Socially Responsible Investing 3.0:
Understanding Finance and Environmental, Social, and Governance Issues in Emerging Markets

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ABSTRACT

In recent years, socially responsible investment (SRI) has shed its common perception as a niche market and has begun to develop as an important global financial market instrument. It is clear that we are about to enter what the authors call the third stage of socially responsible investing, in which SRI becomes a market reality, if not a force, in a number of emerging economies. What is less certain is the pace of this transition—how quickly the mainstreaming of SRI will materialize outside of North America and Western Europe, specifically in the emerging markets of Asia-Pacific, Latin America, and Africa. To improve the theoretical as well as business practice-based understanding of socially responsible investing in emerging economies, this paper discusses the important strategic, operational, and leadership dimensions at the nexus of corporate responsibility, investing, and emerging markets. Three SRI-related sets of questions will be examined in this article. First, what are the important strategic dimensions at the nexus of corporate responsibility, investing, and emerging markets? Second, what are the critical operational dimensions at the nexus of corporate responsibility, investing, and emerging markets? Third, what are the significant leadership dimensions at the nexus of corporate responsibility, investing, and emerging markets? SRI has had an important impact on social, environmental, and ethical business markets in industrialized countries and is likely to have an equally important impact on emerging economies.

I. INTRODUCTION

Socially responsible investing (SRI) is an investment process that integrates analysis of environmental, social, and governance issues into traditional quantitative financial analysis. Socially responsible investors include individuals, government pension funds, and a wide array of nonprofit organizations focusing on an interlinked set of economic, social, and environmental objectives. In recent years, SRI has shed its common perception as a niche market and has developed as a mainstream global financial investment market instrument. Estimates suggest that approximately US$3.74 trillion, or about 11.23 percent of the $33.3 trillion in total assets under management in the United States, is involved in some socially responsible investing strategy (US SIF 2012). The European socially responsible investment market has also grown rapidly and continues to outpace the growth of the overall investment market in Europe (Eurosif 2012).

Academics and practitioners who track the socially responsible investment industry worldwide generally agree that SRI has the potential to advance a deeper set of social, environmental, and ethical business norms on the global level. It is less clear how quickly SRI will become prevalent outside of North America and Western Europe, particularly in the emerging markets of Asia-Pacific, Latin America, and Africa. The first stage of the modern SRI movement (SRI 1.0) came from the turbulent period in the 1960s and 1970s when the growth of social undercurrents such as environmentalism and anti-war activism fueled dramatic changes in business, ecological awareness, and society. The second stage (SRI 2.0), involved a rapid acceleration of socially responsible investments in North America, Western Europe, and other OECD-level countries around the world. The authors believe that SRI is entering a third stage of worldwide growth and becoming a market reality, if not a force, in a number of emerging economies. To improve the understanding of SRI in emerging economies, this paper will first analyze the important strategic dimensions and then highlight the nexus of corporate responsibility, investing, and emerging markets.

II. CORPORATE RESPONSIBILITY, INVESTING, AND EMERGING MARKETS: STRATEGIC IMPLICATIONS

It is hard to underestimate the importance of the financial market development that is taking place outside of North America and Europe in markets referred to as either emerging markets or frontier economies. Corporate responsibility, often seen as the preserve of major companies in developed economies, is gaining ground in these emerging markets. Initiatives such as the UN Global Compact, the UN Principles for Responsible Investment (UNPRI), and the Carbon Disclosure Project are increasingly focusing on emerging

Table 1. Socially Responsible Investment Equities in Emerging Markets

	SRI-focused (US$ million)
SRI funds that invest all their assets in emerging markets	37,712
SRI funds that invest a portion of their assets in emerging markets	14,275
Total	51,987

Source: International Finance Corporation/Mercer (2009)

markets as investors turn toward these markets, attracted to their traditionally dramatic, if volatile, returns.

Although investments in emerging markets typically account for only a small portion of their portfolios, investors from developed countries are more exposed to emerging markets than would be implied by their notional allocations, due to the inherent operational exposure of developed world multinationals to emerging markets. Because of the globalization of business and financial markets, investors in North America and the European Union are investing in emerging markets if they hold equities in US-based companies, such as Apple Inc. and General Electric. Apple Inc. and General Electric, for instance, represent the top five largest stock holdings in the popular index fund for individual investors, Vanguard 500 Index Fund. Emerging market countries such as China and India are also important supply chain management and profit drivers of Apple Inc. and General Electric's business success.

