What gets measured gets managed - exploring the link between sustainability indices and responsible corporate behaviour

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Abstract

While the relationship between financial performance and social performance of companies has received a lot of attention within the Social Responsible Investment (SRI) literature, the link between the metrics used to measure social performance and the impact these metrics have on corporate behaviour remains relatively unexplored. This paper uses concepts developed in institutional theory and economic sociology to explain the role of metrics such as the FTSE4Good Indices within the field of Social Responsible Investment. A conceptual framework that articulates the environmental, relational and cognitive mechanisms whereby indices change corporate behaviour is developed.
1. Introduction

Investors that want to incorporate environmental, social and corporate governance issues (ESG) in their portfolios need information on the performance of companies on these issues. Obtaining up-to-date and relevant information is key to managing their investment portfolios, but much harder to gather than information on the financial performance of a company. This explains the crucial role of social rating agencies that have designed social metrics such as reporting tools, ratings and indices (Sparkes 2002). A growing number of sustainability indices have been developed in the wake of increasing interest in SRI by both individual and institutional investors, such as the FTSE4Good Indices, the Dow Jones Sustainability Index, ASPI Eurozone and the Domini Social Index. Sustainability indices use pre-set selection criteria to measure the social performance of a universe of listed companies.

Academic research on responsible investment has often focused on the financial performance of SRI portfolios and funds (see for a review of this issue and the wider debate on corporate financial and social performance: Orlitzky 1998; Margolis and Walsh 2003; Margolis, Elfenbein et al. 2007). So far, results of studies in this debate are ambiguous. Similarly, most of the research on sustainability indices has investigated their performance relative to traditional financial benchmarks (Statman 2000; Statman 2006; Schröder 2007; Collison, Cobb et al. 2008). Yet, the link between inclusion in the sustainability indices and the impact this has on corporate social behaviour remains relatively unexplored. It is clear more research is needed to conceptualise the influence of sustainability indices on corporate behaviour, which in addition could add to the theoretical groundings of the SRI literature.

For the purposes of the research, corporate social behaviour is seen as resulting not only from external demands but also from organisationally embedded cognitive and linguistic processes (Basu and Palazzo 2008). This approach allows for an examination of a wider variety of issues than normally considered in the Corporate Social Performance (CSP) literature, which usually focuses on measuring corporate activities only (Basu and Palazzo 2008). In addition it allows for examination of both external and internal corporate activities. Corporate discourse, corporate activities and cognitive perceptions on the part of the company are the elements that jointly constitute corporate social behaviour.

Recently authors have drawn attention to the emerging infrastructure that has been created by various actors and organisations to hold corporations accountable for their social performance. According to Waddock various actors in the SRI field have created institutional arrangements, such as standards, codes, research, and measurement tools, that together create a new institutional infrastructure in which corporations need to (re)define their behaviour (Waddock 2008b). These institutional arrangements are changing the system and the 'rules of the game' for multinational corporations, by creating different expectations around corporate practices and performance (Waddock 2008a), in line with the saying ‘what gets measured gets managed’ (Chatterji and Levine 2006).

The SRI industry at large, and the metrics developed to aid the growth of the industry in particular, play a central role in this institutionalisation process. According to Déjean, Gond and Leca, the metrics developed by social rating agencies have made Corporate Social Responsibility (CSR) quantifiable, thus contributing to the legitimacy of CSR in the financial marketplace. Although such

1 Recently Adam and Shavit have explored the consequences for corporate investment in CSR for those companies that are not included in sustainability indices, see Adam, A. M. and T. Shavit (2008). See also Cobb et al (2005) for an empirical study of the financial performance of the FTSE4Good index and its impact on CSR activities of companies. While the study provides a good start for examining the impact of the index on corporate behaviour, the authors concede further investigation is needed to come to a full conclusion.
measurement tools set commonly accepted standards, they are not neutral (Déjean et al. 2004). The work of authors such as Porter (1994; 1995), Callon (1998; Callon, Millo et al. 2007) and Mackenzie (2006; Mackenzie, Muniesa et al. 2007) on calculability and commensuration (see also Espeland and Stevens 1998; Espeland and Sauder 2007) shows that metrics, by reducing complex issues into quantifiable concepts, can shape actors' behaviours as they come to share common meanings.

Even though there seem to be no direct financial benefits related to inclusion in the indices, as evidence related to the influence of inclusion on corporate financial performance and share price remains inconclusive (Curran and Moran 2007), it is argued here that the sustainability indices nevertheless have an impact on corporate responsible behaviour, as they frame corporate behaviour through environmental, relational and cognitive mechanisms. Following the typology that was developed by McAdam for mechanisms underlying social movements, *environmental mechanisms* are externally generated influences on conditions affecting social life; *relational mechanisms* alter connections among people, groups, and interpersonal networks; and *cognitive mechanisms* operate through alterations of individual and collective perception (McAdam 2001). This typology allows for the drawing in of several concepts from institutional theory and economic sociology.

