ADVISORY

IN FOCUS: CORPORATE GOVERNANCE AND SUSTAINABILITY

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Highligts:

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KPMG

cutting through complexity

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Dear Readers,

This issue of InFocus looks at responsible investing.

Sustainability is now a hot topic. The world's population is rocketing and more and more people have money to spend. Climate change appears undeniable and we are using up our fresh water sources. In this context, both individuals and major corporations are changing the way they think and behave.

According to a recent KPMG survey, government pressure in developed countries to internalise external environmental costs is only going to grow, affecting the viability of numerous projects. Local stakeholders in regions where companies operate are being increasingly active in defending their interests. As a result, companies are paying more attention to all three aspects of the impact of their activities (economic, social and environmental) on stakeholders.

The role of the investment community here is no less important, as in many ways it shapes the direction of business development. The traditional approach to doing business is no longer valid: investors want to create long-term value and are increasingly seeking to take social and environmental risks and the quality of corporate governance into account when making investment decisions. This can be seen in the rapid growth of the market for socially responsible investments, which is already worth more than US$3 trillion worldwide.

In Russia, however, this area of investment has yet to gain significant popularity, and as yet no Russian companies are included in the relevant sustainability indexes. At the same time, we sense that interest is growing from the Russian business community, and it would be good if this gap could be closed.

Best regards,

Igor Korotetskiy
Director, Head of Corporate Governance and Sustainability

Responsible investing

Ivan Barsola and
Ekaterina Kosminskaya

Between 30 and 40% of the world's largest institutional investors and asset managers systematically take into account management activities relating to social responsibility, environmental protection and corporate governance (ESG factors) and the relevant figures for the companies in their portfolio. Accordingly, ESG factors affect the market value of listed companies.

Responsible investing: definition and practice

In today's financial markets, ***"responsible investing"*** means investing that takes account of environmental, social and corporate governance (ESG) factors. Financial market ***players*** have traditionally seen responsible investing as an alternative form of investment. With few external incentives and little understanding of the value of this class of investments, such investments were slow to gain popularity. However, changes in the financial markets, in addition to changes in the strategic priorities of the companies themselves, may have a significant impact on responsible investing.

Various stakeholders –from investors to regulators– are paying increasing attention to sustainability and business responsibility. New requirements have forced companies to take sustainability into account and consider ESG factors as part of their development strategy and risk management system.

Studies by the investment banks, such as J.P. Morgan Chase & Co.,[1] show that more and more clients are expecting them to develop "responsible" practices, – i.e. to diversity their securities portfolio by acquiring financial instruments of companies demonstrating a commitment to sustainability principles. Institutional investors and asset managers are increasingly choosing in favour of companies whose activities contribute to the development of society – i.e. in favour of ***"impact investing"***.

[1] http://www.jpmorganchase.com/corporate/socialfinance/business-motivation.htm

Impact investing comes in various categories, including protection of the rights of stakeholders (the local population, employees, suppliers, etc.), development of small and medium enterprises, and development of education, research, medicine, new technologies, etc. A key category of impact investing is "green investing" – investment in companies/funds/organisations that either do not harm the environment or take measures to reduce their impact on it. For example, according to a KPMG survey, the most popular European funds are those with a focus on climate change prevention, the production and use of renewable energy, and the sustainable use of energy, water and other natural resources.[2]

There are many investment funds that specialise in specific areas and pursue both financial and social goals. For example, Agora Microfinance and the Acumen Fund invest in microfinance organisations and social business. It should be noted that such specialised investment funds are often set up and backed by bigger financial institutions and companies. One such example is Energy Aid, a fund recently set up by IBM to provide sustainable energy access to people in developing countries. Private not-for-profit foundations such as the Rockefeller Foundation also engage in targeted impact investing. Such funds focus on program-related investments and make use of various financial tools, particularly equity, loans and guarantees.[3] Initiatives from international organisations are making an important contribution to the development of responsible investing. For example, the UN Principles of Responsible Investment and the Equator Principles relating to project financing, based on International Finance Corporation and World Bank standards, provide the definition of the practice that investors need.

