

Constructing an ESG (Environment, Social, Governance) Index for Emerging Markets: A Pilot In India

Subir Gokarn
Chief Economist, S&P Asia-Pacific

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Agenda

- ▶ Background on corporate responsibility and corporate governance
- ▶ Building an “ESG” (Environment, Social, Governance) model for emerging markets
- ▶ Model development to index construction

Basic Concepts

- ▶ **Business performance can be assessed in social and environmental terms, as well as in traditional financial terms.**
- ▶ **There is great debate about how ESG factors are interlinked with a company's near and longer term financial performance.**
 - **Traditionalists see corporate social responsibility as a potential distraction and loss of focus from fiduciary duty to the company and its shareholders.**
 - **Corporate responsibility advocates focus on the need for companies to focus on its broader social role, particularly with regard to key external stakeholders. They tend to be in two different (but not mutually exclusive) camps:**
 - **values driven (doing the right thing)**
 - **enlightened self interest (the right thing makes the most financial sense for investors)**

Corporate Responsibility: Evolving Focus

Traditional approach to Corporate Responsibility: Public Relations focus

- ▶ Compliance-based: law and regulatory standards
- ▶ Limited integration with corporate decision making and processes
- ▶ Self-selecting disclosure: “greenwashing”

Developing approach to Corporate Responsibility: Strategic focus

- ▶ Reputational Risk
- ▶ Operational Risk
- ▶ Stakeholder Relations
- ▶ New Customers and Markets
- ▶ Sustainable Competitive Advantage

Business Case for ESG

- ▶ “Mainstream” investor orientation:
 - Looking to *maximize financial returns* subject to specific risk tolerances
 - Investing mandate typically does not include a specific social agenda

- ▶ Social and environmental factors come into consideration as an important component of stakeholder relations.

- ▶ Companies need to maintain positive and constructive relations with key non-financial stakeholders such as *employees, customers, communities* to:
 - Maximize sustainable competitive advantage (business risk)
 - Minimize operational/ reputational risks (financial risk)

- ▶ ESG focus is potential impact on investors and stakeholders, both short term and medium/long term

Corporate Responsibility: Key initiatives

- ▶ **Principles for Responsible Investment.** A UN led initiative launched in 2006 to encourage institutional investors to more actively factor ESG issues into the investment process. It has 180 signatories, mostly asset owners and managers, representing over \$8 trillion in assets under management. <http://www.unpri.org/>
- ▶ **Carbon Disclosure Project.** This is an organization representing 284 institutional investors with assets of over \$41 trillion under management which formally requests 2400 of the largest quoted companies in the world by market capitalization, to provide disclosure of investment-relevant information concerning the risks and opportunities facing these companies due to climate change. <http://www.cdproject.net/>
- ▶ **Enhanced Analytics Initiative.** The Enhanced Analytics Initiative is an international collaboration between asset owners and asset managers aimed at encouraging investment research takes account of the impact of ESG and other non-financial factors on long-term investment. The EAI currently represents total assets under management of US\$2.4 trillion. <http://www.enhanced-analytics.com/>
- ▶ **UN Global Compact.** This is a voluntary code of corporate conduct, sponsored by the UN, which articulates 10 principles relating to human rights, the environment and anti-corruption. It has over 2900 signatories from businesses in over 100 countries globally. <http://www.unglobalcompact.org/>
- ▶ **Global Reporting Initiative.** The GRI is an initiative linked to the United Nations Environment Program whose purpose is to develop a set of globally consistent reporting principles and standards for corporate environmental, and social performance. To date, nearly 1000 corporations in over 60 countries have declared their use of the GRI Reporting Framework. <http://www.globalreporting.org/>

Why An ESG Index

- ▶ **An Index relates companies ESG performance to stock market performance**
- ▶ **An Index can incorporate several subtleties, e.g. rules and rewards for performance relative to certain indicators**
- ▶ **An Index can create incentives for companies to improve ESG performance**
 - **An index has assets attached to it, raising the cost of capital for those that aren't on the index**
 - **An index creates a public list of leaders and therefore laggards, driving companies to be on “the list”**

