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Analysis

# Robust Corporate Social Responsibility investment screening

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ABSTRACT

Although a priori company screening is a constitutive feature of Socially Responsible Investment (SRI) funds, it is not easy to substantiate that such screening effectively differentiates between companies on the basis of their Corporate Social Responsibility (CSR) calibre. Fundamentally, this is because CSR comprises several dimensions for which an undisputed aggregative model is lacking. We assess the robustness of companies' CSR rankings with respect to several modelling assumptions. We then build on Gini's transvariation concept to select/reject specific companies in the SRI eligible universe of assets. We illustrate our approach with some specific screening issues as confronted by the ethical advisory committee of a large Belgian bank.



## 1. Introduction

In the slipstream of the growing attention for Corporate Social Responsibility (CSR), the measurement of the CSR performance of companies has become a booming business. Governments, non-governmental organisations, academics and not at least the companies themselves gather interest in quantitative indicators that measure companies' corporate governance and environmental, social and economic performance. The growing industry of Ethical Investment or Socially Responsible Investment (SRI) also requires detailed CSR related information to identify companies deemed acceptable for investment. Although SRI is often associated with investment in small enterprises with socially highly relevant projects (e.g. green economy), the financial markets are entered by a growing number of SRI funds composed out of mainstream publicly listed companies with an acceptable corporate social performance record. In the latter case, SRI boils down to an application of CSR criteria to investment decisions, which makes it obvious that an adequate assessment of CSR is crucial for SRI funds. Their defining quality is the presence of so-called investment screens that are used to select or exclude assets on the basis of some form of CSR assessment prior to the actual investment decision (e.g. Renneboog et al., 2008). In point of fact, this intrinsic two-stage nature of SRI (first screening, then investing) is often mirrored by the organizational set-up of SRI funds. Some CSR specialists (in-house research teams or independent rating agencies) are responsible for creating a so-called "eligible universe" of companies. Regular asset managers subsequently select assets from this universe, basing themselves on standard financial and economic investment criteria. The problem addressed in this paper is cast against this realistic division-of-labor background.[1] Taking it that the existence of an "eligible universe" is the foundational core of SRI funds, the important issue addressed in this paper is to what extent the inclusion/exclusion of specific assets can be substantiated.

It should be clear from the outset that we do not aim at providing some (seemingly) clear-cut intrinsic CSR criterion to deal with this issue. Such an approach seems ill-suited, as the essential difficulty when deciding whether or not an asset will be included in the SRI universe is that the underlying selection standard, CSR, is a complex multidimensional phenomenon. The assessment of a company's CSR calibre is accordingly intricate. This factual statement helps to explain why CSR ratings have been critically appraised as requiring "methodologically demanding judgments that are not always based on neutral criteria", even as being "mostly characterised by rather subjective selection processes" (Steurer et al., 2008). In fact, we take it that such subjectivity is in the end inescapable, given the underlying ontological problem of adequately gauging the dense concept of CSR. Our methodology therefore builds on the intellectual position that it is effectively impossible to justify any exact CSR ranking of companies given the many modelling assumptions that such an exact ranking requires. Yet we show the merits of quantifying the rankings' sensitivity to these assumptions, paving the way for an investigation of their robustness to changing modelling assumptions.

*Abbreviations:* CSR, Corporate Social Responsibility; SRI, Socially Responsible Investment; EIRiS, Ethical Investment Research Services.

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[1] See e.g. Hallerbach et al. (2004) for an alternative, integrated approach.

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In line with a fairly large literature, we shall take it that a screening exercise requires reducing the information contained in various one-dimensional indicators, each describing an important aspect of CSR, in such a way that the eventual ranking of companies (and the concomitant selection of a "best-in-class" subset of these ranked companies) is based on the construction of company-specific composite CSR indices.[2] The idea to use a composite index that aggregates the diverse dimensions of CSR into one number builds on the recognition that the very multidimensionality of CSR may impede an adequate comparison among companies. Ideally, a composite index enables assessing the CSR performance of a company quickly and efficiently and, moreover, allows for benchmarking companies within a particular sector (Krajnc and Glavič, 2005). The numerical nature of such indices adds a flavour of exactness to the screening problem, but we rather consider the construction of a composite index as illustrative for the subjectivity problem associated with CSR ratings. That is, the transparency and simplicity induced by resorting to a summary index manifestly raises the problem "that the researchers who construct the benchmark make choices for the stakeholders who want to judge the company. Stakeholders should thus be aware that these outcomes depend on many assumptions" (Graafland et al., 2004, p. 139).

It is indeed well-known that different construction methodologies for such composite indices exist and that, lacking any clear theoretical guidance as to what unequivocally constitutes the best underlying CSR model, the eventual ranking of companies may largely be driven by the specific modelling assumptions taken. Here, it should be stressed that the latter problem is not genuine to CSR indices; it is pervasive in the many fields for which composite indicators have been developed. Thus, we shall address this concern using an appropriate methodology that has been advocated for composite indicators in general (see e.g. Saisana et al., 2005) and has been endorsed by supranational organisations such as the European Commission and the OECD (Nardo et al., 2008).

