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**Sustainable
Investment in
Turkey:**

The Case in Context -
An Update

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CORPORATE
GOVERNANCE FORUM
OF TURKEY

FOREWORD

Attila Köksal, CFA

Chairman

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“As Capital Markets Association of Turkey, we highly believe the value of investor education to assist them in making better investment decisions. Hence, we are willing to extend investments on firms with sustainable business models.”

The challenges facing the world today are unprecedented and extraordinary. The global crisis has left an indelible mark on financial structures worldwide, and proved that we need to connect the dots between economic performance, social issues and environmental considerations. Over the past decade, sustainability has become a crucial element to formulate appropriate policy responses to these challenges.

In the global arena, investors have started to recognize that the economic, social and environmental conditions in the society can have a direct impact on the business operations and long-term presence of companies. While the importance of sustainable investments has already been acknowledged in the developed countries, there is a growing appetite in emerging markets. Yet, it is a relatively new concept to many Turkish investors.

The new Capital Market Law aims to align the regulations in Turkey with those of the European Union and strengthens investor protection. As Capital Markets Association of Turkey, we highly believe the value of investor education to assist them in making better investment decisions. Hence, we are willing to extend investments on firms with sustainable business models.

To this date, we have witnessed tremendous efforts made by Corporate Governance Forum of Turkey and Borsa Istanbul to analyse and develop sustainable investments in Turkey. I would like to take this opportunity to express my sincere thanks to Corporate Governance Forum of Turkey for producing this report, which I believe will trigger meaningful dialogue among investors, professionals and researchers. The report will be a valuable contribution to the debate on the future of sustainable investments and the challenges lying ahead of our capital markets.

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INTRODUCTION

Dr. Melsa Ararat

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“The focus on stock markets is motivated by the emerging emphasis on the role of stock exchanges in promoting SI as articulated in the objectives of the United Nations (UN) backed Sustainable Stock Exchanges (SSE) Initiative.”

This paper is a sequel to the “Sustainable Investment in Turkey, 2010” report (IFC, 2011). The original report provided a review of the then current state of the sustainable investment (SI) in Turkey and analysed the institutional prerequisites and interventions that would encourage better allocation of financial capital to sustainable firms. This update seeks to study Turkey as a case to analyse SI challenges and prospects in emerging markets with a focus on equity investments through stock exchanges and sustainability indices.

The focus on stock markets is motivated by the emerging emphasis on the role of stock exchanges in promoting SI as articulated in the objectives of the United Nations (UN) Sustainable Stock Exchanges (SSE) Initiative¹. Although this paper provides an update to the relevant sections of the original report, its ultimate objective is to reflect on Turkey’s experience as a case study to assess the feasibility of sustainability indices in promoting SI in emerging markets.

Section 1, **The Global Context for Sustainable Investing**, sets forth the backdrop for our case study, by defining sustainability and its meaning for firms and investors. Next, it explores why sustainability disclosure matters for investment decisions by taking a snapshot of the recent literature. This section also discusses the trends in sustainability disclosure and SI.

¹ See the SSE web site for details: <http://www.sseinitiative.org/> Member exchanges “voluntarily commit, through dialogue with investors, companies and regulators, to promoting long term SI and improved environmental, social and corporate governance disclosure and performance” among companies listed in their exchanges.

Section 2, **Sustainability Issues and Stock Markets in Emerging Markets**, builds on Section 1 and reviews the key sustainability issues in emerging economies. It then provides a critical overview of the role information intermediaries play in assessing sustainability risks, followed by a review of existing sustainability indices that cover emerging market firms.

Section 3, **Turkey: Country Overview**, presents an overview of Turkey’s economy and political economy, thus provides the background for our analysis of SI landscape in Turkey. It then continues with the analysis of key sustainability issues and their implications for sustainable development in Turkey. Turkey’s increasingly vibrant civil society is presented as an emerging driving force for sustainability disclosure and sustainability management.