Despite the recent global financial market uncertainty, the overall importance of emerging financial market development—as well as SRI's increased prominence in emerging markets—has not diminished (Roxburgh, Lund, and Piotrowski 2011). A 2009 report by Mercer Investment Consultants and the International Finance Corporation (IFC) finds that more than US$300 billion in managed assets that were invested in emerging market equities are in either an SRI-labeled fund or a mainstream fund that has made some commitment to integrate environmental, social, and governance (ESG) principles into the core investment process. The report concludes that about US$50 billion of these investments are specifically branded as socially responsible or sustainable (see Table 1).

III. CORPORATE RESPONSIBILITY, INVESTING, AND EMERGING MARKETS: OPERATIONAL IMPLICATIONS

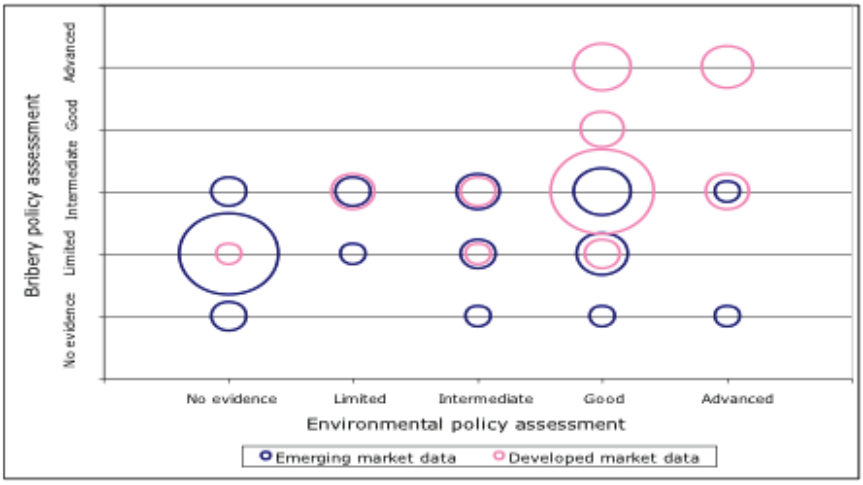
The second critical trend that lies at the nexus of corporate responsibility, investing, and emerging markets is related to the impact on business operations. Specifically, the increasing

call for ESG disclosure practices by global institutional investors and other investment entities is helping to push the disclosure of ESG-related business practices in emerging markets. For instance, as of November 2012, UNPRI had more than 1,100 signatories from 50 countries, managing more than US$32 trillion of assets supporting the core UNPRI principles.

The lack of consistent ESG disclosure occurs with companies around the world, but the problem is especially stark in emerging markets, where it seems to delay socially responsible investing. A 2012 report from the Emerging Markets Disclosure Project (EMDP) highlights the lack of ESG disclosure as the biggest challenge to investing in emerging markets. Although about 90 percent of emerging market companies reports some ESG information, few use international standards (e.g., the Global Reporting Initiative's guidelines) or offer in-depth, relevant information on sustainability risks (e.g., climate change, water use, and human rights) (EMDP 2012).

Emerging market countries have varying degrees of ESG disclosure. A 2009 joint report by EIRIS and EMDP finds that, of the 40 leading emerging market companies sampled, the majority have shown evidence of addressing at least some ESG issues in their public disclosures. Most notably, both EMDP reports conclude that South African and Brazilian companies consistently have the highest assessments of the companies sampled. These countries also developed two of the first socially responsible investment indices in emerging markets: the Johannesburg Stock Exchange SRI Index in South Africa and the Bovespa Corporate Sustainability Index in Brazil. Although there is still considerable variation in performance, companies surveyed in the EMDP report generally scored much better

Figure 1. Comparison of Environmental and Bribery Policies in Large Emerging Market and Developed Market Companies



Source: Sustainable Investment Research Analyst Network (2009)

in environmental areas than in social and governance areas. In fact, some achieved grades in environmental performance and systems that were on par with developed country environmental leaders.

Corporate responsibility, long seen as a luxury for large companies in developed economies, is gaining ground among some corporations in emerging markets. This issue is explored further in Figure 1, which uses bribery as a proxy for social issues. The chart compares emerging and developed market company assessments and shows a polarization of leaders and laggards. Although emerging market companies' environmental policies range in quality, some companies achieved the highest grades in line with their developed peers. This research only looked at the public ESG disclosure of large emerging market companies, but the EMDP survey discovered that poor disclosure, especially among smaller companies, was hampering responsible investor efforts.