This paper will provide a conceptual framework for examining the mechanisms by which sustainability indices change corporate behaviour. The paper is structured in five sections: the next section provides a typology of SRI approaches, and the section following that draws attention to institutionalisation processes in the SRI field. The fourth section of the paper provides an analysis of the development of sustainability indices, introducing the concepts of calculability and commensuration. The fifth section of the paper provides the conceptual framework articulating the mechanisms whereby sustainability indices influence corporate behaviour; concluding with the implications of current findings for the proposed empirical testing of the framework.

2. SRI typology and development

Socially responsible investment (SRI) is a concept that is not easily defined due to the diverse nature of the actors, their motivations for investment, the types of investments and investment strategies commonly used. In general, the term refers to investments made based on considerations of financial returns, as well as extra-financial considerations, such as concerns regarding the ethical, religious, social, governance or environmental impacts of the entities that actors are looking to invest in (Kurtz 2008).

The actors involved in the SRI organisational field in the EU currently range from institutional investors (such as private and public pension funds and insurance companies), fund managers of retail funds, church and charity investors, local authorities, universities and individual investors (EUROSIF 2008). These different investors have different motivations at the core of their investment strategies. Based on the motivations for investors, the following types of investors can be distinguished:

- **values-based**: entails investors who decide to include extra-financial considerations into portfolio selection in accordance with their moral beliefs. Most church and charity investors, as well as investors who choose to exclude or select particular companies or sectors because of their impact on the environment or stakeholders can be described as using a values based approach (Kinder 2005; Kurtz 2008; EUROSIF 2008).

- **value-seeking**: involves investors who use data on extra-financial considerations to determine long-term value of environmental, social and governance (ESG) issues on their portfolio performance, integrating ESG analysis with traditional financial
analysis and risk assessment. This value-seeking approach is most common amongst institutional investors (Kinder 2005; Kurtz 2008; EUROSIF 2008).

- value-enhancing: this group of investors uses shareholder activism and engagement strategies to enhance investment value, focussing mostly on corporate governance issues. This type of investors is most prominently found in the US (Kinder 2005; Kurtz 2008).

- value-promoting: this group of investors is interested in sustainability issues and the investment opportunities that are created by changing regulations and market practices. These are for example individual investors choosing to invest in thematic funds (clean energy, water, etc.) because of their financial and sustainable returns prospects (EUROSIF 2008: 6).

Furthermore, SRI is often described by a classification of the approaches used by investors. Conventional ways of describing these investment strategies in Europe include:

- Screening: this can be negative or exclusionary screening, based on excluding the traditional ‘sin stocks’; positive or inclusionary screening, based on a commitment to take into account positive company behaviour; pioneer screening, which aims to identify the ‘industries of the future’; and norm-based screening, taking into account company compliance with international standards. The best-in-class approach, where leading companies from each sector or industry are identified according to pre-determined criteria, can be considered a form of positive screening.

- Engagement: investors engage in a dialogue regarding issues of concern with companies. This can include a direct, private dialogue with management or targeted companies, or more public actions such as seeking publicity around issues of concern, filing shareholder resolutions and proxy voting.

- Integration: consideration of the long-term value of extra-financial considerations and integration of these issues into traditional financial analysis and portfolio management. (Sparkes 2002; Hellsten and Mallin 2006; Louche and Lydenberg 2006; EIRIS 2007; EUROSIF 2008)

These approaches are not exclusionary; some investors use a combination of approaches, for example using different types of screens or combining screening with an engagement approach. Table 1 provides an overview of common SRI approaches by type of investor.

**Table 1: SRI approaches and strategies**

<table>
<thead>
<tr>
<th>Approach</th>
<th>Main investment strategy</th>
<th>Main type of investor</th>
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<tbody>
<tr>
<td>Values – based</td>
<td>Screening</td>
<td>Retail investment funds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Church and charity investors</td>
</tr>
<tr>
<td>Value – seeking</td>
<td>Screening (limited) Engagement</td>
<td>Institutional Investors</td>
</tr>
<tr>
<td></td>
<td>Integration</td>
<td></td>
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<tr>
<td>Value – enhancing</td>
<td>Engagement</td>
<td>Public Pensions</td>
</tr>
<tr>
<td></td>
<td>Shareholder activism</td>
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<tr>
<td>Value – promoting</td>
<td>Pioneer Screening</td>
<td>Individual investors</td>
</tr>
<tr>
<td></td>
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<td>Themed funds</td>
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Source: Kurtz 2008; Kinder 2005; EUROSIF 2008
National SRI markets vary according to different social, political and regulative contexts for investment. SRI has its roots in religious movements and activist organisations in the US. Church investors and activists have developed campaigns around various issues since the 1960's, including civil rights, Vietnam, consumer rights, and South Africa; when many religious investors abstained from investing in companies that were in any way involved in these issues and urging others to follow their lead. An important difference between the US and European approaches to SRI is the prevalence of shareholder activism in the US, where there is a long tradition of using shareholder rights to influence company behaviour. The regulations on shareholder rights in the EU are more stringent than in the US, making it harder for shareholders to file so-called ‘social proxies’ or non-financial resolutions (Sparkes 2001).

