

# Toxic Chemicals — Asian Investors are At-Risk

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Asian Governments Lagging on Policy Development  
Consumer Response Growing  
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The Message for Investors

# Toxic

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After a decade of global market debate about the impact of toxic chemical risks, the issue is now poised to have a more systematic impact on Asian listed companies. Asian investors have responded to periodic product scares and environmental problems linked to groundwater poisoning or chemical spills. Nonetheless, there has been little effort to address major investment trends linked to greater global focus on the role of chemicals in human health. Indeed, Asia-based analysts and investors have paid remarkably little attention to reforms such as the European Union (E.U.) toxics regulations<sup>1</sup> and the recently passed REACH<sup>2</sup> directive or the factors behind shareholder resolutions in the U.S. linked to toxic chemicals.

As a result, in November 2006, ASRIA and the U.S.-based Investor Environmental Health Network (IEHN) undertook a joint trip to speak to a range of Asian investors, corporates, and environmental and supply chain experts about toxic chemicals. The goal was to assess a range of practical and policy issues which promise to shape the investor response to the toxic chemicals issue in Asia. In particular, we hoped to gain insights into the dynamic surrounding greater consumer activism, and the need for more pro-active government policies. We also sought to look at Asia as a production base, in order to assess the ability of the Asian supply chain to meet the needs of global companies increasingly focused on efforts to de-toxify their supply chains. Our point of departure for this discussion was Wal-Mart's recently announced policies focused on safer chemicals.

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<sup>1</sup> The E.U. toxics regulations include two key regulations implemented on July 1, 2006. The first, known as the Restriction of use of Hazardous Substances (RoHS) requires the elimination of six hazardous substances in electrical and electronic equipment. The substances covered by the regulation are cadmium (Cd), hexavalent chromium (CR VI), Lead (Pb), mercury (Hg), polybrominated biphenyls (PBB) and polybrominated diphenyl ethers (PBDE). The second regulation covers Waste Electrical and Electronic Equipment (WEEE). WEEE requires free recycling of electrical and electronic equipment throughout the EU funded by producers, not consumers.

<sup>2</sup> The Registration, Evaluation and Authorization of Chemicals (REACH) directive approved by the E.U. will establish a single regulatory framework to screen both "existing" and "new" chemicals over an 11-year period. Both producers and importers will assume the burden of proof to establish that chemicals are safe before they are marketed.

**Investors face challenges in assessing performance issues linked to toxic chemicals**

It is important to stress that investors, whether mainstream or SRI, face challenges in assessing corporate and stock performance issues linked to toxic chemicals. The science which defines the public understanding of the impact of chemicals on human health is inevitably uneven. It can take years to demonstrate whether a chemical of concern is actually a problem. In a similar vein, the potential cost to companies and investors of poor, and sometimes criminal, decision-making on toxic chemicals often takes years to crystallize. There are also huge variations in the legal and regulatory structures which shape corporate behavior, public disclosure, and remedies. All of these variables influence the way that Asian investors think about the long-term competitive risks and opportunities which stem from the use and misuse of chemicals. Moreover, they have combined to make toxic chemicals something of a sleeper issue for Asian equity investors with significant, but still largely unrecognized, implications.

Despite the complexity of the issues, and the relative lack of sophistication in the coverage of Asian chemical companies and key downstream industries, our meetings yielded three clear themes for global and Asian investors:

- **Limited Government Leadership** Critical investment drivers are still subdued because most Asian governments are lagging their global counterparts on public policies linked to the use and supervision of toxic or potentially dangerous chemicals. This has created a vacuum which product scandals and volatile public sentiment can change.
- **Growing Asian Consumer Pressure** Asian consumers are rapidly catching up to their developed market peers in terms of concern about unsafe products and the companies who produce or sell them. This has the potential to drive a wedge into traditional government strategies which remain too focused on producer issues at the expense of consumer issues. As a result, investors can expect rapid changes in regulatory practice as governments shift gears to address human health concerns.
- **Supply Chain Training Needed** Global companies which are reliant on Asian supply chains will need to invest in training and technical support if they want to be assured of responsive partnerships with vendors. A command-and-control strategy has the potential to result in the same type of dysfunction which has been common when auditing has been used to police supply chain labor practices. Indeed, global consumer products companies and retailers which fail to link their efforts to a more engaged supply chain strategy may be accused of empty promises by those who know the operating conditions on the ground.

## Asian Governments Lagging on Policy Development

*Asian governments lack a systematic approach to toxic chemicals*

Perhaps the most striking theme to emerge from our meetings in Hong Kong, Seoul, and Tokyo was the extent to which Asian governments lack a systematic approach to management of the chemical sector in general and toxic chemicals in particular. Indeed, in most countries management of the issue is spread across a combination of health, environment, and industry ministries. There is frequently little coordination and companies and investors alike described a lack of clear policy responses to an issue of growing importance.