Compared to developed markets in North America and Western Europe, great variations exist in terms of ESG business practices among different regions (e.g., Africa, South America) in emerging markets. Leading Brazilian and South African companies, for instance, often seem to have more in common with each other than they do with companies in neighboring countries. There also appears to be a substantial gap between companies doing a great deal (often at a similar level to their developed country peers) and those doing little or nothing in terms of ESG business practices. As one starts to look beyond the very largest companies, corporate responsibility in emerging markets is far less common. However, the role of local civil society, investors, and stock exchanges is likely to have a growing impact on the development of corporate responsibility going forward.

IV. CORPORATE RESPONSIBILITY, INVESTING, AND EMERGING MARKETS: LEADERSHIP IMPLICATIONS

A third significant trend that lies at the nexus of corporate responsibility, investing, and emerging markets is related to the impact of SRI on business leadership. Many emerging markets lack the intensity of stakeholder pressure to improve the ESG disclosure that exists in developed economies from governments, non-governmental organizations, and consumers. As a result, an increasing number of stock exchanges in emerging markets are playing key leadership roles in promoting sustainability, transparency, and greater disclosure among their listed companies. Because of their ability to directly influence and monitor the operations of companies seeking to access the equity markets, emerging market stock exchanges can directly influence the sustainability-related business approaches of the listed companies (as well as companies that wish to be listed in the respective stock exchanges) through such market

Table 2. Examples of ESG Guidance & Policy in Emerging Market Stock Exchanges

South Africa	For years, the Johannesburg Stock Exchange has encouraged disclosure through the requirement for listed companies to comply with the King Codes on Corporate Governance. In 2010, the exchange became the first in the world to mandate the disclosure of financial and non-financial performance in one integrated report for all listed companies, on a "comply or explain" basis.
Malaysia	In 2006, Bursa Malaysia introduced a corporate social responsibility framework to guide its listed companies with regard to implementing and reporting on CSR. The exchange retained the group CSR Asia to evaluate the quality of CSR reporting in the country, and Bursa Malaysia published a detailed report on companies' progress in 2008. For the last three years, listed companies have been required to disclose their CSR activities or practices (and that of their subsidiaries); if there are none, the company must post a statement to that effect. The exchange also has plans to improve CSR information flow within the country.
Brazil	The Bovespa Exchange does not require ESG criteria for all listed companies. Instead it has three listing segments to which companies can voluntarily adhere with different standards of corporate governance. Though adherence is voluntary, once listed in a particular segment, adopting the standards is mandatory and enforced by the Exchange.
China	The Shenzhen Stock Exchange issued CSR guidance for listed companies in 2006 and has followed this with training programs. The Shanghai Stock Exchange introduced similar measures in 2008 in the form of the "Shanghai CSR Notice" and the "Shanghai Environmental Disclosure Guidelines." These measures sit within a wider framework of government policy to harness the capital markets to foster environmentally- and socially-sustainable private sector development.
Taiwan	In Taiwan, the regulator has asked all public companies to disclose the state of the company's CSR performance in their annual report. Although this is not articulated in the stock exchange's listing criteria, companies are still obliged to do so in order to be listed on their exchange. The Taiwan stock exchange is considering revising its CSR Best Practice Principles to recommend listed companies allow shareholders to comment on and approve their CSR reporting.
Thailand	In 2006, the Stock Exchange of Thailand (SET) established the Principles of Good Corporate Governance for Listed Companies. In addition, SET has been working with the SEC, the country's regulator, to urge listed companies to disclose such information in accordance with GRI standards.

Source: Sustainable Investment Research Analyst Network (2009)

mechanisms as sustainability indices (see Table 2).

The flurry of activity in many emerging markets reflects the need for the financial markets to internalize environmental and social considerations in order to promote more sustainable development. A key aspect of this process involves increasing and improving ESG reporting. Over the last two years, private-public ventures, such as the Sustainable Stock Exchanges initiative, have begun to explore how the exchanges can work with investors, regulators, and companies to enhance corporate transparency—and ultimately

performance—on ESG issues, and to encourage responsible long-term approaches to investment. According to a World Federation of Exchanges survey (2009), the sustainable investment strategies currently endorsed by stock exchanges fall into three categories: (1) promoting ESG awareness and standards through IPO or ongoing listing requirements; (2) providing informational products and services in the form of sustainability indices; and (3) creating markets for specialized products such as carbon trading and clean-tech investment.