Organisations such as Eurosif and the Global Impact Investing Network (GIIN) create platforms for various financial market participants to share knowledge, enabling them to join forces to become more effective and to develop the market infrastructure as a whole. The GIIN produces its own ratings of funds and companies, reflecting their social and environmental focus. These ratings are used by banks (J.P. Morgan & Co.), international financial institutions (the Inter-American Development Bank) and other categories of investors. There are also specialized sustainability indexes such as Dow Jones Sustainability Index Group and FTSE4Good Index Series.

International standards, ratings and indexes help investors to determine the framework of responsible investing, keep track of key trends and best practices and perform benchmarking. They also help companies to identify strategic priorities and areas worth developing in order to protect themselves from reputation risks and make their assets more attractive to investors.

It can be said with confidence that companies that demonstrate a high level of corporate governance, particularly with regard to ensuring that their governing bodies are transparent and effective and avoiding conflicts of interest, are committed to protecting stakeholders' rights, and are acting to reduce their negative impact on the environment, are gradually becoming the most attractive to investors.

[2] European Responsible Investment Fund Survey, May 2012

[3] http://www.rockefellerfoundation.org/what-we-do/program-related-investments

The benefits of responsible investing for companies and investors

Responsible investing has a financial benefit for both investors and companies. A number of studies focussing on responsible investing that have been carried out in the last few years by international banks (e.g. Morgan Stanley), leading specialised investment companies (e.g. SAM) and consulting agencies (e.g. Oekom Research) have confirmed the positive relationship between a company's financial performance and its sustainability-related activities, including environmental and social initiatives and the standard of corporate governance.[4] In particular, the SAM White Paper *Alpha from Sustainability* reveals that in 2000–2011 firms adhering to sustainability principles outperformed those that did not.[5]

CFOs and investors recognize that tangible, results-focused sustainability strategies are evidence of sound management, resulting in increased readiness to adapt to changing markets and respond to customer needs. A clear sustainability strategy incorporating ESG factors helps to provide confidence and reassurance that a company has a solid foundation for sustainable growth.

Investors, in turn, are coming to realise that responsible investing can be just as profitable. A KPMG survey published in 2011 shows that in 90% of cases there is a positive or neutral relationship between responsible investing and investors' financial performance.[6] This is why more and more analysts believe that responsible investing is gradually becoming a new approach to investing.[7]

According to a research conducted by KPMG, between 30 and 40% of the world's largest institutional investors and asset managers formally take into account ESG-related corporate governance and management practices and performance of the companies that comprises their equity portfolio. Therefore, ESG factors have an impact on market value of listed companies.

Improving corporate sustainability makes good business sense. According to SAM – an investment organization that focuses exclusively on sustainability investing – it directly impacts bottom lines, raises corporate profiles, helps ensure competitiveness in the long run, and increases employee and stakeholder engagement with the company.

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[4] http://www.sam-group.com/en/sustainability-insight/sam-corporate-sustainability-assessment.jsp
http://www.oekom-research.com/index_en.php?content=responsible-investment-services

[5] Alpha from Sustainability – Sustainability leaders outperform sustainability laggards, SAM, 2011

[6] Articulating the value of sustainability to mainstream investors (KPMG, 2011)
http://www.kpmg.com/GR/en/IssuesAndInsights/ArticlesPublications/Sustainability/Documents/Sustainable-Insight_Jan_2011.pdf

[7] European Responsible Investment Fund Survey, May 2012

The effect of responsible investing on the business environment

In terms of adherence to sustainability principles, particularly those regarding environmental protection, there are clear differences between industries. According to a 2012 KPMG International survey, the industries doing most to minimize their environmental impact are the automobile and chemicals industries. At the same time, the oil & gas, electricity, and mining & industrial metals industries are increasingly taking the initiative. Bringing up the rear are the transport and consumer sectors. However, the research shows that sustainability is a common trend for all sectors: with pressure from stakeholders and regulators growing and companies having to take greater account of sustainability in order to be competitive, the sectors lagging behind today are expected to catch up with today's leaders in terms of their environmental protection efforts in future.