Section 4, **Analysis of the Turkish Case**, takes a closer look at both the demand and supply side of sustainability disclosure based on the experiences of Borsa Istanbul’s Corporate Governance Index and Sustainability Index Project. It discusses the interplay between different actors and the conflicts of interest between them against the background presented in sections 1, 2 and 3.

Section 5, **Conclusion**, concludes. We look at Turkey as a “case” and draw more general conclusions for SI through stock exchanges and sustainability indices in EMs where possible.

I.1 Sustainability Imperative

There is a growing belief that firms can and should pursue strategies that address economic, social, and environmental problems that, if unresolved, may erode the basis for businesses' continuity. However, continuity and sustainability are not synonymous. Sustainability refers to an on-going equilibrium between an artefact and its supporting environment, in which they interact with each other without mutual detrimental effects (Faber, Jonra and Van Engelen, 2005). A sustainable business therefore closely and proactively assesses its impact on the economy, the environment and the society in order to minimize its negative impact and maximize its positive impact.

Economic dimension of sustainability is of fundamental importance to firms and is best reflected in their choice of business models, competitive strategies and governance arrangements. Social dimension of sustainability emphasizes the embedded nature of business in society. Issues such as poverty, access to medicine, access to clean water, polarization of income, and social exclusion are all related to the context in which businesses dynamically interact with the society. Environmental dimension of sustainability considers the impact of economic activities on natural resources, ecological balance, and on the pressing issue of global warming.

Adopting sustainability strategies and policies has potential benefits for firms; it can be viewed as a signal of management quality and is often linked to competitive advantage stemming from management foresight, innovation and better risk management. The costs associated with pursuing the potential benefits however, need to be reconciled with investors' expectations of financial return. The equilibrium between the two is influenced by investors' perception of materiality of sustainability issues within their investment horizons, and availability of firm specific sustainability information.

For institutional investors with longer-term investment horizons, the potential impact of environmental and social issues on the risks and returns of their investment portfolio is obvious.

SI can be investigated through two tracks:

1. Supply of financial capital to publicly listed firms in the form of equity investments through the stock markets, using strategies that incorporate sustainability risks into the investment processes; a market driven approach,
2. Supply of financial capital in various classes and forms to listed or privately held firms with due consideration of the investment's impact on economic and social development: a mission driven approach.

Both tracks share the common presumption that there is a conflict between the objectives of maximizing the "intrinsic" values of firms—which can be thought of as firms' full-information value—and maximizing their short-term value. This report focuses only on the first track, investment in sustainable firms through strategies that explicitly integrate sustainability risks that are frequently classified into environmental (E), social (S), and governance (G) related risk factors into traditional financial analysis.

I.2 Literature

Firms differ with respect to the emphasis they put on long-term versus short-term profitability, how much they care about their impact on the stakeholders and the environment, and to what extent they use moral reasoning for making decisions that involve ethical dilemmas. Some scholars argue that firms can "do well by doing good" (Margolis, Elfenbein and Walsh, 2007). Others posit that ignoring the interests of stakeholders can eventually destroy shareholder wealth (Freeman et al, 2010).

On the opposite side, some argue that sustainability can be a type of agency cost where managers may receive private benefits through pet projects or by colluding with other stakeholders against the interests of the shareholders (Jensen, 2001). For example, according to Gray (2012), adopting higher social and environmental standards that cost more than what the customers are willing to pay for can be financially detrimental for the firm. In order to avoid such costs, Porter and Kramer (2011) suggest that firms must embrace sustainability goals in the core of business by adopting business strategies that create "shared value" for all stakeholders.