Just as a company can be linked to the reputation of the exchange where it is listed and the exchange's listing requirements, there is a business case for exchanges to influence companies and lead by example on ESG disclosure and performance. Many exchanges, however, have become for-profit entities and are thus generally disinclined to introduce strong mandatory disclosure requirements that may cause companies to list on alternate exchanges with less regulation. Healthy and effective financial markets, whether they are based in industrialized or emerging markets, require market transparency, which is promoted by focusing on the long-term interests of companies and their investors. Fortunately, many emerging market stock exchanges are moving quickly beyond their developed peers in terms of promoting ESG and transparency practices. The South African Johannesburg Stock Exchange requires a high degree of reporting integration, for example, and many other exchanges (Egypt, Brazil, China, India, among others) have developed rules and guidance regarding ESG disclosure (Morales and van Tichelen 2010).

Most stock exchanges have some form of mandatory corporate governance disclosure requirements incorporated into their IPO and ongoing listing rules, but only four exchanges, three of which are in emerging markets, also take social and environmental factors into account. Bursa Malaysia and the Johannesburg Stock Exchange have incorporated full ESG disclosure requirements into their ongoing listing rules, and the Shanghai Stock Exchange has introduced environmental requirements for companies in the 14 most energy-intensive industries that must be met before an IPO can be initiated. Requiring the integration of ESG and financial reporting is the key to real change in further implementing the sustainability agenda. Companies using the equity markets for capital-raising are good targets for increased ESG disclosure, which can help investors with their decision making and allow companies to have greater access to new types of capital (Siddy 2009).

China has been at the forefront of SRI business leadership and innovation with its environmental disclosure requirements for IPOs. In 2008, the Chinese Ministry of Environmental Protection (MEP) launched the "Green Securities" policy and the "Green IPO" policy in partnership with the China Securities Regulatory Commission. These policies aim to make it harder

to raise capital by requiring increased environmental record disclosures for companies that want to list. The regulations now require enterprises in 14 polluting industries to go through an environmental assessment by the MEP before initiating an IPO or obtaining refinancing from banks. Further, during a 10-day pre-IPO evaluation period, the MEP conducts its own assessment and incorporates public opinion through a national telephone survey. Within the first year of the new rules, 20 out of 38 companies had their IPOs rejected or were subject to further assessment by the MEP (Siddy 2009).

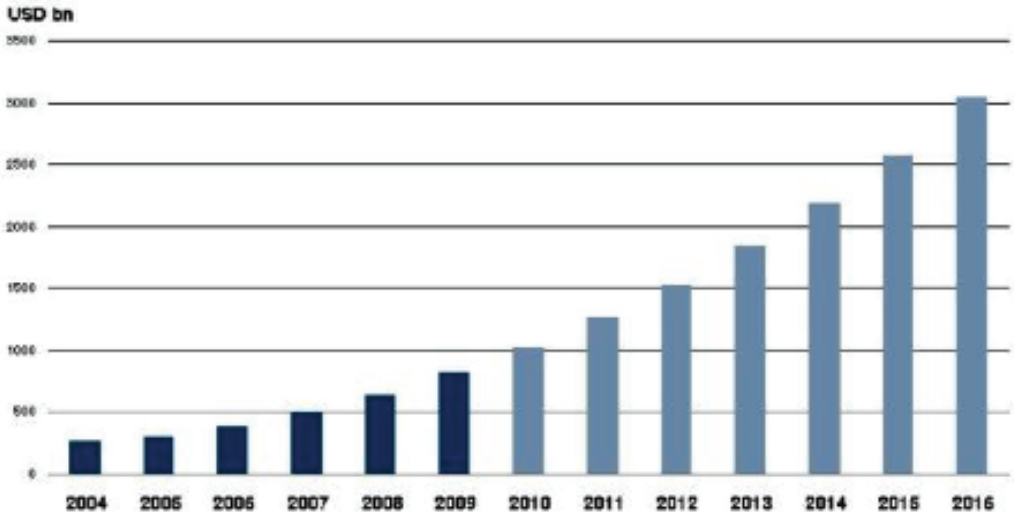
V. FUTURE OF RESPONSIBLE INVESTING IN AN ERA OF GLOBAL COMPLEXITY

Keeping in mind that any prediction about the future of emerging markets and socially responsible investment is subject to many uncertainties, this paper offers the following three suggestions on how socially responsible investing might be more fully integrated into emerging markets.