More and more companies from different industries are publishing sustainability reports. For example, 84% of mining companies, 78% of auto manufacturers and 70% of energy companies issue such reports.[8] Companies in these industries make up a significant proportion of leading sustainability indexes such as the Dow Jones Sustainability World Index.[9]

With green investing becoming increasingly popular, various countries have set up environmental exchanges. In China alone, three such exchanges have been operating since 2010, providing integrated systems for trading in environmental financial instruments. The services provided by environmental exchanges include trading in company shares, property rights and intellectual property rights relating to the environment and energy, as well as registration of Clean Development Mechanism project transactions involving CO_2 emissions trading.

In addition, a number of sustainability indices has been developed, which directly affect companies' financial performance. The most authoritative of these are the Dow Jones Sustainability Indexes (DJSI). A company's inclusion in the DJSI depends on its ESG performance, as assessed according to a methodology developed by SAM especially for the DJSI. There are also ratings by credit agencies and specialised research/consulting firms available to help investors perform benchmarking of companies' sustainability activities.

In light of the growing focus on responsible investing, the requirements for information gathering, performance evaluation and reporting are getting tougher. Various non-financial reporting standards have been developed, principally those of the Global Reporting Initiative (GRI), which apply to practically all companies irrespective of their location, size and type of activity. In addition, work is underway on developing standards for integrated reporting.

Under pressure from stakeholders, the biggest stock exchanges are changing their listing requirements. For example, the UK's Department of Environment, Food and Rural Affairs has announced that from April 2013 all companies registered in Britain and listed on the London Stock Exchange's main market will have to publish details of their greenhouse gas emissions. The new requirement applies to 1,800 companies. Regional exchanges in South Africa, France, Denmark, Sweden, etc., also require companies to disclose information on sustainability.

It is clear that the development of responsible investing will have a serious impact on business for Russian companies focussed on Western markets and listed on foreign exchanges. While the need to comply with the new situation will involve extra costs, it will also open up opportunities from attracting reliable investors focussed on long-term investment, and from improving companies' internal processes, leading to greater operational efficiency and sustainability.

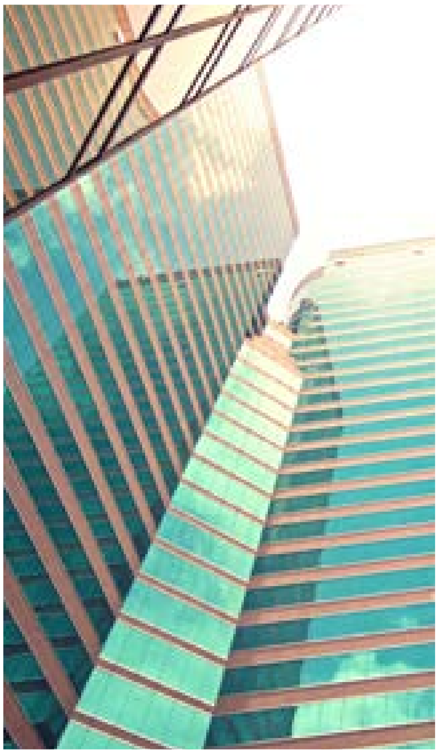
[8] Expect the unexpected: Building business value in a changing world, 2012

[9] http://www.sustainability-indexes.com/images/indexes-monthly-djsi-world_tcm1071-337267.pdf

International requirements for responsible investing

Maria Zakharova and Svetlana Skryagina

More and more companies in the financial sector are making sustainable development principles part of their business model. Such principles include an approach to responsible investing that demonstrates a responsible attitude to environmental, social and governance issues, a willingness to work together with stakeholders, and attention to long-term business development.



Today, the main international guidelines on sustainability are the UN Principles of Responsible Investments (UN PRI), developed by the United Nations, and the Equator Principles, based on the standards and policies[1] of the World Bank and the International Finance Corporation (IFC).

The **UN PRI** were devised by the UN together with major institutional investors, and representatives of the non-for-profit sector and academia in 2005. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large.