Table 2: SRI in the UK, EU, VS

<table>
<thead>
<tr>
<th>Classification used</th>
<th>US</th>
<th>EU (including UK)</th>
<th>UK</th>
</tr>
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<tr>
<td>1. Screening</td>
<td>1. Core SRI</td>
<td>1. Core SRI</td>
<td></td>
</tr>
<tr>
<td>2. Shareholder activism</td>
<td>2. Broad SRI</td>
<td>2. Broad SRI</td>
<td></td>
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<tr>
<td>3. Community investment</td>
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<table>
<thead>
<tr>
<th>Investment strategies used</th>
<th>US</th>
<th>EU (including UK)</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Screening</td>
<td>$2.71 trillion/£1.37 trillion</td>
<td>€2.67 trillion/£1.96 trillion</td>
<td>€959 billion/£764 billion</td>
</tr>
<tr>
<td>Shareholder activism</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engagement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integration</td>
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*AUM as of 31 December 2007 for EU/UK, for 2007 for US, value in pound calculated using exchange rate 31 December 2007.*

In the UK, where the SRI market is the largest of the European countries in terms of assets under management, SRI can also be traced back to religious investors, while the environmental movement has had great impact on the development of SRI in the UK as well. Government regulation has also been an important driver for the development of the UK SRI movement with a change to the 1995 Pension Act. Since the amended act has come into force in 2000, pension funds in the UK are required to provide transparency on whether and how they take into account extra-financial considerations in the selection, retention and realisation of their investment. Pension funds and other institutional investors have become important actors in the UK SRI movement.

The diverse national contexts in which the SRI movement developed have led to different classifications of SRI by practitioners. For instance in the US SRI is classified as containing the following strategies: screening (exclusionary and inclusionary), shareholder advocacy and community investing (SIF 2007). The latter category includes microfinance, social venture capital and community lending. The European Social Investment Forum (EUROSIF) however categorises broad and core SRI. The core SRI investor are made up by those that make extensive use of screens (both positive and negative), whereas broad SRI is made up by investors who use one or two screens, and rely more on engagement and integration strategies (EUROSIF 2008).

Community investment is sometimes included in SRI classifications (Kurtz 2008). However Sparkes is of the opinion that this last approach should not be considered as socially responsible investment, even though both types of investments are concerned with social impacts, as the former is most often based
on a banking model rather than on an equity finance model (Sparkes 2002). Since the focus of this paper is on sustainability indices, which rank the equity of socially responsible companies, only SRI based on equity investments is taken into account.

The approaches used by equity investors within the SRI field in the EU have changed over the years. With the advent of institutional investors and mainstream organisations more sophisticated approaches have been developed. Generally speaking common approaches to SRI have developed from negative to positive screening to a best-in-class approach and pioneer screening, with lately an emphasis on the company’s relationship with its stakeholders (Louche 2004; ORSE 2007). Table 2 highlights current assets under management in the main SRI markets.

3. Institutionalisation in the field

Institutional theorists have used the term “field” to denote formations of organisations that are similar, have common practices, or share a certain focus of attention such as a market (Anand and Peterson 2000). The common definition of an organisational field is: ‘those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services or products’ (DiMaggio and Powell 1983: 148). An increase in the extent to which certain organisations interact, an increase in the information load they share, and the development of a mutual awareness that they are involved in a common debate, signals an ongoing process of institutionalisation in an organisational field (DiMaggio and Powell 1983). Organisational fields can form around a central issue -such as SRI- and field formation is not a static process, but will evolve over time as the issues around which the field is formed evolve and new actors are drawn into the field (Hoffman 1999).

Even though SRI markets have developed in differing situational contexts due to the differences in national regulative and socio-political systems, the organisational field as a whole shows increasing institutionalisation. The SRI industry is a fast growing segment of the financial market, no longer limited to religious societies and churches or green investors. The increase in SRI assets under management can be partly contributed to a growing number of institutional investors that take into account environmental and social concerns in their investment outlook. The core SRI industry is also become more mature, with a trend towards increased cooperation between the organisations and investors. Increasing interaction and information-sharing can be seen developing through initiatives such as the Principles for Responsible Investment initiative that is supported by the United Nations. This institutional investors’ initiative aims to stimulate increased cooperation between investors, for example by providing an online forum where PRI signatories can post ideas and proposals for collaboration with peers to seek changes in company behaviour. Investors also share information on their SRI strategies in the annual “PRI Report on Progress” (EUROSIF 2008). In June 2008, there were 381 signatories, representing USD 14 trillion in assets under management (PRI 2008). Furthermore, social research agencies have been working together since 2001 to develop a quality standard that promotes good quality research. The latest version of the standard was approved in 2007 (CCSR-QS 2008).