Empirical research on the effect of sustainability strategies on firm value and performance outcomes is relatively new with the exception of burgeoning studies that focus on corporate governance dimension of sustainability¹. The findings of these studies are contradictory, ranging from a positive to a negative, to a U-shaped, or even to an inverse U-shaped relation (Margolis and Walsh, 2003). Conflicting results are attributed to theoretical and empirical limitations of prior studies, measurement errors and omitted variable bias. A recent study by Eccles Ionnou and Serafeim (2011) addresses some of these issues by using a matching sample of firms to investigate the differences in performance between High Sustainability and Low Sustainability firms, categorized as such by 27 indicators, over a period of 18 years. They provide compelling evidence that High Sustainability firms in the US significantly over-perform their counterparts both in terms of stock market and accounting performance. Their results are stronger for business to customer firms, firms that brand recognition matters, and firms that use large amounts of natural resources. One of the most comprehensive studies on long-term investing is a review of 100 academic studies, including four meta-studies (Deutsche Bank Group, 2012). The study concludes that 89% of the research studies show that firms with a high ESG rating outperform the market and their counterparts in accounting-based measures.

¹ See Claessens and Yurtoglu (2011) for a review of literature on governance to firm value research in emerging markets.

If stakeholders actually reward sustainability and sustainability performance is difficult to observe for investors, what role indices can play in encouraging higher investments into the member firms? Studies on the role of indices on influencing firm value are rare². Shining some light on the topic, a recent study (Doh, Howton and Howton, 2012) investigates the market reaction to addition or deletion of a firm to a social index. The authors report a negative effect on firm value associated with a firm's deletion, but no positive effect associated with the addition. Their explanation is based on information asymmetry argument; firms with positive social performance will be likely to share this news before being added to an index, whereas firms with deteriorating performance will tend to keep silent about it. These results highlight the role of information intermediaries with specific expertise in helping markets to price material sustainability risks.

From firm management perspective, integration of ESG factors into strategic management and business models is difficult since it requires a mind-set that runs against generally accepted management dogmas; profit maximization and shareholder primacy. Some legal scholars challenge the shareholder primacy norm outright arguing that the social norm provides incentives and pressures to pursue profit maximization at all costs although no company law system requires directors to do just that³. Reforming the core company law is proposed as a venue to promote sustainable firm. This proposal is inherently connected to the calls for a critical appraisal of the firm theory, especially in relation to the objectives and boundaries of the firm (Chassagnon, 2011).

From investment management perspective, Universal Owner hypothesis has been gaining ground against the traditional perspectives of fiduciary duty. A Universal Owner is defined as a long-term beneficiary of a diversified investment portfolio that is spread across markets. The hypothesis states that a portfolio investor benefiting from a company externalizing costs might experience a reduction in overall returns due to these externalities adversely affecting other investments in the portfolio, and hence overall market return. The long-term financial returns to the Universal Owner therefore depend on the ability of global markets to produce economic growth on a sustainable basis (MSCI, 2011). As articulated by UN Environmental Program "Universal Owners have a clear financial interest in the enduring health of the economy" (UNEP, 2011).

Universal Ownership concept shapes the arguments for a fundamental reappraisal of the fiduciary duties of investment management especially for pension funds. Such reappraisal is expected to lead to innovations in the definition of fiduciary duty involving more than just protecting the interests of the current beneficiaries, but also instilling public confidence in fiduciary services and thereby supporting the efficient functioning of the financial services industry, and contributing to social well-being⁴.

² See Fowler and Hope (2007) for a critical review of sustainability indices and their impact.

³ See Sustainable Companies Project, University of Oslo, <http://www.jus.uio.no/ifa/english/research/projects/sustainable-companies/>

⁴ See Hawley, Hoepner, Johnson, Sandberg, Waitzer (2014) for a comprehensive coverage of Institutional Investment and Fiduciary Duty debate.

I.3 Sustainable Investing

At the end of 2012, 47.3% of the global assets were invested in equities.

During the same year, US\$3.74 trillion or 11.3% of all US-based assets under management incorporated sustainable investment strategies in their portfolios, representing a 22% increase in 3 years (US SIF, 2012). This trend is based on increasing availability of sustainability disclosure. A survey of investors reports that sustainability disclosure is used by investors in a number of ways; (i) to understand industry trends and externalities likely to affect the capital formation in economic analysis, (ii) to understand the factors driving competitive advantages and their potential for value creation and spill over affects in industry analysis, (iii) in assessing management quality and a firm's ability to respond to emerging trends, and ultimately (iv) to adjust the return and valuation calculations to reflect materiality of sustainability risks (UN PRI, 2013).