Liquid Tradable Index Construction

- ▶ A liquid tradable index with 50 stocks which are the highest scoring companies on the combined ESG scale
- ▶ The index would be weighted by ESG scores and not by market capitalization
- ▶ This will take away the size impact of companies and the index will measure performance on ESG basis
- ▶ This index structure will differentiate between a standard market capitalization weighted index performance and an ESG based performance
- ▶ This approach is best suited for narrow targeted indices
- ▶ A three year historical performance will be calculated

A Broader Market Capitalization Weighted Index

- ▶ **A 200 stock index for a broader measure of the market**
- ▶ **A market capitalization weighted index**
- ▶ **Stocks will be selected on the basis of ESG scores**
- ▶ **Stocks above the mean ESG score of the universe will be eligible for inclusion**
- ▶ **Sector representation and liquidity will be taken into account for stock selection**
- ▶ **A three year historical performance will be calculated**

Analysis of ESG Performance

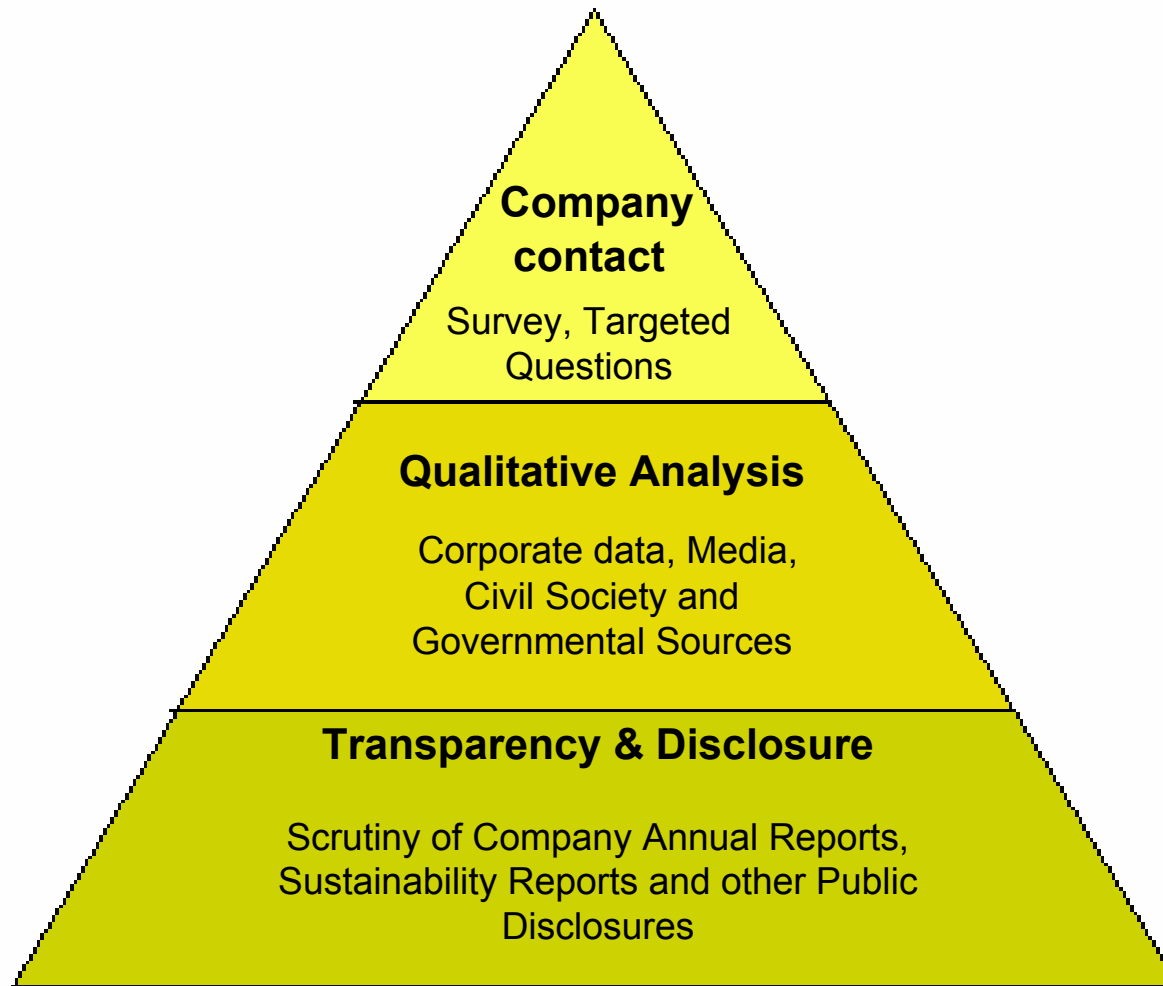
What knowledge claims can we make?