The trend in growing interaction and information sharing does not mean that there is no contention over issues within the organisational field. As was mentioned before, the conception over what exactly constitutes SRI differs between European and US contexts, therefore the boundaries of the field are still contested. However some central beliefs are commonly shared throughout the field. Most organisations involved in the field share the belief that the investment process can be used as a means to change the behaviour of specific corporations on social and environmental issues. This emphasis on specific corporate change is
new, as the religious groups that form the roots of the current movement had previously simply screened out objectionable companies, making it impossible to seek reform in corporate behaviour (Louche and Lydenberg 2006). A second shared belief is the conviction on the part of investors that environmental, social and corporate governance (ESG) issues are material to financial returns. This conviction can be seen as the raison d’être (Schepers and Sethi 2003) of the SRI industry and constitutes the central belief that is diffused throughout the organisational field (Gond and Palazzo 2008).

Institutional fields can shape the possibilities for behaviour of organisations that find themselves within the field. This includes companies, as their choice of behaviour is seen as a choice constrained by a narrowly defined set of legitimate options determined by the prevailing logics within an organisational field (Scott 1991; Friedland and Alford 1991). It is generally agreed in the literature on Corporate Social Responsibility (CSR) that investors, especially institutional investors that practice SRI strategies, can be important change agents for corporate responsible behaviour. Sparkes and Cowton for example draw on the concept of fiduciary capitalism (Hawley and Williams 1997) to explain the growing influence of institutional investors on companies. They claim the larger share ownership held and the engagement approach used by this type of investors provide great incentives for companies to act on investors’ concerns (Sparkes and Cowton 2004).

Substantial collective action is needed to represent an equity position that is large enough to influence corporate behaviour, but many claim this continues to be inhibited by the lack of commonly agreed criteria of socially responsible conduct (Schepers and Sethi 2003). The lack of commonly shared and reliable performance measures are often cited as the main barrier for the further development of the SRI market into the mainstream financial markets and as a barrier to enhancement of the influence SRI can have on companies (Vogel 2005). However the indices provide a set of measurement criteria around which investors’ interests can converge. This prompts the need to examine existing SRI metrics more closely in order to arrive at a better understanding on how the SRI field could influence corporate behaviour.

The concept of market information regimes proves useful in linking together investors and individual companies within the SRI field. Market information regimes provide a predictable set of field-wide activity through routinization in the collection, delivery, and interpretation of information about market activity (Anand and Peterson 2000: 271). Anand and Peterson found that market information regimes impact on behaviour in organisational fields in three ways: they provide a common focus of attention, the constitution of fields is information regime-dependent, because reframing the scope, methodology, or tone of a market information regime creates a change in participants’ understanding of the field itself, and the inclusion of new categories of market information can itself spur the formation of new niches within a field (Anand and Peterson 2000). It is argued that the development of SRI or sustainability metrics such as Domini Social Index, Dow Jones Sustainability Index and FTSE4Good and numerous other social performance measurement practices developed by social rating agencies constitute a market information regime in the SRI field that aids the legitimacy and institutionalisation of SRI in the financial markets. The next section looks at these sustainability indices in more detail.

4. Sustainability indices: what they are and what they do

The first sustainability index was the Domini 400 Social Index, launched in May 1990 by Kinder, Lydenberg, Domini, and Co (Fowler and Hope 2007). The DSI consists of primarily large-cap US companies. It uses positive and negative screens: excluding companies with significant revenues from alcohol, tobacco, gambling,
nuclear power and weapons contracting. It includes companies with positive records in community involvement, the environment, employee relations and hiring practices.

Launched in September 1999, the Dow Jones Sustainability Indices were the first indices to track the performance of companies on a global scale. The DJSI consists of a family of indices; each index is made up of the top 10% performing companies in 57 industry groups. The DJSI do not apply negative screens: no industry is excluded in the selection process and in the composition of the indices, but investors do have the option to apply filters against certain sectors (Dow Jones 2008).

The FTSE4Good Indices are also made up of a group of indices that measure the performance of socially responsible companies around the world. The series consists of five benchmark indices and four tradable indices covering the EU, the US, Japan and the UK. The selection criteria for inclusion cover climate change, environmental management, countering bribery, human and labour rights and supply chain labour standards. Tobacco producers, nuclear weapons producers and producers of whole weapon systems are screened out. Since the launch of the series in July 2001, the FTSE Group have continuously ratcheted up the criteria, adding more strenuous criteria for positive screening, while trying to reduce negative screening. For instance companies involved in the mining of uranium are no longer excluded, but need to meet additional industry specific criteria (FTSE 2007).