SI manifests itself in practice in two investment approaches: integration and engagement. The integration approach involves tilting the portfolio by overweighting firms with high ESG ratings and underweighting firms with low ESG ratings when all other financial considerations are equal. In some cases, portfolio construction also involves negative screening but this approach is not common in mainstream investments. Sustainability indices allow investors to pursue the former approach. On the other hand, there is an on-going fundamental debate about the usefulness of indices and passive strategies in changing corporate behaviour of the firms included in the indices. The alternative approach is engagement. Some investors prefer to take an active role by engaging with the firms that are low ESG rated and demanding improvements in sustainability performance. By using "voice" rather than "exit", these investors expect to influence the firms to adopt sustainable strategies and outperform their rivals (Barber, 2005).

I.4 Sustainability Disclosure Trends

In the late 1990s, the apparent need for systematic ESG disclosure prompted the creation of Global Reporting Initiative (GRI) and Carbon Disclosure Project (CDP) as voluntary disclosure initiatives. 2013 has seen an intensified effort in order to develop global sustainability accounting and disclosure standards. International Integrated Reporting Council (IIRC) in the UK, Sustainability Accounting Standards Board (SASB) in the USA, and Investor Network on Climate Change Risk of CERES are the leading institutions in this vein.

Figure I.1 below presents the drivers of disclosure standards and how they feed into legislative efforts.

Under various names as corporate social responsibility, sustainability, corporate citizenship, more than 10,000 firms had issued reports with non-financial information in 2013⁵. Rooted

⁵ See The Corporate Register Web-site at <http://www.corporateregister.com>

Lydenberg (2013) discusses the future implications of the disclosure trends. He notes that availability of ESG data will enable research into valuation models that assess the positive and negative ESG externalities. If those valuations are expressed

6 France has already legislated mandatory disclosure of more than 40 sustainability indicators as early as in 2011.

1.5 Emerging Markets

7 This is not an easy task, as demonstrated by the experience of EU's Emission Trading Scheme. See EC press release on [http://europa.eu/rapid/press-release MEMO-12-854_en.htm](http://europa.eu/rapid/press-release_MEMO-12-854_en.htm)

[illegible]

with booming equity markets such as China and Russia leading to a 2.6% forgone return in 2006 (Wilshire Associates, 2007).

Unpredictability of risks exerts a downward pressure on investment horizons and justifies the overemphasis on the liquidity as a key investment parameter in EMs. While ESG risks have a negative effect on investment horizons in EM equities, short-termism affects EMs more severely than developed markets. For example, the moves by the US Federal Reserve to pull back from quantitative easing towards the end of 2013, coupled with political uncertainty in countries such as Turkey and Thailand, prompted investors to withdraw money from emerging markets. MSCI Emerging Markets index fell 6.6% in January, following a 5% fall in 2013 while the US S&P 500 index went up 29% in 2013.

Subject to relatively less investor pressure, many emerging market companies are also in deficit of stakeholder pressure that exists in developed economies from governments and consumers to improve their sustainability performance. This deficit mandates the stock exchanges to play a key role. A number of exchanges have embraced this role. According to a World Federation of Exchanges survey in 2009, the sustainable investment strategies endorsed by stock exchanges fall into three categories: (1) promoting awareness around materiality of ESG risks and standards through IPO or on-going listing requirements; (2) providing informational products and services in the form of sustainability indices; and (3) creating markets for specialized, theme based products such as carbon trading and environmental indices.

Sustainability indices in EMs based on publicly available information serve multiple purposes to this end. First of all, they raise the disclosure standards without the costly mandatory regulations. Second, they provide a benchmark for assessing the sustainability performance of firms by investors and encourage longer investment horizons.