We can objectively measure certain factors which can serve as proxies or as evidence that might suggest good governance of stakeholder relations. These relate to:

- 1. Company ESG disclosure**
- 2. Company public commitment to corporate responsibility and corporate governance and to recognized ESG standards**
- 3. Evidence of mismanagement or value adding management of stakeholder relations**

These factors can be objectively assessed and form the foundation of our criteria for assessing ESG.

The Broad Approach for Scoring ESG



Transparency and Disclosure – What Gets Measured Gets Management Attention

- ▶ **T&D is the key for evaluating emerging market companies as ESG disclosures are at a very rudimentary stage**
- ▶ **Is one of the most useful/practical ways to assess qualitative factors and uneven information in a comparative model**
- ▶ **Provides an object foundation for index construction, whether or not there is incremental disclosure through public information screening and survey completion**
- ▶ **Simple and Objective Scoring**
- ▶ **Lead to increased pressure on companies to display greater and more sophisticated T&D**
- ▶ **Used for measuring on all three parameters of governance, environment and social accountability**

Transparency and Disclosure – Disclosure Items

127 Corporate Governance (G) disclosure items identified

- ▶ Shareholder rights
- ▶ Audit Process
- ▶ Financial and operational indicators
- ▶ Board and management profile
- ▶ Ownership structure
- ▶ Business Ethics

61 Environmental and Social (ES) disclosure items identified

- ▶ Environment
- ▶ Employees
- ▶ Community
- ▶ Customers/Product

Disclosure Themes

- ▶ Operational and financial performance
- ▶ Management and governance structures
- ▶ Corporate policies and codes of practice

Transparency and Disclosure – Scoring Process

- ▶ All 188 items scored on a binary (1/0) basis for each disclosure item
- ▶ Composite ESG T&D score is 50% G and 50% E and S
 - Greater amount of disclosure items available on governance
- ▶ 188 items include 27 “Extra Point” G questions for disclosure of governance practices that are discretionary and which generally reflect good governance practices
 - Extra point questions contain greater weighting
- ▶ Weighting of ES disclosure items differs according to sector
 - High, Medium and Low impact
- ▶ Candidates for inclusion in the liquid tradable index are likely to have T&D scores that lie at least one standard deviation above the mean
- ▶ Candidates for inclusion in the broader market capitalization index are likely to have T&D scores that are at least above the mean

Transparency and Disclosure Results – Take Away

ESG Composite (188 items)

- Mean normalized ESG score is 35 (out of 100), with a standard deviation of 8
- Scores ranged from 21 to 65

Governance (127 items)

- Mean normalized ES score is 50 (out of 100), with a standard deviation of 5
- Scores ranged from 37 to 73
- Out of 127 disclosure items of G, on 45 items the data is always disclosed (1=yes)
 - e.g. identity of shareholders holding more than 10% share, method of asset valuation, decision making process for directors' pay etc.
- Similarly, on 6 items the data is never disclosed (0=no)
 - e.g. shareholding in the company by individual senior managers, cross ownership, transparency of the procedure for initiating inquiries with the board, ownership structures of affiliates etc.

Environment and Social (61 items)

- Mean normalized ES score is 19 (out of 100), with a standard deviation of 13
- Scores ranged from 1 to 71
- Out of 61 disclosure items of ES, there is no item where the data is always disclosed (1=yes)
- However, there are 4 items where the data is never disclosed (0=no)
 - e.g. total water used by source, number of strikes/ lockouts and the number of employees involved, number or percentage of employees that are unionized etc.