The long-term goal of the initiative is to build a sustainable financial system and increase business awareness of the impact of ESG factors on company development.

Principles of responsible investing

Investment companies signing up to the initiative voluntarily commit to six key principles:

1. To incorporate ESG issues into investment analysis and decision-making processes
2. To be active owners and incorporate ESG issues into their ownership policies and practices
3. To seek appropriate disclosure on ESG issues by the entities in which they invest
4. To promote acceptance and implementation of the Principles within the investment industry
5. To work together to enhance our effectiveness in implementing the Principles
6. To report on their activities and progress towards implementing the Principles

According to the UN PRI, companies that ignore ESG factors are unlikely to have an effective risk management system and are therefore an unsafe investment. On the other hand, if companies are able to respond promptly to the demands of society and to find business opportunities in them, this has a positive effect on their market value. Today, more than a thousand major investment companies, with collective assets under management of more than US$30 trillion, have signed up to the UN PRI. As yet, however, none are from the Russian investment community.

Another international responsible investing initiative is the **Equator Principles**.[2] Compliance with these principles facilitates effective environmental and social risk management in project finance.

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[1] The IFC Sustainability Framework and the World Bank Group Environmental, Health, and Safety Guidelines.

[2] The Russian version of the Principles is available at http://www.equator-principles.com/resources/equator_principles_russian.pdf

The Principles apply to all new project financings globally with total project capital costs of US$10 million or more, and across all industry sectors.

Since their launch in 2003, the Equator Principles have become the de facto standard used in the financial sphere for determining, assessing and managing environmental and social risk in project finance transactions. 70% of international Project Finance debt in emerging markets is covered by Principles.[3]

The basis of Equator Principles form two frameworks; International Finance Corporate Performance Standards on social and environmental sustainability and the World Bank Group Environmental, Health, and Safety Guidelines (EHS Guidelines).

IFC Performance Standards define the role and responsibilities of IFC clients in the field of project management, including social and ecological aspects.

World Bank Group EHS Guidelines are technical reference documents, providing general and industry-specific international industry best practice in the field of resource efficiency and pollution prevention.

IFC uses EHS Guidelines as a source of technical information during project due diligence.

Equator Principles:

Principle	Statement of Principle
1. Review and Categorisation	Each project is assessed and categorized in accordance with magnitude of its potential impacts and risks based on the environmental and social screening criteria of the International Finance Corporation (IFC).
2. Social and Environmental Assessment	For Category A and B projects, the Borrower has to conduct a Social and Environmental Assessment ("Assessment") process to address relevant social and environmental impacts and risks of the proposed project.
3. Applicable Social and Environmental Standards	For projects located in non-OECD countries, and those located in OECD countries not designated as High-Income, as defined by the World Bank Development Indicators Database, the Assessment refers to the applicable IFC Performance Standards.
4. Action Plan and Management System	For most countries, for all Category A and B projects, the Borrower has to prepare an Action Plan, which addresses measures for any risks indentified in the Assessment.
5. Consultation and Disclosure	For all Category A and most Category B projects consultation with stakeholders (project affected communities) has to be carried out.
6. Grievance Mechanism	For all Category A and most Category B projects the Borrower has to establish a grievance mechanism effective throughout the whole project life.
7. Independent Review	For all Category A and most Category B projects an independent review of the Assessment, Action Plan and stakeholder consultation process has to be conducted.
8. Covenants	For all Category A and most Category B projects the Borrower agrees to the following: • to comply with all relevant host country social and environmental laws, regulations and permits in all material respects; • to comply with the Action Plan (where applicable) during the construction and operation of the project in all material respects; • to provide periodic reports to financial institutions – the lenders; • to decommission the facilities in accordance with an agreed decommissioning plan.
9. Independent Monitoring and Reporting	For all Category A and most Category B projects an independent third party review is required to verify the Action Plan and other obligations.
10. Reporting	Each institution adopting the Equator Principles commits to report publicly at least annually about its Equator Principles implementation processes and experience.