The belief that ESG issues are material and SRI is profitable in the long term underlies the development of most of the indices. For example the FTSE4Good indices were designed to identify current thinking on corporate social responsibility and investment, measure company compliance and report in a useable format the performance of the constituent companies (Collison, Cobb et al. 2008). The indices are used by fund managers to identify socially responsible companies and serve as benchmarks against which fund managers can evaluate the performance of their fund (Collison et al. 2008). Indices such as the FTSE4Good are used to put together structured products and index-tracker funds, while they can also be used as a proxy by investors for identifying target companies or development of engagement strategies with those companies not included in the index (Oulton 2006).

The indices are built on data provided by rating agencies and these rating agencies associated with each index use different SRI strategies: the DJSI is built on the best-class approach, DSI uses KLD’s data composed by various negative screens and the FTSE4Good index is based on a mixed screening approach employed by the research and rating agency EIRIS (Fowler and Hope 2007) (See appendix 1 for an overview of the sustainability indices). Rating agencies can be viewed as the intermediaries between the financial community and management of companies (Louche, Gond et al. 2005). They can reduce information costs for investors, produce, assemble and diffuse information that is difficult to gather or measure (ORSE 2007:6).

In setting and upholding the standards by which corporate social performance is measured, rating agencies hold considerable systemic power within the organisational field (Déjean, Gond et al. 2004). This power stems to a great extent from the way they have used measurement tools to ensure the legitimacy of the SRI industry in the financial market. Indices have been part and parcel of the financial world for decades and represent a rational, calculated benchmark and tool for investment policies. Rating agencies in Europe have used the example of mainstream financial tools to calculate extra-financial concepts through the sustainability indices (Déjean et al. 2004). The pioneers of the modern form of SRI in the US, KLD Research & Analytics, modelled the Domini Social Index on the methodology of Standards & Poor’s as a way of systematically generating and disseminating data, and through this model framed the thinking about SRI in the US in the 1990’s (Waddock 2008). The reputation of the FTSE Group in the mainstream
financial world, combined with the publicity surrounding the developments in the FTSE4Good indices, is believed to have promoted the concepts and beliefs of SRI with investors in the UK (Collison et al. 2008).

Sustainability indices have been criticised for their reliability, comparability, and construct validity, as critics claim they are not useful indicators of corporate social performance (Chatterji and Levine 2006). The main disagreement voiced by critics relates to the perception that corporate social performance is a multi-faceted concept made up of a number of attributes (Mitnick 2000), which can be difficult, if not impossible to aggregate and quantify (Rowley and Berman 2000).

This process of aggregation and quantification of a number of diverse attributes (imagine for example in the FTSE4Good indices: labour, human rights, environmental, supply chain and corruption policies) through the means of a metric is akin to a commensuration process. Commensuration, or the transformation of different qualities into a common metric, makes it possible to reduce complex information into numbers that can be compared, thereby simplifying decision-makinng processes (Espeland and Stevens 1998). It abstracts and reduces information, and renders what is being measured relative and comparable. It is thereby an inherently political process: ‘...it reconstructs relations of authority, creates new political entities, and establishes new interpretive frameworks’ (Espeland and Stevens 1998: 323). In effect, sustainability indices provide the common metric by which corporate financial performance and corporate social performance are linked together and valued.

The proliferations of various types of rankings can be seen as stemming from an increased market-like orientation of consumers towards social issues that have an inherent qualitative nature. The spread of rankings and other quantitative measures are used to mitigate conflict, overcome distrust, coordinate between various social demands (Porter 1995) and as a method to control organisations and make them accessible to outsiders (Espeland and Sauder 2007). Indices are based on free-market place of social information, favouring the market place above regulation or litigation (Lydenberg 2005; Vogel 2005). Markets need information to function effectively; therefore measurement tools have become increasingly important. A measurement tool can subsequently shape the growth of a market, and impact on the behaviour of participants (Callon 1998; Mackenzie and Millo 2003; Callon and Muniesa 2005; MacKenzie 2006; Callon, Millo et al. 2007) Measurement tools such as sustainability indices are market devices (Callon et al. 2007), that are used to produce abstract information used for calculation by participants in the market. Market devices are not neutral, but developed within certain social contexts that determine what is taken into account for calculation, and these social contexts and chosen methods of calculation will affect the quantifiable objects and hence the choices open to market participants (Callon et al. 2007).