First, SRI investors in North America and the European Union need to strengthen their understanding of the regional financial markets in emerging economies. India is a rising global economic power and China is likely to supplant the US as the largest economy in the world over the next few decades. SRI and traditional investors need to better understand China's financial market conditions outside of Hong Kong, Shanghai, and other relatively wealthy coastal cities. The Eurasia Group estimates that the second largest province in China in terms of GDP (Jiangsu, US$620 billion) is equal in size to Turkey (US$614 billion), and the third largest province (Shandong, US$597 billion) is larger than Indonesia (US$540 billion) (Ma 2011). Up to 70 percent of the future market growth of the 20,000 western multinationals is tied up in emerging markets, and China and India alone account for nearly 40 percent of the future global market growth (Eyring, Johnson, and Nair 2011). A 2009 Business for Social Responsibility/ International Finance Corporation report identifying domestic SRI vehicles for Chinese investors notes that there has been a retail SRI mutual fund available for domestic Chinese investors since 1998. Underscoring the growing economic importance of SRI market development in countries such as China, the National Social Security Fund of China—the country's largest pension fund with total assets of US$82 billion—lists "responsible investment" as one of its four core investment principles.

Second, while the political uncertainty that is currently gripping the Middle East region has captured international attention, there is a critical need for SRI investors and traditional investors to better understand the growing Shari'ah-compliant investment assets. According to Credit Suisse, Islamic finance is now one of the fastest growing business segments in the world. Its compound growth rate was 26 percent between 2004 and 2009,

Figure 2. Shari'ah-Compliant Investment Funds (2004-2016)



Source: The Banker, Booz & Company, Credit Suisse (2011)

and it is estimated to reach US$822 billion by the end of 2009. Shari'ah-compliant assets are likely to triple by 2016 when they are expected to reach US$3 trillion (see Figure 2) (Leins 2011). A 2011 International Finance Corporation report made the following observations, among others, about the state of socially responsible investments in the Middle East and North Africa (MENA):

- MENA responsible investment levels are low, but not insignificant. Although the MENA SRI levels are low, they are higher than comparable markets in India and China.

- Shari'ah-compliant investment funds are similar to "negative-screen" responsible investment funds in North America and Europe. In many parts of the world, negative-screen SRI funds typically precede positive-screen responsible investment funds, which then adopt increasingly aggressive criteria for environmental, social, and governance screening (negative-screen funds use negative investment screens to exclude certain investments while positive-screen funds prioritize investments according to positive ESG criteria so that the more positively a company meets certain criteria, more likely or higher the investment). Shari'ah-compliant investing may not follow this pattern, but the IFC report notes that "their commitment to Islamic ideals and general interest in betterment of society has the potential to translate into support for 'positive-screen' sustainable investments" (IFC 2011).

- Sovereign wealth funds (SWFs) may represent the greatest responsible investment opportunity

in the MENA region. There are a number of sustainability-related investment trends in the MENA region, all of which have important implications for the regional SWFs. Most notably, these include the growing emphasis on sustainability within the national agendas of MENA region countries, including investments in sustainability and clean technology sectors, as well as increased use of ESG screens in the SWFs' investment portfolios (IFC 2011).

Third, SRI, in conjunction with the global private capital markets, needs to facilitate the business sector's investment in local climate solutions in the developing world. The biggest change in global governance in the past two decades may be the shift in the way economic, social, and environmental stakeholders are working together to forge collaborative solutions to address a wide range of climate change and other sustainability concerns. Although debates should continue about what constitutes the proper role of the banking and financial services industry in an increasingly resource-constrained world, private sector financing will undoubtedly be needed to complement the existing national development assistance programs as well as international environmental financial mechanisms like the Global Environment Facility (Park 2012).

VI. CONCLUSION

In terms of accelerating climate finance on the global level, the key metric for success may be to what degree SRI, in collaboration with private capital markets, can change the institutional mismatch between the need to access available public and private investments and the capability of achieving this end. The tragedy of global climate finance, as currently designed, is that any country or region that wishes to tap the available financial flows to help with their respective climate risks needs to have a certain amount of institutional capacity to achieve funding success. For example, the Democratic Republic of Congo (DRC) (ranked 187 in the 2012 UN Development Program Human Development Index) may have a much higher need for international funding to help manage its climate risks than the Republic of Korea (ranked 15 in the 2012 UN Development Program Human Development Index). However, as members of the non-Annex 1 parties (non-industrialized group of countries) to the United Nations Framework Convention on Climate Change, these two countries have to compete for available funds (beyond whatever small-scale grants might be available) to finance clean development mechanisms and other climate mitigation/adaptation projects. Unsurprisingly, Korea has been more successful than the DRC in accessing global climate finance.

These drivers set the stage for the next phase of growth in SRI. The global effects of increasing SRI in China, Shari'ah-compliant investments, and better-targeted climate finance will be amplified in the coming decades. SRI has the potential to advance a deeper

set of social, environmental, and ethical business norms on the global level and is finally becoming a market reality, if not a force, in a number of emerging economies.

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