With the introduction of indices, reporting practices are improved and hence firms become increasingly aware of their risks associated with ESG issues. As more information becomes widely available, best practices are identified. As a result, regulatory frameworks and listing rules improve in support of better ESG performance. Furthermore, as investors become mature in their understanding of sustainability factors, they start conducting their own ESG research and assessments suited to their own needs.

SUSTAINABILITY ISSUES AND STOCK MARKETS IN EMERGING MARKETS

2.1 Key Sustainability Issues in Emerging Markets

While EMs offer exceptional investment opportunities due to economic growth expectations, they are also associated with higher levels of political and economic risks for investors (Harvey, 2004). Consequently, developed country firms with above average exposure to EM economies have lagged the broader S&P 500 index by 40% over the past three years (Economist, 2014).

More importantly, at a fundamental level, there is real tension between environmental, social and economic developmental priorities and population growth in EMs as they are being challenged by resource constraints, social unrest, global standards, and international demands for corporate sustainability. EM economies are also expected to hit hardest by climate change, due to factors such as disadvantageous geography, fragile infrastructure, and lack of resources devoted to disaster recovery or adaptation.

On the other hand, EM companies have the opportunity to develop innovative solutions to social and environmental problems of our time to ensure future sustainability, with their population growth and inexpensive labour and manufacturing costs.

Crosscutting sustainability risk areas in EMs include air pollution, water sanitation and scarcity, climate change adaption, corruption, labour rights, human rights, poverty, disclosure, and corporate ethics (IFC, 2011). While all EM countries share some risks and opportunities as outlined here, unique sustainability challenges exist and relative importance of issues differ based on political context, history, and availability of natural resources in every EM country. For example, while Brazil faces environmental challenges related to Amazon's deforestation and relations with indigenous people are of concern; South Africa is working to repair social inequalities and faces the challenge of depleting water resources. Conflicts between companies and indigenous peoples in India pose risks for companies in addition to depleting water resources, whereas in China environmental pollution, product quality, and labour issues are at the forefront. Complicated governance structures in Russia discourage influence from foreign investors (Sustainalytics, 2012; EIRIS, 2012).

The diversity with respect to sustainability challenges in EM countries makes it challenging to identify overarching key sustainability issues. A thorough understanding of each market with its unique challenges is required for a healthy assessment. That said, indicators drawn (Table 2.1) from globally recognized country surveys, academic research, and official statistics can

be helpful as a proxy for overall country performances and give a broad overview of corporate sector's ESG performance in selected emerging markets. While use of common metrics allows comparability, they do not provide much information about specific issues. We must also note that the quality of economic statistics is often dubious in less developed countries. Furthermore, rankings based on perceptions, such as Transparency Index, are especially problematic as these are context and culture-dependent. Combined indices can also be oversensitive to updates; marginal revisions can substantially change the rankings. Such rankings should therefore be used as broad guidelines and as sources of additional knowledge, rather than as absolute insight. The performance indicators presented in Table 2.1 are explained in the Appendix.

Table 2.1: ESG Performances of Selected Developing Countries

Category	Variable	Brazil	Russia	India	China	South Africa	South Korea	Mexico	Turkey
Environmental	Environmental Performance Index 2014 – Score out of 100 (Rank)	52.97 (77)	53.45 (73)	31.23 (155)	43.00 (118)	53.51 (72)	63.79 (43)	55.03 (65)	54.91 (66)
Social	The Global Competitiveness Index 2013-2014 – Score (Rank)	4.33 (56)	4.25 (64)	4.28 (60)	4.84 (29)	4.37 (53)	5.01 (25)	4.34 (55)	4.45 (44)
Social	Human Development Index 2012 – Score (Rank)	0.73 (85)	0.788 (55)	0.554 (136)	0.699 (101)	0.629 (121)	0.909 (12)	0.775 (61)	0.722 (90)
Governance	Ease of Doing Business Index 2013 – Rank	116	92	134	96	41	7	53	69
Governance	Corruption Perception Index 2013 – Score (Rank)	42 (72)	28 (127)	36 (94)	40 (80)	42 (72)	55 (46)	34 (106)	50 (53)

