international criticism and may hurt China's national image and business reputation, as well as the employees of these businesses (Global Environmental Institute 2010). The former Director General of the Chinese Academy of International Trade and Economic Cooperation, which is part of MOFCOM, has commented that China faces a major hurdle in enforcing environmental laws in overseas investments due to the need to improve its laws, increase academic research in this field, and increase visibility of applicable laws (Global Environmental Institute 2010).

Individual Chinese investors face challenges on multiple fronts: political, economic, legal, business, and cultural. Both internal (domestic) and external (international) sources contribute to these challenges, which

can affect the success of overseas projects. As described in Box 4, multiple risks are associated with these challenges, including environmental and social risks. These risks must be addressed to avoid short- and long-term problems in a project. Many of these risks hinder the long-term success of an investment; addressing them early can reduce risk. Practices such as risk assessment and management, as well as grievance mechanisms that flag potential problems, can prevent negative outcomes. Risks must be actively avoided through strong policies and consistent implementation of those policies. WRI is currently researching the benefits of risk assessment and mitigation, and examining case studies where environmental and social risk management has affected the success of a project.

These risk factors illustrate the many challenges involved in overseas investment projects, regardless of whether the investor is a Western economy or an emerging economy like China. Identifying these factors can help elucidate and categorize how challenges should be handled, and what areas of expertise are pertinent. Identification of risk factors is crucial to mitigating the potentially negative effects these factors can have on the success of an investment.

Poor understanding of the regulatory and legal environment in host countries is another challenge that potentially applies to the risks listed above. Environmental and social policies are part of the regulatory and legal environment of a country.<sup>15</sup> Understanding a foreign country's regulatory and legal environment is a complex process that involves collecting, analyzing, and processing information about a host coun-

try. This information must then be incorporated into the planning and implementation of investments. In 2009, a group of institutions—the Chinese Academy of International Trade and Economic Cooperation, the Investment Promotion Agency of MOFCOM, and the in-country Economic and Commercial Counselor’s Office—published the Guidebook of Investment Environment series by country and region. Each of the 165 guidebooks provides information about investing in a specific country and highlights potential problems. These books, which are updated annually, are designed to help investing enterprises make informed decisions when operating overseas.<sup>16</sup>

Supervisory challenges faced by Chinese regulatory bodies should also be identified and addressed. Supervision of SOEs, banks, or any large institution is an enormous task, but can be handled effectively through open, trustworthy, and frequent communication with the business community. This communication can be strengthened by creating strong policies and guidelines based on sound principles. Translating these policies into routine business practices may be difficult, but can be accomplished through careful design and implementation plans.

Policy implementation is a final challenge. Whereas strong policies are a necessary first step toward positive environmental and social performance, policies are only as

effective as their implementation and enforcement mechanisms. An effective policy generally contains or is accompanied by guidance on how it should be implemented, including timing, methodology, and tools to administer it.<sup>17</sup> Clear guidance should be given on how to enforce the policy and ensure compliance, which can include monitoring and oversight mechanisms. Effective policy implementation requires funding, training,

Policy implementation is a final challenge. Whereas strong policies are a necessary first step toward positive environmental and social performance, policies are only as effective as their implementation and enforcement mechanisms.

coordination, monitoring, and evaluation. Barriers such as time, cost, and assumption of responsibility by different branches of government may impede implementation. China needs to invest sufficient resources in implementation and enforcement to demonstrate its commitment to these policies.

## Opportunities for China

China’s rapid economic growth and global influence offers it an opportunity to become the new global leader in environmental and social performance. China can shape the direction, impact, and return on the increasing amounts of OFDI it is investing abroad. Its policies in this area could strengthen environmental and social sustainability, an important consideration

for every country. Long-term resource security and investments that support sustainably produced products is important in a resource-constrained world. These policies could also strengthen China’s international profile and provide financial benefits as institutions develop more efficient and effective ways to manage overseas investments.

However, these opportunities are coupled with challenges. The Chinese government’s policy efforts reveal a growing commitment to environmental and social concerns, but there is significant room for improvement. Comprehensive policies are needed at multiple levels and in a variety of insti-

tutions, such as the central government, SOEs, and private companies. Once these policies are created and adopted, effective implementation will be crucial. In the case of national government or national-level SOE policies, implementation largely depends on buy-in, training, and coordination across the numer-

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ous Chinese ministries and SOEs involved in overseas investment. Strong environmental and social performance can be achieved only if incentives and enforcement mechanisms ensure effective implementation and accountability.

Governments as well as national and international institutions are paying increasing attention to environmental and social policies. International financial institutions such as the IFC are also looking for ways to keep their standards updated. China could seize this opportunity to step into the role of facilitator and leader, initiating exchanges with other investors. The exchange of experience and knowledge among Chinese, foreign, and international institutions would contribute greatly to the knowledge base available to all investors. The focus of these dialogues, international forums, study tours, or informal exchanges would be peer-to-peer exchange among equivalent institutions such as government-to-government, SOE-to-multinational company, and financier-to-financier. These exchanges would also contribute to one of the goals of China's 2011–2015 five-year plan: to develop mutually beneficial cooperation with other countries.