As a result of this policy vacuum, it is clear that E.U. policy development has become the key driver of the toxic chemicals agenda in Asia. Awareness of the RoHS and WEEE standards is high in Asia, especially among investors and company experts focused on supply chain companies which ship product into the E.U. Nonetheless, our contacts described different levels of response to the E.U. toxics standards implemented this year, often reflecting contrasting government strategies. For example, Japan is regarded as the clear regional leader on chemical policies. As a result, investors consistently described the leading Japanese chemicals and consumer companies as being well prepared to meet the new standards.

In a similar vein, the Korean government was viewed as having successfully supported the consumer electronics sector's efforts to reach early compliance. (See *Taking Stock* at [www.asria.org/publications](http://www.asria.org/publications)) By contrast, there is a general perception that government leadership in Taiwan and China has lagged, resulting in an uneven response by companies. Indeed, the key to the Japanese and Korean responses was the decision to move toward domestic standards which can be made consistent with the intent of RoHS and WEEE, effectively creating home market financial incentives to support domestic as well as export producers.

*The E.U. is regarded by Asians as they policy leader on toxic chemicals*

While the E.U. with its new REACH directive is regarded by Asian investors and companies as the policy leader, the lack of coherent national policies in the U.S. has limited awareness of many new, and quite activist, policies emerging in the U.S. at the state level. This is particularly true of new policies on chemicals such as brominated flame retardants and mercury. Nonetheless, it would appear that U.S. policy is not perceived as a factor shaping toxic chemical trends in Asia although policies by major U.S. brands are identified as driving a range of supply chain manufacturing trends.

As is often the case in Asia, it is clear that scandals—whether product or company-specific—play the most powerful role in shaping government and public policy initiatives. That said, the tools for policy enforcement remain weak and governments are often reluctant to arbitrate public disputes once questions have been raised about corporate behavior. Indeed, it is clear that Asian companies,

even those which may be compliant, run the risk of getting caught between soft government standards and public outrage when questions arise.

To date, relatively few Asian companies outside of Japan have moved toward precautionary policies emerging in the E.U. and the U.S. Nonetheless, leading Asian companies in the cosmetics and consumer products sectors may find themselves under growing pressure to differentiate themselves from sector laggards which have the potential to damage consumer confidence. This trend is also apparent in research conducted on Japanese chemicals and consumer companies which indicates significant gaps between the reporting and compliance capabilities of the leading sector players versus the laggards.

In addition to lack of proactive government policymaking, it should be noted that most Asian countries lack class action suits or a history of shareholder engagement which could impose constraints on listed companies with poor toxics records. While there have been some limited attempts to raise the profile of these issues using limited shareholder activism tools, shareholder resolutions face significant practical barriers which limit the effectiveness of this tool. Japan is the only country in Asia with a degree of organized shareholder access to legal remedies in the case of corporate malfeasance. Nonetheless, public awareness of classic toxic chemicals problems lags other developed markets. Indeed, questions about the manufacture and use of asbestos have only recently been raised.

## Consumer Response Growing

One recurrent theme in our conversations with Asian experts was the disconnect between static regulation of the chemical sector and growing consumer discontent with limited government responses to toxic chemical problems. While the discussion is often prefaced with a warning that Asian consumers remain very price sensitive, it is clear that the emergence of an Asian consumer culture has resulted in increasingly public protests against unsafe products. Indeed, this sea change has been so strong that many Asian governments are now struggling to re-orient policy development from a single-minded focus on chemical sector development to include a new focus on consumer health and safety issues. Here the infrastructure is lacking at the government level. For example, China just implemented its first revised food safety law in November 2006 after years of broadly reported tainted food problems. And now with the law in place, there is publicly acknowledged controversy over the ability of the bureaucracy to effectively enforce the law.

*Asian consumers - price sensitive, but increasingly focused on safety*

The recent fiasco in Southern China for the SK-II cosmetics brand offers an apt illustration of the risks for global and local brands.<sup>3</sup> Owned by Procter & Gamble, SK-II faced a consumer backlash in China after reports that its premium products may have had unacceptable levels of chromium and neodymium. Despite the fact that other Asian government regulatory agencies acknowledged that SK-II's product met national standards, the furor gained momentum in part due to consumer suspicions and a history of lax enforcement in the Chinese market of dangerous products. In the end, Procter & Gamble, SK-II, and the Chinese government all came in for criticism from angry consumers and the press when neither the government nor the companies offered clear remedies for confused consumers.

While China is often a source of vivid product scares, contacts in Korea and Japan describe a new middle class focus on lifestyles of health and sustainability (LOHAS) concerns which is reflected in active debate about high risk consumer products. The press has been responsive in publicizing problems linked to household products, consumer electronics, and children's plastic toys. Low or no-cost accessories, commonly distributed with consumer products, have become a particular focus of concern. These promotional items are typically manufactured at the distant end of developing country supply chains and have sparked a number of controversies due to the use of banned chemicals.