Comparisons of ratings used for sustainability across a range of criteria for emerging market companies and developed market peers are useful for understanding key ESG issues and progress. For instance, RobecoSAM's sustainability data for 2012 showed that differences between EM and developed market companies that are included in Dow Jones Sustainability Indices are remarkably narrow particularly along social dimensions (e.g. stakeholder management, labour practice). The gap is larger for environmental criteria, corporate citizenship and philanthropy. Furthermore, the number of emerging market companies listed in the index has grown from five in 1999 to over 25 in 2012 (mostly coming from Brazil and South Africa) and their total sustainability scores have risen significantly. These trends demonstrate (Economist, 2014) improved sustainability practices in emerging markets (RobecoSam, 2013). A report by Sustainalytics states that the comparison of ESG scores of emerging and developed market companies shows that the disclosure of relevant policies is relatively poor, and most notable differences exist in the areas of corporate governance and ethics. The report suggests that the risks associated with the protection of minority shareholder rights is higher in EM companies due to the family or state-control at high levels of ownership concentration. The information gap due to poor disclosure regimes, resulting from less scrutiny from government, NGOs, and media, increases the risks associated with bribery and corruption in EMs (Sustainalytics, 2012).

2.2 Information Intermediaries

Availability of third-party ESG research is an important condition for companies to be considered for inclusion in investment portfolios or products by international investors who are concerned about sustainability issues. The consolidation trend throughout the past decade in ESG research organisations placed data providers, such as MCSI, Thompson Reuters, and Bloomberg, in control of ESG research. Other ESG research houses include RobecoSAM, EIRIS, Sustainalytics, Inrate, Vigeo, and Goldman Sachs Sustain (SustainAbility, 2013).

Deficiencies in ESG research in EMs are a significant barrier for attracting long term investments. Research firms acknowledge the challenges in covering EMs. Most consider EMs as a specialization. Lack of data, reliability of data, and the differences in pressing sustainability issues invalidate the business models that work for research on developed markets and firms. Controlled firms, which are a part of financial conglomerates with opaque ownership structures, pose extra challenges as they can rarely be assessed as stand-alone entities.

Therefore, coverage by international ESG research houses of EMs is generally limited. These houses generally conduct ESG research for companies that are included in global index series such as FTSE All World, MSCI All Country World Index, and S&P Global Broad Market Index. As a result, generally, only the largest companies in each market are covered leaving out smaller firms and smaller EMs. Against this market failure, sustainability indices launched by stock exchanges are instrumental in expanding the research universe covered by ESG research providers. For instance, EIRIS have been expanding its EM research coverage through collaborations with a number of stock exchanges around the world, including the Borsa Istanbul in Turkey, the Johannesburg Stock Exchange in South Africa and the Bolsa Mexicana de Valores in Mexico.

Most ESG research providers currently base their evaluations on publicly available information and/or solicit companies to disclose information that is not available in the public domain. This is particularly problematic for EMs where publicly available information is far less than developed markets. Eurosif predicts that in the future, ESG providers will be increasingly expected to anticipate future risks more actively, incorporating information that may be outside the public domain and employing more advanced means to complement their current processes (Eurosif, 2010).

For improving data availability and reliability in EMs, GRI, CDP, IIRC, SASB, Investor Network on Climate Change Risk of CERES and other institutions are making important efforts for provision of guidance that facilitates largely consistent disclosure, yet allows for contextual flexibility. Contextual flexibility is important, as what risks may be material will depend on the context (SSE, 2012). The Emerging Markets Disclosure Project (2008-2012), an initiative of the US SIF Foundation, have also carried out engagements with companies in selected EMs (Brazil, Indonesia, South Africa and South Korea) with the goal of advancing sustainability reporting in the emerging markets.

