Corporate Governance Stock Exchange Indices Around The World

Objectives – Types – Critical Elements – Performance – Lessons

A World Bank and International Finance Corporation Study

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Background

- The global financial crisis has become a *catalyst* for reexamining the effectiveness of existing capital market incentives and financial regulatory structures and a number of countries are placing increasing emphasis in making corporate governance reforms a high priority.

- As a result, requests for guidance on how to *adequately build incentive structures* that promote good governance and foster its implementation in corporate practices have become more common.

Rationale for the Study

1. *Investor Guidance and Expectations*: CGIs can provide a strong signal to investors on how companies are run. Yet the pre-defined set of corporate governance and/or corporate social responsibility requirements may or may not always follow “globally recognized” standards and **investor expectations can fall short.**
2. *Integrity of the adopted methodology*: Indices could contribute to addressing the recurrent issue of how to measure CG implementation. It is therefore of paramount importance that what is being measured is funded on **objective considerations** based on a conflict-free approach.
3. *Attracting Companies to the Index*: Based on the notion that better governance practices improve company performance, the resulting rankings or tiers that CGIs generate can pave the way to economic and financial performance returns for companies that have made governance a corporate priority. **Connecting the corporate governance dots to these pay-offs may not always be a straight line.**

Corporate Governance Indices studied

Country	Stock Exchange	Index Name
Brazil	BM&FBOVESPA	Corporate Governance Stock Index
China	Shanghai Stock Exchange (SSE)	Corporate Governance Index
Italy	Borsa Italiana	FTSE Italia STAR
Mexico	Mexican Stock Exchange (BMV)	Indice IPC Sustenable
Peru	Lima Stock Exchange (BVL)	Good Corporate Governance Index
Turkey	Istanbul Stock Exchange (ISE)	Corporate Governance Index
South Africa	Johannesburg Stock Exchange (JSE)	Socially Responsible Investment (SRI) Index
South Korea	Korea Stock Exchange (KRX)	Korean Corporate Governance Index (KOGI)

Objectives of CGIs

Three main objectives to launch a corporate governance index can be identified :

1. Raise the "governance ceiling"

- Effective policy tool where law and regulation are slow to improve
- Index criteria can directly address perceived weaknesses

2. Give companies opportunity to differentiate themselves

- Important for companies especially in markets with CG weaknesses
- Companies can effectively showcase their commitment

3. Tap into growing pool of funds chasing good CG and ESG practices

- Survey after survey shows that ESG factors are becoming mainstream
- CG is the most watched of these factors

Types of CGIs

CGIs can be categorized in a number of ways:

1. Degree of commitment of index member companies

Listing tiers (Novo Mercado, STAR) have mandatory special listing rules and require higher degree of commitment.

2. Automatic vs voluntary evaluation

Automatic evaluation gives more credibility to indices since companies cannot choose to have their practices analyzed.

3. Membership capped

Limiting the maximum number of companies may suggest to investors that it is more difficult to be part of the index.

4. CG vs. ESG criteria

Depends to large degree on principal purpose of index

Critical Elements of CGIs

Four areas are most critical in the analysis of a CGI or ESG Index:

1. Index Criteria

- Governance Criteria
- Market-based criteria

2. Process of company evaluation

- Type of information
- Governance evaluators
- Methodology
- Vetting of information

3. Disclosure

- Disclosure of index methodology
- Disclosure of ratings

4. Supervision of indices

- Monitoring and review of compliance with index criteria
- Exclusions from indices

Performance of CGIs - Growth

1. Growth in Indices

- Most indices have grown very strongly since inception

Index	Launch Date	Original Constituents	February 2013
Brazil BM&FBOVESPA CG Index	2001	18	174
China SSE CG Index	2008	199	266
Italy FTSE STAR	2001	20	66
Mexico BMV IPC Sustentable	2011	23	29
Peru BVL Good CG Index	2008	9	9
South Africa JSE SRI Index	2004	49	79
South Korea KRX KOGI Index	2003	50	50
Turkey ISE CG Index	2007	7	45

Performance of CGIs – Market Benchmarks

2. Performance since inception against market benchmark

CGI/ESG Index	Market Benchmark	100= Year	CGI Jan 2013	Benchmark Jan 2013	Differential	Annualized Differential
Brazil IGC	IBOVESPA	2001	788.1	410.4	+377%	**29%**
China SSE CGI	SSE 180	2008	47.8*	46.5*	+1.3%	**0.33%**
Italy FTSE STAR	FTSE MidCap	2003	134.7	87.6	+47.1%	**4.7%**
Mexico IPC Sust	IPC	2008**	279.4	212.8	+66.6%	**13.3%**
Peru IBGC	IGBVL	2008	157.3*	141.1*	+16.3%	**4.1%**
S. Africa JSE SRI	JSE All Share	2004	340.9	376.9	-36%	**-4%**
S. Korea KOGI	KOSPI	2003	257*	302*	-45%	**-5%**
Turkey ISE CGI	IMKB 100	2007	140.3	156.9	-16.6%	**-2.7%**

* Closing values as of May 2012
** The Mexican Index, launched in November 2011, was backdated to 2008 to allow for a longer comparison period.

Performance of CGIs – Market Benchmarks & ETFs

2. Performance since inception against market benchmark

- Brazil and Mexico have substantially outperformed the market, Brazil benefitting from progressive weighting applied to Novo Mercado companies
- Most indices track the market closely:
  - significant overlap between large cap main index companies and companies in the CG index.
  - Lack of depth in capital markets

3. Development of Investment Products

- So far, only two exchange-traded funds have been developed from the indices, in Brazil and China. Mexico is in development.
- Reasons include lack of differentiation in some cases, lack of market depth and relative novelty of index in others.

Key Findings of the Study

1. Corporate governance indices can be an effective market solution in addressing legal and regulatory gaps, and in enhancing corporate behavior and company's visibility.
2. Evidence suggests that indices based on binding listing rules allow greater access to capital than those based on corporate governance codes or other scoring mechanisms.
3. Investors recognize the importance of corporate governance in their investment decisions, and the difficulty in gathering related information especially in emerging markets. If set up correctly, CG Indices can bridge the information gap.
4. Given the qualitative nature of CGIs, investors need to be careful to properly understand the building blocks and methodology an index is based on as information and expectation asymmetry may pose unforeseen risks.
5. In most CGIs, key challenges for investors remain: access to index information and rating methodology is limited, and company evaluations are rarely made public.
6. Virtually all CGIs have had strong constituent growth. However, most are struggling to beat the benchmark index. This often reflects the overlap of constituent companies and a lack of depth in the capital markets.

Lessons – Eight Steps to build a successful CGI

1. **Use a wide initial consultation process**
2. **Define the objective(s) of the index**
3. **Select the index approach**
4. **Differentiate criteria from standard governance practices**
5. **Build a transparent and credible evaluation process**
6. **Achieve maximum possible disclosure**
7. **Effectively monitor index criteria**
8. **Develop the index**