The more a measurement tool gets used by participants in the market and becomes institutionalised, the greater the impact of the tool on practice will be (Espeland and Stevens 1998). For example, reputational effects stemming from a rise in ranking place or from an exclusion from an index will be greater when the tool is more widely used and has become institutionalised in decision-making processes. When critics of sustainability indices claim that corporate social performance is non-calculable or non-commensurate, they reach the opposite conclusion, because as a consequence of the stated non-calculability they place serious doubts on the viability of the SRI market (Vogel 2005; Hellsten and Mallin 2006). Espeland and Sauder show on the other hand that metrics can have important implications for institutionalisation of the organisational field: as metrics reduce distinctiveness through comparing organisations on the same scale, they reduce fragmentation in the field( Espeland and Sauder 2007).
5. Mechanisms by which sustainability indices influence corporate behaviour

It is clear that the process of rendering a concept such as corporate social performance calculable and commensurate by means of a metric is political and value laden. This section will examine how the measurement tools that have been developed shape the behaviour of market participants. The mechanism by which behaviour is influenced can be divided in three types: environmental, relational and cognitive. This typology is chosen because, according to Davis, these mechanisms are especially apt for making sense of social change processes and are broadly applicable to organisational phenomena in times of economic transition (Davis and Marquis 2005), and it can be argued that this is the case for the organisational field of SRI in current times.

The most widely observed link between inclusion in the sustainability indices and corporate behaviour points to issues of legitimacy (cf. Louche 2004; Cobb et al. 2005; Fowler and Hope 2007). Legitimacy can be understood as ‘a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions’ (Suchman 1995). To examine more closely how and why legitimacy issues influence corporate behaviour, this section will look at how legitimacy issues are affected by environmental, relational and cognitive level mechanisms.

5.1 Environmental mechanisms

Environmental mechanisms constitute of externally generated influences on conditions affecting social life (McAdam 2001). Institutions make up an important part of the environmental context (Pfeffer and Salancik 1978; Scott 1991). The environmental context is likely to be a determinant of organisational responses to institutional influence, for instance environmental uncertainty will affect organisations’ conformity or resistance to institutional demands and expectations (Oliver 1991). When goals are ambiguous and the environment uncertain, organisations may model themselves on other organisations that they perceive to be more legitimate or successful, a process labelled mimetic isomorphism (DiMaggio and Powell 1983).

The environment for corporate social performance and corporate social responsibility is highly uncertain: goals are ambiguous, new issues arise constantly, stakeholders demand diverse and sometimes conflicting actions, while the limited regulation that exists to guide decision-making remains voluntary. In this context companies will closely observe the behaviour of other companies that have devised social policies and actions that are deemed to be successful and legitimate (March and Cohen 1974). Obtaining inclusion in one of the sustainability indices can be one of those actions. This is especially pertinent in the period directly after the launch of an index. Management of the FTSE4Good indices report that a number of well-known brands experienced pressure to obtain inclusion in the indices because their competitors were already included (Oulton 2006). For example Tesco were excluded from the FTSE4Good indices when it was first launched in July 2001, as its environmental policy did not meet the criteria for inclusion. Tesco lobbied to be included on the indices because its competitor Sainsbury was already included. The company was told to change its environmental policy and in September 2002, after making subsequent changes, it was included in the indices (Cobb, Collison et al. 2005).

The change in company behaviour can be limited to discourse and does not necessarily lead to a change in activities or internal structure. Westphal and Zajac draw attention to this strategic management of institutional pressures, showing that companies can adopt institutionalized policies and programs in discourse but decouple (Meyer and Rowan 1977) these policies from the actual functioning of the company. This way companies can satisfy external demands from stakeholders
while keeping control over resources. Symbolic actions such as the decoupling of legitimate formal practices and actual company behaviour can nevertheless enhance legitimacy, and this is further enhanced when using socially acceptable language to justify behaviour (Westphal and Zajac 1994; 1998).

To communicate with rating agencies whose research forms the basis of the sustainability indices, companies must develop replicable communication procedures and structures (Schäfer 2005). Most indices are updated on an annual or half-yearly basis and both rating agencies providing data for the FTSE4Good and Dow Jones Sustainability Indices use surveys to collect data (Chatterji and Levine 2006). It requires substantial investment of resources on the part of companies to respond to the surveys, which could lead to a change in existing organisational structures and responsibilities within the company (Schäfer 2005), regardless of whether activities are merely symbolic or real. Compliance with criteria can also change internal structure, as a majority of companies in a survey on the impact of the FTSE4Good index reported significant effects on some of their internal processes, for example, reporting and management procedures, as a result of complying with the FTSE4Good criteria (Cobb et al. 2005).