Essentially, this methodology seeks to transcend the subjectivity problem by assessing to what extent alternative modelling assumptions (that are, indeed, hardly open to objectification) bear on eventual company rankings. In short, if a company ranks consistently high, regardless of variations in the construction methodology, there is a good case to be made that the company's underlying "raw CSR data", rather than the index construction itself, are ultimately the major drivers of its ranking, thereby confirming its robustness to methodological choices. In this sense a robustness analysis is conducive in validating the result of subjective decisions. However, what distinguishes the problem at hand from the conventional use of composite indicators is that SRI screening obliges to go beyond a mere ranking of companies. Modelling uncertainty possibly carries over, through the ranking, to the very heart of SRI, viz. the composition of the eligible universe. This requires complementing the existing robustness assessment methodology with a tool that helps in deciding whether a company should be in the eligible universe or not. It is exactly the latter which constitutes the central contribution of the current paper.

The SRI company selection problem is ultimately a practical one. Indeed, to illustrate our proposed methodology we shall address some concrete questions arising within the External Council of Sustainability Analysis that creates the SRI eligible universe for a large Belgian bank. Yet such practical problems relate to deeper issues regarding the desired level of transparency that should be upheld in SRI. Taking its own transparency seriously, the organization we use for our case study extensively documents the working of its screening procedure on its website (www.kbcam.be). While this provides an exemplary signal to both screened companies and (potential) investors, this disclosure occasionally leads to discussions on the appropriateness of some of the dimensions included in the CSR index, the suitability of the defined dimension weights, and the potential influence of the used aggregation scheme.

**Table 1**
Three dimensions of Corporate Social Responsibility.

| | People | Planet | Profit |
|---|---|---|---|
| Company A | 0.8 | 0.4 | 0.053 |
| Company B | 0.4 | 0.1 | 0.093 |
| Company C | 0.1 | 1 | 0.055 |

Given the modelling uncertainty that inevitably arises when trying to gauge Corporate Social Responsibility, the transparency dilemma instigates (i) the need for a thorough uncertainty analysis, and (ii) an asset selection procedure that is both robust and easy to convey to stakeholders, including the (sometimes unsolicited) firms that eventually will find themselves positioned at one side of an investment screen. The latter is particularly relevant for investors in the light of the growing evidence of a positive — bidirectional and simultaneous — link between corporate social performance and financial performance (see e.g. Waddock and Graves, 1997, and the meta-analysis of Orlitzky et al. (2003). Investors aware of this result might require an adequate investment screen to best guarantee financial results and, not to the least, environmental and social improvements. In this sense, the problem we study and the solution we propose are evidently not confined to the practical difficulties confronted by one particular SRI fund. More generally, the need for transparently and judiciously communicating CSR ratings bears on the credibility of various "infomediaries" that act as information brokers between firms and stakeholders in the field of CSR, and which have a potentially crucial role in fostering the CSR performance of firms (see e.g. Dubbink et al., 2008).[3,4]

The rest of this paper is laid out as follows. The next section briefly recalls the subjectivity problem inherent in the construction of composite indicators, and its bearing on an investment screen by means of a simplified example. Section 3 describes the data and some specific questions raised by those responsible for the investment screen in our case study. Section 4 then assesses the robustness and sensitivity of companies' rankings to different modelling assumptions. The toolbox we discuss broadens the scope of the robustness analysis advocated by Graafland et al. (2004). Building on Gini's concept of "transvariazione" (Dagum, 1960), we present a robust screening method in Section 5. Finally, Section 6 offers some summarizing comments.

## 2. Composite CSR Indices for SRI Screening: Handle with Care

An example recalls the type of assumptions that have to be made when constructing a composite index. Suppose for simplicity that only three indicators are available, each of them capturing an important CSR aspect. The "People" indicator could for instance refer to the female/male ratio in top level jobs; the "Planet" indicator is based on a quantitative rating by experts from NGOs of the companies' environmental policies, while the "Profit" indicator reports the figures for some ratio such as return on assets. Indicator scores for three firms are shown in Table 1. For each of the three indicators, a higher value

[2] Evidently, other avenues for CSR assessment have been explored as well. Ness et al. (2007) discuss, next to indices, also product-related assessments and integrated assessment tools. Specifically for CSR, Schäfer (2005) provides a closer look at the different rating approaches that are used, thus documenting a crucial stage in composite indicator construction that is not addressed in this paper. As pointed out by Schäfer, such approaches produce ratings that serve as an input for sustainability and CSR indices.

[3] For example, stakeholders may want to know why a firm is left in or out an SRI financial index (such as e.g. the Domini Social 400 Index, the FTSE4Good indices, the Ethibel Sustainability Index, the Dow Jones Sustainability Index, etc.).

[4] Our methodology may thus be at least partially useful in addressing the critique of Schäfer (2005) that "while CSR rating institutions call for corporate transparency and operate as 'social accountants', the industry itself is currently lacking sufficient transparency."