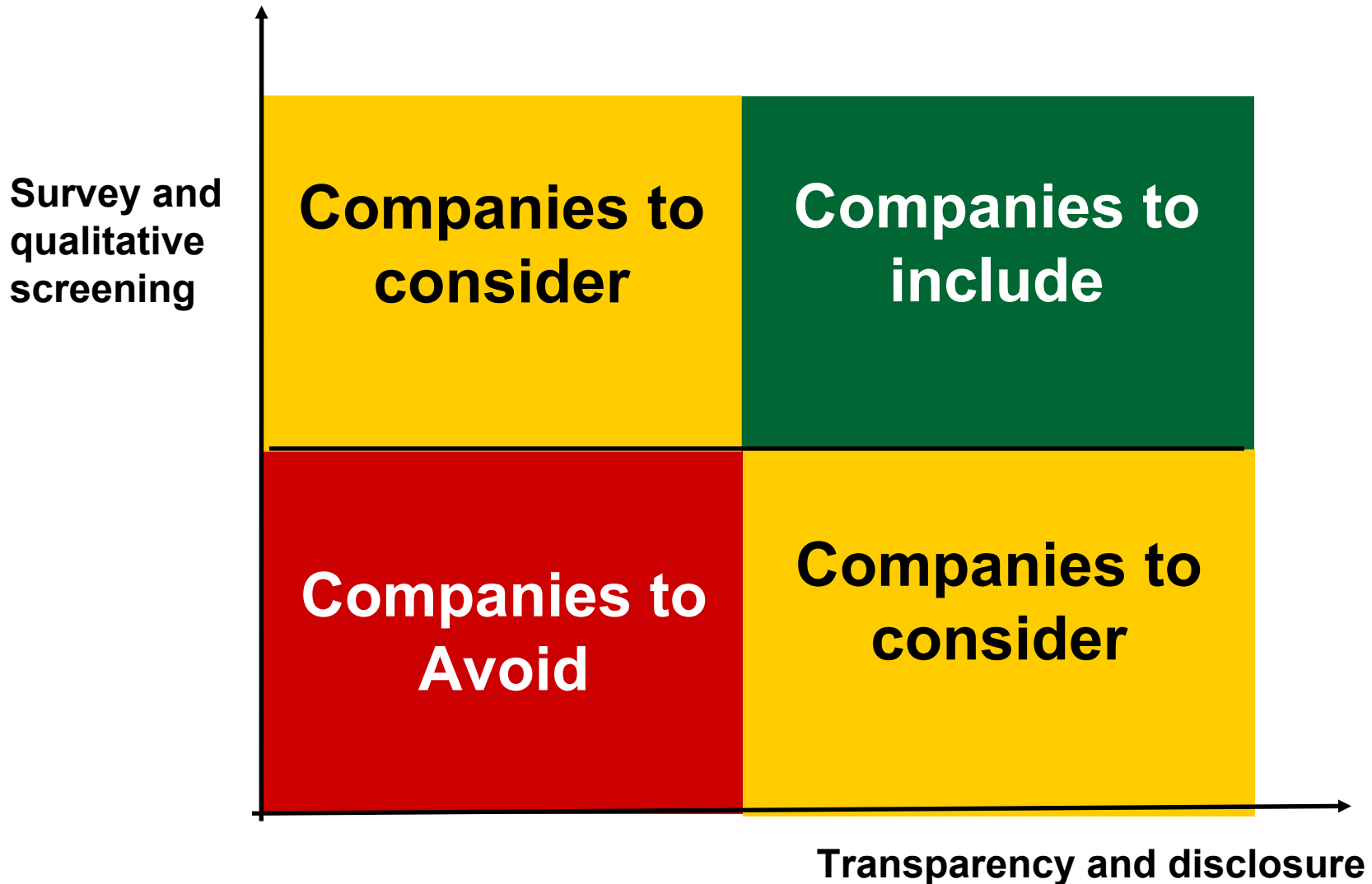
ESG Parameters : Qualitative Review Framework