Currently, 79[4] financial institutions have adopted the Principles, with the aim of promoting socially responsible project financing and avoiding negative impacts on ecosystems and local communities. The idea is for environmental and social risks to be reduced, mitigated and/or compensated for appropriately. In addition, signing up to the Principles and putting them into practice reduces reputational risks for investors and helps to strengthen relationships between investors, borrowers and local stakeholders, particularly local communities.

Under the Principles, projects are divided into three categories, depending on their risk level.

Category A – Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented.

Category B – Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures.

Category C – Projects with minimal or no social or environmental impacts.

3 Equator Principles. http://www.equator-principles.com

4 Effective on 28 January 2013, http://www.equator-principles.com

Each risk category has its own review and assessment procedure. The risk management process is designed to ensure that maximum account is taken of risks and to minimise negative consequences for both the investor and the borrower.

Initiative	Nature of involvement	Participation criteria	Reporting
Principles of Responsible Investment	Voluntary	• Compliance with the Principles of Responsible Investment • Increased awareness of the PRI among company employees	• Mandatory annual reports (from the second year of membership). • From 2012, a new Reporting Framework has been introduced that includes both reporting based on a common list of indicators for all investors and individual requirements for the disclosure of various parameters depending on the investment model and asset class. • Some indicators are subject to mandatory disclosure, but this only concerns non-confidential data. • Adopters will have to submit reports based on the indicators starting from the 2013–2014 reporting period. These indicators will form the basis of the PRI assessment methodology.
Equator Principles	Voluntary	• Development of internal policies and procedures for environmental and social risk management in project finance	• Mandatory annual reports (from the second year of membership). • The annual report should describe the procedures and experiences involved in applying the Equator Principles, including the number of transactions reviewed under the Principles and which industry they relate to, as well as information on project implementation progress, where applicable.

Development of Equator Principles attracted attention of international financial community to social and environmental issues in the area of project finance. Moreover the Principles fueled the discussion in the field of responsible investment and triggered creation of new initiatives, in particular, the development of Carbon Disclosure Principles in the US.

Compliance with the principles of responsible investing allows companies to gain access to potentially more sustainable and cheaper sources of funding.

Dow Jones Sustainability Indexes and SAM methodology

Ivan Barsola, Ekaterina Kosminskaya ,
Edoardo Gai, Head of Sustainability Services, SAM Group

Mindful of the new regulatory requirements and recognizing the financial benefit of responsible investing, investors increasingly demand effective and reliable tools for benchmarking companies' performance in the area of sustainability. Sustainable Asset Management (SAM) offers a globally recognised framework for benchmarking companies' performance in the ESG realm. SAM's globally recognised methodology is at the heart of the Dow Jones Sustainability Indexes group – the highest rated sustainability index in the world.

With the playing conditions in the financial markets changing and companies focussing increasingly openly on a "sustainability strategy", companies and investors need ways of benchmarking companies' environmental, social and governance (ESG) performance.

Developing criteria to evaluate a corporate sustainability strategy is a relatively new discipline. Analysts and investors demand independent and objective information from an authority they can trust. SAM offers a globally recognised framework for benchmarking companies' performance in the ESG realm. SAM's globally recognised methodology is at the heart of the Dow Jones Sustainability Indexes group – the highest rated sustainability index in the world.

The Dow Jones Sustainability Indexes (DJSI) are the most authoritative stock market index of sustainability today. The family includes global and regional broad market indexes, subindexes excluding alcohol, gambling, tobacco, armaments and firearms and/or adult entertainment, and global and regional blue-chip indexes.[1]

[1] http://www.djindexes.com/sustainability/

The SAM Corporate Sustainability Assessment is based on economic, environmental and social factors (referred to as dimensions), which are initially given equal weighting of 33% and include the following general (i.e. applicable to practically every sector) criteria:[2]

Economic Dimension

- Corporate Governance
- Code of Conduct, Compliance
- Risk & Crisis Management
- Customer Relationship Management
- Innovative Management

Environmental Dimension

- Environmental Management System
- Environmental Performance
- Climate Strategy
- Product Stewardship
- Biodiversity

Social Dimension

- Human Capital Development
- Talent Attraction & Retention
- Occupational Health & Safety
- Stakeholder Engagement
- Social Reporting

In addition to the general criteria, industry-specific criteria and their relative significance are also assessed. On average, these industry-specific criteria make up 57% of the assessment factors. Since the measurement of non-financial indicators is not always as objective as that of numerical indicators, SAM has established principles underlying the criteria for assessing companies' performance in various areas of sustainability. These include the relevance and financial impact and materiality for the long-term growth and development of the business.