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<sup>3</sup> For a clear summary of the case, see <http://en.wikipedia.org/wiki/SK-II>

The consumer-regulatory dynamic has created complex risks and opportunities for investors. Asian companies clearly worry that simply meeting government standards offers no assurance of consumer confidence. Indeed, in quality-sensitive consumer product segments, the premium producers worry that brand image can be damaged by low-end non-compliant producers because governments and the press have little incentive to defend government standards. Nonetheless, the traditional industry associations have little experience of supporting pro-active standards development and companies are reluctant to embrace precautionary policies as a competitive tool.

This lack of industry initiative could result in higher risk for consumer products companies as more Asians turn to the internet for product information and news. For example, internet bulletin boards in China have become a fast-paced source of consumer views on products. While the reports are not always correct, they can create a high-speed viral response which can dismantle a company's brand equity in a matter of days. Similar patterns are evident in Korea and Japan where product quality problems are frequently raised first on the web before making their way to the traditional media.

Asian NGOs are beginning to show more active interest in the toxic chemicals issue. Both Japan and Korea have well-established consumer groups which periodically focus on product quality issues. In China, Greenpeace has begun to work on toxics issues related to consumer electronics products. While consumer reaction has been somewhat limited due to the "modern" appeal of electronics products, they are now considering outreach work more focused on food and product safety—an area which resonates with a broader cross-section of urban Chinese. In the meantime, WWF Japan has teamed up with a coalition of NGOs and academics to launch Toxics Watch—a website which will publish toxic chemical release data on Japanese companies.

## Cleansing the Supply Chain Will Not be Easy

In addition to mapping the Asian investment landscape related to toxics chemicals, a second goal was to assess how global companies reliant upon the Asian supply chain would translate commitments to precautionary chemicals programs to the realities of the Asian supply chain. On this issue, the feedback was consistent. The supply chain which manufactures a large number of the consumer products distributed in developed North American and E.U. markets is brittle and unprepared to address many of the emerging toxic chemical issues. In part this reflects the history of limited local market regulation, but it is also a byproduct of the punishing economics of the supply chain where new higher cost solutions can be undercut by lower cost producers.

At a practical level, Hong Kong-based supply chain and compliance experts identified a series of challenges for global companies hoping to rely on vendors to implement precautionary policies. One over-riding problem stems from the prevalence of mislabeled bulk chemicals in China. While established vendors are thought to have more rigorous testing regimes, as the Chinese supply chain has extended into more remote provinces, the supply chain has become difficult, if not impossible, to police. In addition, it is common for suppliers to substitute locally available chemicals for the specified international standard chemicals on the view that the end consumers will not be able to detect the difference.

Supply chain specialists also agreed that as the global brands seek to enforce higher standards in the chemicals area, it will be necessary to provide training and technical assistance. There are clearly mixed views about the level of compliance with existing RoHS standards across the mid- and lower tier of the Chinese supply chain. Indeed, there is a common perception that “compliance” has come to mean the existence of one RoHS manufacturing line in a factory with multiple lines. This creates the appearance of potential compliance without guaranteeing actual compliance.

Given the complexity of the supply chain, our Hong Kong contacts stressed that second- and third-tier suppliers would be reluctant to commit to higher standards without a clear commitment from global brands to aid in any transition. There was also a belief that if the large global retail chains hope to achieve their goals that they would need to work very closely with leading vendors which have established operations in China to set realistic standards. Without this, there is a fear that cynicism and non-compliance would become the norm as critical links in the supply chain hide compliance issues.

*A reality check for strained supply chains*

***Opportunities for safer replacement products and innovative bio-chemicals***

Although much of the discussion in our meetings focused on risk, changing global regulatory and consumer standards should also create tangible marketplace incentives for chemical producers with safer replacement products and innovative bio-based chemicals derived from plants and other living organisms rather than from petroleum. Nonetheless, there is concern that price and market dynamics may stand in the way of innovative products, especially if they are destined for the price sensitive consumer electronics sector. According to some market participants, even well established bulk chemical providers find it hard to establish demand for innovative products unless they are willing to price on par with existing chemicals. In addition, innovators are sometimes frustrated to find that the consumer electronics manufacturers will not commit to a product which cannot be second-sourced from a competitor.

One key to easing the adoption of innovative chemical products may be further innovation, within Asia, focused on the emerging field of green chemistry. Green chemistry focuses on strategies for reducing or eliminating hazardous chemicals. Scientists in Japan and Korea have begun to pursue the field and Chinese academics are beginning to assess the field as one which might present a leapfrogging opportunity for China. Given the domestic scarcity of traditional oil-based chemical feed stocks in China, green chemistry innovations could pay significant competitive dividends in China's supply chain industries.