5.2 Relational mechanisms

Relational mechanisms alter connections among people, groups, and interpersonal networks. The relational mechanisms by which sustainability indices alter the connections between companies, peers and stakeholders appear to be both positive and negative. Companies in the FTSE4Good indices regarded inclusion in the indices as being helpful in improving relationships with stakeholders, such as environmental groups, pension funds, fund managers and investors (Cobb et al. 2005). Louche found that there is a general belief among companies that companies listed on the indices represent the best performing companies in terms of social, environmental and financial performance and the indices are seen as a social test for responsible performance of companies, while also being used as indicators or benchmarks by a wide groups of stakeholders, including, but not limited to investors (Louche 2004: 248). Indices can thus be seen as certification contests: social tests of products and organisations (Thomson 1967) wherein the technical criteria chosen to evaluate performance are themselves the outcomes of institutional processes (Rao 1994: 32). Organisations rated as winners achieve legitimacy and a reputation of competence (Rao 1994). On the negative side Cobb et al find, based on a number of stakeholder interviews and a survey of companies included in the FSTE4Good indices, that the greatest leverage of the index on corporate behaviour is based on fear of exclusion. Companies felt that it was important to remain within the indices to avoid any stigma or embarrassment that might be caused by being expelled (Cobb et al. 2005: 6).

It is clear that relational mechanisms can affect a company’s activities and discourse in an attempt to comply with social tests and stakeholder expectations. These can in turn have an effect on the internal structure of the companies as well. Inclusion in sustainability indices is often publicised through displays of the indices’ logos and mentioning of inclusion and ranking place in sustainability reports. For instance it has been reported that 50% of the 40 biggest stock rated French corporations were referring to these metrics to present their CSR policies in their communication (Gond and Herrbach 2006). In effect, these companies are producing and disseminating identities that align with the indices, which in turn can shape internal processes of identification (Espeland and Sauder 2007).

5.2 Cognitive mechanisms

Cognitive mechanisms operate through alterations of individual and collective perception; words like recognize, understand, reinterpret, and classify characterize such mechanisms (McAdam 2001). Information plays a crucial role in generating collective perceptions:
The cognition of markets occurs through the generation, distribution, and interpretation of a web of information about activity in the "market." That is, market information is the prime source by which producers in competitive fields make sense of their actions and those of consumers, rivals, and suppliers that make up the field (Anand and Peterson 2002: 271).

In markets where consumers face significant difficulty in evaluating products, and where intermediaries exist to help them with this evaluation, classification of information plays a key role (Zuckerman 1999: 1405-1406). In these so-called mediated markets, the intermediaries confer legitimacy to products, often by using product categories (Zukerman 1999: 1400). For example, in the financial market investors and analysts use classificatory structures to compare and value assets. These classifications are based on industry boundaries; analysts specialise by industry sector to compare the performance of a company to its peers (Zuckerman 2004). Failure to attract coverage from analysts who specialise in a company’s industry – for instance because it is not clear which industry a company operates in – can cause the firms equity to trade at a discount (Zuckerman 1999).

Classification is problematic for investors in the SRI field who are using a pioneer screening approach, and who are actively looking for the ‘industries of the future’. Traditional classification of companies according to broad industry group can hide innovative firms. For example the Danish firm Vestas, which produces wind turbines, is classified under engineering firms, while clearly being quite different from traditional engineering firms. This makes it difficult for investors or analysts to identify innovative, responsible firms. The indices can play a role in identifying and classifying these firms (FTSE 2008).

Furthermore, the information provided by the indices frames the perception of corporate social performance of companies and causes them to react to this frame. Most sustainability indices were explicitly designed to promote corporate responsible behaviour in a frame that was logical and legitimate for investors and companies alike. For example, Dr Craig MacKenzie, a member of the FTSE4Good Advisory Committee, explained that FTSE4Good is not just designed to contain ‘squeakily clean’ companies; its function is to encourage progress towards greater corporate social responsibility in the business world (Cartridge and MacKenzie 2001 in Collison et al. 2008).

Measures elicit reactive responses, which can cause participants to become more like what is being measured (Espeland and Sauder 2007). For example the surveys that are sent out by the rating agencies to collect the data used for updating the indices on annual or half-yearly basis will signal to companies which criteria are deemed important for measuring corporate social performance. Evidence suggests most companies will consequently try to address these criteria (Cobb et al 2005, Oulton 2006). This is especially salient when criteria are made more stringent or new criteria are introduced. The FTSE4Good indices have a team dedicated to helping companies meet the new criteria that have been introduced since the launch of the indices.

Commensuration transforms cognition by changing the locus and form of attention, and alters the distribution of attention and relevance, thus changing the terms under which people make decisions (Espeland and Sauder 2007: 22). Sustainability indices provide a market information regime that is needed to interpret and make sense of the market, and whilst distributing that information they also have an important role to play in shaping the market.