Since 1999, when the DJSI were launched, SAM has been conducting its annual Corporate Sustainability Assessment of 2,500 publicly traded companies from 58 industries using industry-specific questionnaires.[3] The results for each indicator receive a score of between 0–100 points, which is multiplied by the weight of the relevant criteria, which varies from industry to industry. In addition, SAM carries out Media and Stakeholder Analysis (MSA) as part of the Corporate Sustainability Assessment – monitoring of media and stakeholder commentaries and other publicly available information from consumer organisations, NGOs, governments or international organisations. The publicly available information on companies' ESG activities is monitored in conjunction with RepRisk – the leading provider of information on compliance by companies with the principles of the UN Global Compact.[4]

Where a company incurs a reputational risk (e.g. a conflict with stakeholders or the initiation of legal proceedings), an analysis of the information from stakeholders that is published in the media is taken into account in calculating the total score, depending on the level of the potential impact. The risk level is assessed using the MSA scale, which is also from 0 to 100. Where an MSA risk arises, a certain number of points is deducted from the maximum MSA score of 100. The result is then multiplied by the weight previously allotted to the risk indicator, which varies from industry to industry and is used only if the risk occurs. The top 10% of companies within each industry are selected for inclusion in the DJSI World index – the biggest and most authoritative in the sustainability field.

Together, the DJSI allow investors to identify the world's sustainability leaders for different industries and to perform regional and global industry benchmarking. Like other indexes used in asset pricing, the DJSI represent an important stimulus for companies to improve their sustainability practices.

SAM keeps statistics on the indicators for each criterion in the questionnaire for the different industries. This makes it possible to carry out detailed benchmarking of ESG performance indicators among companies in different industries.

Through its long-standing commitment to sustainability investing and direct company access, SAM has gained extensive knowledge and expertise in sustainability trends, strategies and investor concerns. As such, it is ideally placed to offer companies insights into both their current and potential sustainability performance. These insights are based on:

- Material sustainability issues that SAM believes drive company performance, such as corporate governance, climate change, innovation management, talent attraction and development of human capital;
- The sustainability practices of companies that are recognised as leaders in the field.

[2] http://www.sustainability-index.com/sustainability-assessment/corporate-sustainability-assessment.jsp

[3] http://www.sustainability-index.com/images/sam-csa-methodology-en_tcm1071-338252.pdf

[4] http://www.reprisk.com/repriskscope/

KPMG's partnership with SAM

The formation of an alliance between SAM and KPMG in late 2011 was an important event for KPMG's responsible investing services. SAM has chosen KPMG as the partner of choice.

Becoming a member of the DJSI is no easy task. The questionnaire is complex and extensive, and requests information about areas that are not always familiar to managers. Only a minority of companies manage to become members of the index on their first try.

Currently KPMG provides this service for 35 companies in the Dow Jones Sustainability Indexes. For 8 of these companies, KPMG has been providing this service for more than five years.

KPMG clients can receive an independent SAM assessment of their sustainability activities, including an analysis comparing them with the best practices of companies in the relevant industry. KPMG helps businesses to develop, benchmark and improve their corporate sustainability strategies.

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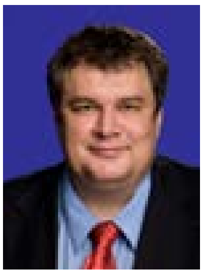

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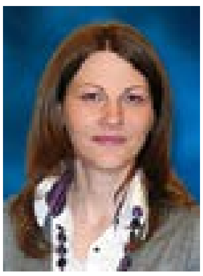

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