BM&FBOVESPA Sustainability Index & the Responsible Practices of Brazilian Corporations

ISSUE BRIEF
EXECUTIVE SUMMARY

BM&FBOVESPA, Latin America’s leading exchange in number of transactions and one of the world’s largest in market value, created the Corporate Sustainability Index (ISE—Índice de Sustentabilidade Empresarial) in 2005 with financial support from the International Finance Corporation (IFC). At the time of its creation, there was only one emerging market sustainability index, the Johannesburg Stock Exchange in South Africa, which was created in 2004. According to the World Federation of Exchanges, there are now more than 50 sustainability indexes around the world, across their 51 member exchanges.1

In launching the ISE, BM&FBOVESPA and its technical partner Fundação Getúlio Vargas (FGV) sought to develop an investment product that could be used by responsible investors to facilitate the investment process, either by buying securities issued to track the ISE, or by using the analysis performed by the Index managers as proxies in their own investment decisions. The ISE was designed to create an efficient investment mechanism to group companies with superior performance that manage environmental, social, and governance risks and opportunities.

It was anticipated that corporate sustainability leaders would show superior performance and that, consequently, the inclusion of a company in a sustainability index would stimulate demand for their shares, and potentially increase their price. In order to be included in a sustainability index, companies have to demonstrate the quality of their sustainability practices, a process that could improve the company’s competitiveness and may lead to an enhanced reputation (in both the financial, and the product and services markets).

Coinciding with the fifth anniversary of the ISE, IFC commissioned an evaluation of the Index’s impact on the corporate sustainability practices of its member companies. The objective of this evaluation was to assess the impact of the Index on strengthening the sustainability practices of its member companies. Findings and conclusions were based on companies’ responses to an online questionnaire, supported by personal interviews and desk research of over 40 Key Performance Indicators over time, in publicly available information about a company. In order to assess the impact of the ISE on its member companies, these were divided in four groups. Group 1 comprised companies that have been in the Index since its inception; group 2 consisted of companies that were members, left the Index, and were later readmitted; group 3 included companies that were members and left the Index; and group 4 consisted of companies that were never part of the Index. From this evaluation, it was concluded that the ISE had a considerable impact on the corporate sustainability practices of companies, both the member companies as well as those that were never part of the Index. The ISE served as a reference guide for initiation of sustainability practices as well as for their continuous improvement.

Almost all of the respondents of group 1 said they improved their sustainability practices as a result of their participation in the ISE: 86 percent of the companies perceived an improvement in their environmental and governance performance, while 57 percent of the companies noted an improvement in their social performance. Several companies in groups 2, 3, and 4 noted the importance of participating in the ISE admission process, as it provides companies with a better understanding of their limitations regarding corporate sustainability practices.

A company in group 1 that belongs to several indexes stated: “ISE is more rigorous than other indexes as we have to provide evidence of our practices;” another company noted: “Being in ISE has allowed us to differentiate from the competition in services, which are basically a commodity;” and a company that tried unsuccessfully to become a member indicated: “The ISE questionnaire has been a very valuable roadmap for our sustainability strategy and hope that one day we will qualify.”

The firms that have been in the Index (for some time or since its inception) report valuable benefits in terms of improved sustainability practices, better reputation, and, to some extent, positive impacts on their stock price, access to capital, and liquidity in the stock market.

The evaluation found that the expected benefits from the ISE membership, as well as the perception of the obtained results, are rather high (Figure 1). The major benefits seem to be in terms of the companies’ own review of their sustainability practices, leading to increased competitiveness, satisfaction of being a responsible company, and an improved reputation.

FIGURE 1. RESPONSES TO EVALUATION QUESTIONNAIRE ON THE PERCEIVED BENEFITS OF THE INDEX
(Group 1 - companies that have always been in the index)

The ISE supported a rapid move to sustainable practices among listed firms, with most relatively large companies with liquid stocks eager to participate. As experience has been gained, the requirements for membership have been tightened, and fewer firms have been applying. The percentage of companies that accept the invitation to apply for membership has dropped continuously from 52 percent in 2005 to 38 percent in 2009, while the number of invited companies has remained relatively constant at around 130. During 2010, this number increased to 183 companies and the response rate dropped to 29 percent.

Since the launch of the Index in 2005, sustainability in Brazil made significant progress overall. This is evidenced by the growth of the Instituto Ethos (an institution promoting corporate responsible practices in Brazil and Latin America) member companies, which increased from 200 companies in 2000 to almost 1,400 in 2010. It is also reflected in the number of signatories to the Global Compact: in 2006, approximately 92 out of 3,200 (~3 percent) signatories were from Brazil, while in 2010 the number had jumped to 354 out of 7,700 (~5 percent). Moreover, Brazil is the developing country with the largest number of financial institutions that are members of the Equator Principles (eight out of a total of 68 members in 2010).

ISE has been one of the many efforts undertaken in Brazil to promote sustainable practices. However, 64 percent of group 1 companies (always listed on the Index) stated the ISE was the most important factor in developing sustainable practices over the past five years.

Sustainability indexes are constructed to act as independent, consistent, and rational benchmarks for private and institutional investors on the evaluation of the performance of their sustainability investments (including funds focused on sustainability companies). As such, liquidity, access to capital, and stock prices are expected to be favorably impacted. However, in the case of the ISE, no such evidence could be found.