Furthermore, some EM countries issued legislations around mandatory disclosure of certain social and environmental information. These global and local efforts together with stock exchange indices and ESG enhanced listing requirement help improve data availability in emerging markets and reduce the costs associated with gathering ESG related data, which will in turn eventually increase availability of third-party ESG research on companies in smaller EMs.

International players in ESG research have established research methodologies that are constantly reviewed and improved. Coverage of EM companies by these organisations therefore offers a consistent and comparable assessment of sustainability performances. However, their research methodologies that were primarily tailored for developed countries does not always fit local conditions in emerging markets. Some organisations tailor their methodologies and performance criteria to fit local conditions and investor interest. For example, EIRIS research methodology was adjusted for JSE's Socially Responsible Investment Index to account better for local conditions and priorities. Another approach is to develop unique standards for developing indices by local research houses. For example, research methodology for the BM&FBOVESPA Corporate Sustainability Index was designed by the Sustainability Research Center (GVCes) at Fundação Getulio Vargas's Business School (FGV-EAESP). However, utilising tailored methodologies introduces barriers for investors that want to use them for constructing regional or global portfolios.

2.3 Sustainability Indices

Sustainability indices identify a set of companies from an underlying universe of companies based on an assessment of their sustainability performance and disclosure. Index providers select companies based on sustainability criteria, which generally include environmental, social, and governance measures or a subset of these issues (IFC, 2011).

Dow Jones Sustainability Index (DJSI) series were launched in 1999 as the first global sustainability benchmark. This was followed by the launch of the FTSE4Good Index in 2001. A number of sustainability indices were introduced in developed markets since early 2000s for different universes of companies with varying focus areas (e.g. environmental indices, controversial weapons indices, clean technology indices, social indices). The selection universe for these indices sometimes covers emerging markets, most notably the constituencies of MSCI and S&P/IFCI.

So far, emerging market sustainability indices have been launched primarily by stock exchanges (e.g. JSE, BM&FBovespa, Borsa Istanbul) and only recently by private companies (e.g. S&P, Dow Jones, ECPI). While private companies mostly aim to develop investment products to attract investors, stock exchanges have been using indices to improve reporting quality and reputation. Emerging markets indices can also be classified as global (e.g. ECPI Ethical Emerging Markets Tradable Equity Index, S&P/IFCI Carbon Efficient Index, Dow Jones Sustainability Emerging Markets Index), regional (e.g. CEE Responsible Investment Universe Index, S&P/Hawkamah ESG Pan-Arab Index), or

country specific (e.g. JSE Socially Responsible Investment Index, Borsa Istanbul Sustainability Index, BM&FBOvespa Corporate Sustainability Index, BMV Sustainability Index). Most notable examples of sustainability indices developed for emerging markets are summarized in Table 2.2 (IFC, 2011).