6. Conclusion and implications for further research

Within the SRI field various types of investors and investment strategies can be distinguished. Some investors are motivated purely by their moral beliefs, while others focus more on the material gains that can be won by taking into account
extra-financial information. Despite the wide variety of organisations within the field, processes of institutionalisation do occur. Within recent years we have seen increased interaction and information sharing between organisations involved in SRI, and despite differences of opinion we can see the diffusion of commonly accepted beliefs, especially regarding the materiality of ESG issues. The metrics that have been developed within the field play an important role in these institutionalisation processes. A lack of common standards and methodologies is often cited as the main barrier to the SRI industry becoming ‘mainstream’. This claim posits an important reason for taking a closer look at the metrics in use in the industry, in order to examine in depth their influence on the behaviour of SRI market participants.

Through a process of calculability and commensuration, sustainability indices have contributed to making CSR quantifiable in the financial marketplace. They have created a market information regime by framing the scope and methodology of the market for corporate social performance, thereby actively framing participants’ understanding of the market, both investors and companies alike. This paper has focused on the way the market information regime formed by sustainability indices has the potential to shape company behaviour. It is clear that sustainability indices can influence corporations’ CSR, seen as comprising company discourse, activities and cognition, through environmental, relational and cognitive mechanisms. The uncertain institutional environment in which the sustainability indices have been developed plays an important role in creating isomorphic pressures, which are channelled in part through the sustainability indices and the pressure for inclusion in the indices. In the relational context, indices are used as social tests, as benchmarks to comply with stakeholder demands of investors as well as other stakeholder groups. The cognitive mechanisms at play may be especially strong in the case of sustainability indices due to their quantified nature. By a process of commensuration they organise, integrate and eliminate information, making vast amounts of information irrelevant, and imposing a shared metric on what remains (Espeland 2007: 17). In financial markets, where market information regimes play an important role in making sense of the market, indices could have significant impact on identity formation by companies, which in turn will affect discourse, but also activities and cognition on the part of the companies.

**Figure 1: The conceptual framework**

The identified mechanisms are not operating independently but interact with each other. All three types of mechanisms will have an impact on company discourse, activities and cognition. The conceptual framework provided in figure 1 draws a (tentative) diagram of the three types of mechanisms and elements of responsible
corporate behaviour. It is clear that more research need to be done in order to come to a full picture of how and how much the identified mechanisms affect each element of company behaviour. The conceptual framework provides a useful starting point for the process of mapping out impacts of each type of mechanism, but further empirical testing is needed to refine the framework.

Importantly, mechanism-based theorizing can aspire to explain but not predict (Davis and Marquis 2005). There is limited empirical evidence as of yet concerning the three elements of responsible corporate behaviour as outlined above. Further insights could be gained by using qualitative research methods, such as discourse analysis, case-studies and interviews. The social studies of finance, in which many of the concepts highlighted in this study are defined and tested, often takes a longitudinal, quantitative approach (see e.g. Rao 1994; Westphal and Zajac 1994; Zuckerman 2000; MacKenzie 2006). Since sustainability indices are socially-constructed concepts, a more qualitative method would be well suited to take this construction into account, allowing for additional insights and adding to the quality of this emerging field of study. Empirical testing of the framework will use combination of quantitative and qualitative methods. Further attention will also be paid to the methods used to construct sustainability indices, the rationale for the criteria by which social performance is measured and the processes by which new criteria are designed and implemented.

References


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FTSE 2007 Adding Value to your investment. 5 Year Review

FTSE 2008 Environmental Indices see http://www.ftse.com/Indices/FTSE_Environmental_Technology_Index_Series/index.jsp


## Appendix 1

<table>
<thead>
<tr>
<th>Name index</th>
<th>Research agency/benchmark supplier</th>
<th>Approach used</th>
<th>Traditional financial benchmark used</th>
<th>Coverage</th>
<th>launch</th>
<th>Criteria used in screening</th>
</tr>
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<tr>
<td>FTSE4Good</td>
<td>EIRIS/FTSE Group</td>
<td>Exclusionary and inclusionary screening</td>
<td>FTSE</td>
<td>Global</td>
<td>2001</td>
<td>- environmental</td>
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<td></td>
<td></td>
<td>All companies that meet criteria included</td>
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<td></td>
<td></td>
<td>- stakeholders</td>
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<td>- human rights</td>
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<td>- labour standards</td>
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<td>- countering bribery</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Plus exclusion</td>
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<tr>
<td>DJSI</td>
<td>SAM/ Dow Jones &amp; Company</td>
<td>Best-in-class</td>
<td>Dow Jones</td>
<td>Global</td>
<td>1999</td>
<td>- economic</td>
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<tr>
<td></td>
<td></td>
<td>Only top 10% in industry</td>
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<td>- environment</td>
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<td></td>
<td></td>
<td></td>
<td>No exclusion</td>
</tr>
<tr>
<td>Domini 400 Social Index</td>
<td>KLD</td>
<td>Extensive excl screening</td>
<td>S&amp;P 500</td>
<td>USA</td>
<td>1990</td>
<td>- community involvement</td>
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<td>400 companies stable</td>
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<td>Plus exclusion</td>
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