Moreover, the evaluation found that the removal of a company from the Index had little to no impact on the price of its share, or on the reputation of the firm and its sustainability practices on the short term. This does not imply that companies do not benefit from being socially responsible (e.g., in the form of access to markets, better prices, lower costs, better value for their assets, better reputation, more productive workers, etc.), but it is difficult to prove.

The evaluation of the ISE’s impact on corporate sustainability also allowed exploration into the impact on the development of the Socially Responsible Investment (SRI) industry. Following the introduction of the ISE, there was a rapid shift to the creation of new SRI funds, but most of them have remained relatively small, with the market controlled by the two funds that existed before the creation of the ISE. In October 2010, there were 10 sustainability funds (not including Governance Funds that have existed before the creation of the ISE), managing $580 million. The largest two, which existed prior to the ISE, manage 70 percent of the assets. Most of the observed growth has resulted from value appreciation.

The Index has had limited success in serving as a benchmark for larger investors, as it has a relatively small number of companies, which provides only partial diversification. Besides this structural issue, the evidence that corporate sustainability is important for investors because it aims to increase long-term shareholder value by integrating long-term economic, environmental, and social aspects into the business strategy, has also been limited.

There is a trade-off between stringent sustainability criteria and the usefulness of the Index to investors. The more investors are interested in the ISE, the more incentives companies receive to adopt and implement responsible practices. In order to improve the impact on the financial markets (access to capital, stock prices, liquidity), the evaluation suggests that the Index needs to become an investment benchmark that is used to construct and compare SRI portfolio performance, and to attract domestic and foreign investment to the Index and its component stocks.

In summary, the expectation that the ISE would contribute to increased sustainability awareness and improvements in the responsible practices of listed and non-listed firms in Brazil, as well as broader awareness of sustainability in Brazil has been confirmed.

Looking to the future, for the Index to continue to have an impact on the companies’ sustainability practices, it must have an impact on the financial community as well. The sustainable investment community in Brazil should therefore consider:

- Stimulating commercial demand for ISE by outreach to asset managers, institutional investors, retail investors, and regulators to raise awareness of the translation of corporate sustainability into better returns in the stock market.
Support can include dissemination and capacity development on the value of sustainable investment;
• Enhancing feedback and transparency of ISE by sharing rationale for both inclusion/non-inclusion to the Index with companies;
• Revising the ISE entry questionnaire so as to allow companies to report back on the most material sustainability issues related to their industry; and
• Decreasing the turnover of stocks (by tolerating small deviations from non key responsible practices but without tolerating irresponsible ones).

ABOUT IFC

IFC, a member of the World Bank Group, is the largest global development institution focused on the private sector in developing countries. We create opportunity for people to escape poverty and improve their lives. We do so by providing financing to help businesses employ more people and supply essential services by mobilizing capital from others, and by delivering advisory services to ensure sustainable development. In a time of global economic uncertainty, our new investments climbed to a record $18 billion in fiscal year 2010. For more information, visit www.ifc.org.

IFC’s strategy in Brazil focuses on promoting access to finance and developing capital markets to reach low-income individuals, microenterprises, and small businesses. IFC seeks to strengthen infrastructure and public services, including health and education, by increasing private sector participation. Other key areas include improving the investment climate and helping small businesses join the formal economy. IFC also promotes social and environmental sustainable practices, specifically in the Amazon region. As of June 2010, IFC’s committed portfolio in Brazil was $2.4 billion.

ABOUT BM&FBOVESPA

Established in 2008, BM&FBOVESPA is Latin America’s leading exchange in number of transactions and one of the world’s largest in market value. In 2009, it accounted for 80 percent of all trading in the derivatives market and 90 percent of the trading of equities. A listed company, it has 1,079 permanent employees and 67 interns (figures for December 2009). Through its trading platforms, it holds the registration, clearing and settlement of transactions with equities, securities, commodities and others. It also acts as a central securities depositary; licenses software and stock indices; provides information to support the market; and performs risk management activities of transactions made through its systems.

The purpose of BM&FBOVESPA is to serve as a benchmark for listed companies. In line with this, it has been developing a consistent governance framework aimed at ensuring safe decision making, watching over the smooth progress of internal processes, controlling systems and procedures, and offering maximum transparency to all its stakeholders.

ABOUT FGV

Created by the Fundação Getúlio Vargas, FGV-EAESP is a pioneer in the teaching of Business Administration in Brazil and is one of the principal Brazilian centers of teaching, research, publication, and consulting in the field of Administration. The School offers a complete range of courses for professional training at the undergraduate, graduate, and continuing education levels. The Centre for Sustainability Studies (GVces) is a place of study, learning, reflection, innovation, and knowledge production, staffed by professionals with a wide range of multidisciplinary expertise. It works on the formulation and monitoring of public policies, the construction of self-regulation instruments, and the development of business management tools and strategies for sustainability on a local, regional, national, and international level.

BM&FBOVESPA Sustainability Index & the Responsible Practices of Brazilian Corporations (English and Portuguese):
http://www.ifc.org/sustainableinvesting

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Special thanks to the staff of BM&FBOVESPA and the Center for Sustainability Studies of the Fundação Getulio Vargas, FGV for their valuable support.
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