Corporate Governance	Environment	Employee Relations	Community	Customers / Product	Business Ethics
Ownership Structure	Environmental Pollution	Labor Rights	Human Rights	Product Safety and Quality	CSR Leadership
Shareholder Rights	Natural Resources Use	Employee Health & Safety (H&S)	Community Investment	Monopolistic Practices	Corruption
Transparency, Disclosure and Audit	Management Policy and Performance Indicators	Equal Opportunity		Customer Relations	Business Ethics
Board Structure and Effectiveness		Employee Relations			

Qualitative Assessment

- ▶ **Analysis of independent sources of information from regulatory agencies, NGOs, and the media as well as company sources such as websites, regulatory filings, and CSR reports.**
- ▶ **Scoring on both negative and positive scale**
 - **5 point scale: 1 – 3 – 5 – 7 – 9**
 - **Default = 5 if neutral or limited information**
- ▶ **Weighting given sector impacts for ES factors**
- ▶ **Qualitative performance factors that are clearly material from both a social and a business impact perspective used as “flags” or screens**
 - **Catching instances of “extremes”**
 - **Assessing differences between disclosure quality and examples of specific performance**
- ▶ **Qualitative review can be expressed quantitatively**
 - **Focus on scores below mean or one standard deviation below as criteria to exclude high T&D scorers from index**
- ▶ **Seeking to ensure that companies with good ESG T&D disclosure but poor performance are not included in the index**

T&D Approach and Foundation for ESG Index



Some Scoring Results–Corporate Governance T&D Score

Sector	Average Score	Standard Deviation
Consumer Discretionary	50	5
Consumer Staples	51	4
Energy	50	7
Financials	48	6
Health Care	50	6
Industrials	48	4
Information Technology	51	6
Materials	51	5
Telecommunication Services	51	3
Utilities	50	5

Scoring Results Cont.–Environment and Social T&D Score

Sector	Average Score	Standard Deviation
Consumer Discretionary	13	8
Consumer Staples	14	11
Energy	27	17
Financials	14	9
Health Care	19	8
Industrials	16	10
Information Technology	18	11
Materials	33	14
Telecommunication Services	38	12
Utilities	26	11

Company Contact/Survey

- Questionnaire development part of the project activity: to be determined
 - *Feedback welcome from investor consultation*
- Targeted ESG performance questions part of the project activity: to be determined
 - *Feedback welcome from investor consultation*
- Design to draw on existing templates but shaped by learning from first two stages
- Critical “experimental” component of the project
 - *Testing companies’ willingness for deeper disclosure*
 - *Boundaries of this willingness*
- Usable responses will provide basis for value added scoring
- Challenge is to get a sufficiently large response rate with data of high quality

Thank You

Appendix

Analysis of Stakeholder Relations

1. Company public commitment to corporate responsibility generally and to recognized ESG standards

- ▶ **Company public recognition of/commitment to recognized codes and standards relating to ESG issues. Can include: UN Global Compact, Global Sullivan Principles, Equator Principles, Principles for Responsible Investing, etc.**
- ▶ **General company affirmation of principles and commitments relating to ESG in internal and external communications.**
- ▶ **Evidence that company is or is not living up to its commitments?**

Analysis of Stakeholder Relations

2. Company ESG disclosure

- ▶ Can be “measured” even in its absence (T&D concept)
- ▶ Approach is supported by the premise that companies manage what they disclose—disclosure will focus management attention on ESG factors.
- ▶ Disclosure patterns are patchy- reflects the lack of structured reporting in this area to date.
- ▶ Global Reporting Initiative (GRI). Leading standard setter, but criticized by both corporates and investors for rigidities. 700+ global companies report under GRI, such as BP, Matsushita Electric, McDonald’s, Telefonica, RWE.
- ▶ Also beginning to see independent assurance reports on ESG related performance standards.
- ▶ Beware CSR as public relations tool, offering form over substance. Risk of self-selecting, possibly misleading, “greenwashing” or “window-dressing”.