The proposed exchanges would enable Chinese SOEs to benefit from lessons about the success and failure of various policies, and offer insight into how to improve them. China could use lessons from other countries to its advantage and develop safeguards, standards, and guidelines that exceed those already in existence. China, a relatively new entrant to the large-scale OFDI scene, can bypass years of trials by other countries and institutions to emerge as a new standard-setter that

can then share its experiences with other countries and institutions.

By increasing its knowledge and leading a new generation of policies, China can spark a race to the top with robust environmental and social policies. At the same time, it can lower investment risk and improve performance. As an increasingly key international investor and experienced recipient of foreign investment, China is well positioned to lead. Ultimately, policies that simultaneously accommodate China's needs and the environmental and social needs of host countries will be the most successful approaches to effective environmental and social governance of OFDI. In this way, China can bring mutual benefit and "win-win" development to host countries.



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## ENDNOTES

1. Outward foreign direct investment is direct investment from one country going outward to another country.
2. South Africa ranks first.
3. From US\$0.9 billion in 2000 to US\$68.8 billion in 2010, calculated with data from UnctadStat (2012) and MOFCOM (2011).
4. Calculated from China ExIm 2004 and 2010 Annual Reports.
5. “Capital in transit” is generally categorized as “business services,” which might eventually be channeled into the extractives sector as well.
6. In July 2010, for example, the International Energy Agency estimated that China had become the world’s largest energy consumer (although on a per capita basis, it only consumes about one-third of the OECD average), see IEA (2010). Likewise, oil demand for transportation is expected to quadruple by 2030 (IEA2007).
7. In the case of safeguards, for instance, such institutions should: anticipate social and environmental risks, make plans to avoid such risks, manage implementation of those plans, monitor results, and respond to harm.
8. From 2012 to 2014, the World Bank will be updating its environmental and social safeguard policies.
9. See generally Independent Evaluation Group 2010.
10. For more information, see IFC’s Sustainability Framework, [http://www1.ifc.org/wps/wcm/connect/Topics\\_Ext\\_Content/IFC\\_External\\_Corporate\\_Site/IFC+Sustainability/Sustainability+Framework](http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework), World Bank’s safeguard policies, <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/EXT-POLICIES/EXTSAFEPOL/0,,menuPK:584441~pagePK:64168427~piPK:64168435~theSitePK:584435,00.html>, and the Equator Principles, <http://www.equator-principles.com/>.
11. “OPIC Agreement” is defined in this document as “An OPIC loan agreement, guaranty agreement, project consent, or insurance contract.”
12. CBRC 2012. Chapter I: General Provisions, article 4.
13. CBRC 2012. Chapter IV: Process Management, article 21.
14. See, for example, Economist, “Trying to Pull Together: Africans are Asking whether China is Making their Lunch or Eating It,” April 23, 2011.
15. See presentation by Zhang Guang Rong, “China’s Overseas Investment in Energy & Resources Sector: Win-Win Cooperation and Common Prosperity,” presentation at WRI Emerging Actors in Development Finance, 2011. [http://powerpoints.wri.org/gei\\_book\\_launch/guangrong\\_zhang\\_china\\_overseas\\_investment\\_in\\_energy\\_resources\\_sector\\_2011-06.pdf](http://powerpoints.wri.org/gei_book_launch/guangrong_zhang_china_overseas_investment_in_energy_resources_sector_2011-06.pdf)
16. See description of books at MOFCOM’s Outward Investment and Economic Cooperation Department website, <http://fec.mofcom.gov.cn/gbzn/gobiezhinan.shtml>
17. For more information, see Herbertson et al. 2009.

## ACRONYMS

ADB	Asian Development Bank
BNCES	Brazilian Development Bank
BRICS	Brazil, Russia, India, China, and South Africa
CAEP	Chinese Academy for Environmental Planning
CBRC	China Banking Regulatory Commission
CDB	China Development Bank
China ExIm	The Export-Import Bank of China
CSR	Corporate social responsibility
EIA	Environmental impact assessment
EPC	Engineering, procurement and construction company
FDI	Foreign direct investment
GEI	Global Environmental Institute
GRI	Global Reporting Initiative
IFC	International Finance Corporation
IFFE	International Financial Flows and Environment Objective
IPIECA	International Petroleum Industry Environmental Conservation Association
MEP	Ministry of Environmental Protection
MOFCOM	Ministry of Commerce
OECD	Organisation for Economic Co-operation and Development
OFDI	Outward foreign direct investment
OPIC	Overseas Private Investment Corporation
SASAC	State-owned Assets Supervision and Administration Commission
SEA	Strategic environmental assessment
SOE	State-owned enterprise
SPS	Safeguard policy statement
TNCs	Transnational corporations
UNCTAD	United Nations Conference on Trade and Development
WRI	World Resources Institute

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