## The Message for Investors

*Sustainability investors have an information advantage*

Much of the feedback gathered during our six days of dialogue with Asian specialists made it clear that toxic chemicals are a classic sleeper issue. While product scandals and groundwater problems are rising, the broader economic and social implications for human health have largely been ignored by policymakers and the financial community. The limited base of public knowledge on this topic reflects the fact that it cuts across sectors—from chemicals to consumer products—and requires an understanding of both very local consumer trends as well as global and local regulatory issues. As a result, as is often the case with cross-cutting sustainability issues, many investors have little systematic understanding of the issues.

For portfolio investors, the impact of ignorance could prove high as many of Asia’s largest listed sectors have high and unmonitored risk exposures. In an effort to define the profile of risk for investors in Asian equities, we have conducted a quick benchmarking exercise matching potential risks to Asia’s leading sectors. Using FTSE’s Asia ex-Japan All Cap index as a benchmark, we found that as much as 70% of the investible market is potentially exposed to toxic chemicals risk ranging from product liability to credit risks. This surprisingly high figure reflects some Asia-specific issues and the finance and heavy industry orientation of Asia’s equity markets.

### Higher Toxics Risks for Asian Investors?

- Limited Credit Controls** Concentrated sector exposure in Asia is higher than in North America or Europe due a lack of pro-active industry and regulatory activity. For example, Asia’s banking sector potentially carries higher risk exposure as credit policies for the chemicals and consumer products sector are unlikely to pick up issues linked to toxic chemicals. Although HSBC is unusual in having a formal chemicals policy, most leading country-level banks lack even basic ESG credit policies. The region-wide information gap on contaminated land poses a second layer of risk for the banking sector. With large and growing property, construction, and REIT sectors, Asian investors arguably face toxic chemical risks across a range of linked sectors.
- Can the Tech Sector Move Beyond Simple Compliance?** Asia’s tech sector is also at greater risk than its global peers. Although many have worked to comply with WEEE and RoHS, there is little evidence outside of Japan that Asia’s electronics sector approaches issues linked to chemicals usage in a strategic fashion. Indeed, sector disclosure on environmental issues is low, making it hard, if not impossible to assess performance.
- Maturing Consumer Sector** Asia’s consumer sector continues to grow rapidly and to diversify. The demand for consumer products, cosmetics, and a growing array of packaged foods will inevitably raise questions about safety and quality control. Nonetheless, few Asian consumer companies or retailers have developed the types of systematic policies which are necessary to manage toxics risks. As the “wellness” theme makes its way into Asian culture, however, public attention to this issue is bound to rise.

With this in mind, it seems two important conclusions deserve emphasis and will shape ASRIA's future work in this area:

1) **New Government Strategies Needed** The question of toxic chemicals and human health is a rapidly emerging, high impact issue in Asia due to rising consumer and public awareness and the impact of global competition and policy changes. Although the key issues are not well understood by consumers and market participants, new scientific and legal developments will act as a driver for awareness across the region. At the same time, Asian governments will come under growing pressure to respond to regulatory leadership from the E.U. and sporadically from the U.S. These efforts will encourage Asian governments to think more strategically about drivers for industry reform and regulatory enforcement; and

2) **Investor Information Gap** Asian investors have little systematic understanding of the toxic chemicals issue. This gap in knowledge creates an opportunity for those investors capable of identifying previously ignored drivers for sector leadership and unanalyzed sources of risk. As a result, sustainability investors may have an advantage in applying research findings developed in other markets to Asian markets. At the same time, banks and mainstream investors may need to assess their risk management tools to fill the gap in market knowledge. One challenge for portfolio managers is the fact that toxic chemical-linked risks have the potential to transform some normally low beta assets into high beta assets when companies discover that steady cash-flow products can give rise to significant liabilities.

## **ABOUT ASrIA**

### **The Association for Sustainable & Responsible Investment in Asia**

[www.asria.org](http://www.asria.org)

ASrIA is a not for profit, membership association dedicated to promoting corporate responsibility and sustainable investment practice in the Asia Pacific region. ASrIA's members include investment institutions managing over US\$4 trillion in assets, however membership is open to any organisation which has an interest in sustainable investment.

ASrIA has taken a leadership role in promoting sustainable investment in Asia since our founding in 2001. ASrIA has run conferences, seminars and workshops, and published wide-ranging research on SRI issues. ASrIA has also created a very wide network of organizations and individuals interested in the broad range of policy issues and investment strategies which are essential to the implementation of SRI in Asia. ASrIA's website, [www.asria.org](http://www.asria.org), is the primary resource for SRI in Asia, attracting over 4,000 page views per day and over 5,000 subscribers to our regular e-bulletin.