Analysis of Stakeholder Relations

3. Management and board controls, risk management and incentive systems relating to ESG factors

- ▶ How are ESG risks defined and overseen by enterprise wide risk management systems or other forms of internal control?
- ▶ Evidence of board engagement around ESG factors
- ▶ Links of ESG to broader balanced scorecard or other qualitative forms of performance reporting
- ▶ Links to incentive systems
- ▶ CSR function? Seniority, job spec and reporting line.
- ▶ Company engagement with legitimate stakeholder groups

Analysis of Stakeholder Relations

4. Evidence of mismanagement or value adding management of stakeholder relations

Examples of stakeholder relations related events that can affect investors:

- ▶ Employee unrest or loss of key staff
- ▶ Health and Safety violations
- ▶ Lawsuits
- ▶ Regulatory penalties
- ▶ Community/NGO disputes
- ▶ Alienation of customers and suppliers
- ▶ Loss of brand value
- ▶ Loss of reputation

A key issue for investors here is materiality.

- ▶ Individual incidents can vary in impact on the company's financial performance and strategic positioning.
- ▶ Chronic or multiple problems could signal broader management issues

Strongest Analytical Profile

- 1. Company public commitment to corporate responsibility and to recognized ESG standards:** The company has publicly announced its commitment to a recognized ESG standard (e.g., Global Compact, etc) and there is no evidence to suggest the company is in violation of its commitment.
- 2. External Reporting:** Good public disclosure on key areas of employee, community and environmental activities. Top reporters will use the GRI framework or report in broad accord with this framework and will also have independent verification/assurance of ESG performance standards.
- 3. Links of external social and environmental reporting to internal risk management and incentive processes.** Evidence that the company has identified material social and environmental risks and has introduced processes to manage and govern the company with regard to these risks. These matters have explicit board oversight.
- 4. Proactive stakeholder relations.** The company maintains proactive programs to address interests of legitimate stakeholder groups.
- 5. Evidence of harmful relationships.** No evidence of material problematic relationships with non-financial stakeholders that could impair longer term performance.

Weakest Analytical Profile

- 1. Company public commitment to corporate responsibility and to recognized ESG standards: A lack of a public commitment can be viewed as a neutral or somewhat negative factor. However this can be a more significant weakness if a company has made a public commitment to a recognized ESG standard and there is evidence to suggest the company is in violation of its commitment.**
- 2. External Reporting: No or minimal social reporting. Or there is evidence that the company may “greenwash” or distort its performance to present a more positive image than is justified by its processes and track record.**
- 3. Links of external social and environmental reporting to internal risk management and incentive processes. No evidence that the company has identified material social and environmental risks or has not introduced processes to manage and govern the company with regard to these risks. Board oversight over stakeholder relations either non existent or minimal.**
- 4. Proactive stakeholder relations. The company does not maintain proactive programs to address interests of legitimate stakeholder groups, and there is evidence that this is harming the company’s reputation and strategic stakeholder relations.**
- 5. Evidence of harmful relationships. Documented history of employee disruption, environmental litigation, and conflicts with local communities or regulators. These have potential to have a material impact on the company’s finances or longer term operational performance.**

Questions to Guide Analysis of Stakeholder Relationships

- ▶ **Has the company publicly committed to or acknowledged one of the recognized ESG standards?**
- ▶ **What is the role of the board with regard to oversight in this domain?**
- ▶ **How are social and environmental issues identified by the company's management?**
- ▶ **How does disclosure of stakeholder relationships relate to internal risk management and incentive systems?**
- ▶ **How extensive is the company's own social and environmental reporting?**
 - ▶ **Does it make use of the GRI framework?**
 - ▶ **Is both good and bad news reported, or is this an exercise in window dressing?**
- ▶ **Does the company maintain an active policy of engagement relative to investor or stakeholder groups?**
- ▶ **Is there evidence of problematic relationships with key stakeholders?**

Information Sources: Stakeholder Relations

- ▶ **Annual report**
- ▶ **Sustainability/Corporate Responsibility Reports**
- ▶ **Website**
- ▶ **Media coverage**
- ▶ **NGO reports**
- ▶ **Independent assurance reports (if any)**
- ▶ **Government reports**
- ▶ **Regulatory filings**