Table 2.2: Summary of Sustainability Indices in Emerging Markets

Index Name	Launch Date	Country/Region	Owner	ESG Data Provider
Exchanges				
Johannesburg Stock Exchange Socially Responsible Investment Index	2004	South Africa	JSE	EIRIS & University of Stellenbosch Business School's Unit for Corporate Governance in Africa
BM&FBOVESPA Corporate Sustainability Index (ISE)	2005	Brazil	BM&FBOVESPA	Center for Sustainability Studies at Fundação Getulio Vargas (University of Sao Paulo)
CEE Responsible Investment Universe Index	2009	Eastern Europe	Wiener Bourse	Mag. Friesenbichler Unternehmensberatung
Korea Stock Exchange SRI Index	2009	South Korea	Korea Stock Exchange	Korea Corporate Governance Service /Eco-Frontier
Shanghai Stock Exchange (SSE) Social Responsibility Index	2009	China	Shanghai Stock Exchange	China Securities Index Co.
(Siddy, 2009) Brazil Carbon Efficient index	2010	Brazil	BM&FBOVESPA	Trucost/BM&FBOVESPA
CSI ECPI ESG China 40 Index	2010	China	China Securities Index Co.	ECPI
Bolsa Mexicana de Valores (BMV) Sustainability Index	2011	Mexico	BMV	EIRIS
Bursa Malaysia ESG Index	2012	Malaysia	Bursa Malaysia	
Borsa Istanbul Sustainability Index	2014	Turkey	Borsa Istanbul	EIRIS/Sabancı University Corporate Governance Forum
Companies				
ECPI Ethical Emerging Markets Tradable Equity Index	2006	Emerging Markets (Global)	ECPI	ECPI
OWW Responsibility SRI Index Series	2006	Malaysia	OWW Consulting	OWW Consulting
S&P ESG India Index	2008	India	S&P	S&P
Dow Jones Sustainability Korea Index	2009	South Korea	DJSI	SAM
S&P/IFCI Carbon Efficient Index	2009	Emerging Markets (Global)	S&P	Trucost
SRI-KEHATI Index	2009	Indonesia	KEHATI/OWW Consulting	OWW Consulting
Hang Seng Corporate Sustainability Indexes	2010	China	Hang Seng Indexes Co.	RepuTex
S&P/EGX ESG Index	2010	Egypt	S&P	Egypt Institute of Directors
S&P/Hawkamah ESG Pan-Arab Index	2011	Middle East and North Africa	S&P	Hawkamah
Dow Jones Sustainability Emerging Markets Index	2013	Emerging Markets (Global)	Mar-DJSI	SAM

Source: IFC, 2011; DJSI; own research

The views about the usefulness of local sustainability indices developed by stock exchanges vary. International research firms find them useful, as they tend to improve the availability of ESG data, which can also be used by international research firms. Asset managers that prefer active investment strategies consider indices as competition but appreciate their information value in constructing their own portfolios. Some of the industry professionals argue that the local indices help raise the prestige of stock exchanges but do not function as commercial instruments; they have not been instrumental in the development of investment products by institutional investors and attract investors. Furthermore, exchanges point out that sustainability initiatives and products do not contribute significantly to their revenue and that the immediate business case was in enhancing issuer credibility. Emerging market exchanges were more likely to view ESG credentials as a competitive differentiator and reputation-enhancing factor. Some developed market exchanges also view them as a helpful reputational tool (SSE, 2012).

Challenges for Sustainable Investing in Emerging Markets

Although investor surveys conclude that “the biggest challenge to investing in emerging markets is a lack of ESG disclosure” (EIRIS, 2009) (EIRIS, 2012), it is unlikely that ESG disclosure would be sufficient to stimulate SI in a single country. Large institutional investors cannot reduce their investment universe (that is, decrease the potential for diversification), even in largest emerging markets such as India and China without a corresponding increase in portfolio risk.

On the other hand, the perception of EMs as fragile and exposed to high political and macroeconomic risks effectively marginalizes ESG risks and liquidity becomes the most important criterion for investing in EM firms. Satellite markets such as Turkey offer a limited number of investable stocks that meet liquidity criteria, resulting in an overweighting of high liquidity firms that meet market cap requirements in country allocations. Additional criteria reduce these numbers further at the expense of diversification. Most mainstream institutional investors with long-term investment horizons, therefore, focus primarily on active ownership strategies and monitoring in EMs.

The second challenge facing the SI industry in our view is the limited availability of comparable, context-specific ESG information about EM firms with a sufficiently large coverage of countries to help diversification of macro risks. Language can be a considerable barrier (Sustainalytics, 2012). Existing index universes generally cover companies in a single country, while investors are usually interested in having a multi-country or regional exposure and therefore find country indices less useful (IFC, 2011). While the concept of global or regional EM indices incorporating ESG risks appeals to institutional investors, ESG research in EMs has challenges as explained earlier in section 2.2. The trade-off between comparability and relevance is difficult to get right and requires an in-depth understanding of emerging markets. This makes ESG assessment a costlier exercise in EMs, and research firms have difficulty achieving economies of scale.

IFC's report from 2011, *Assessing and Unlocking the Value of Emerging Market Sustainability Indices*, notes that the lack of transparency of the index construction and methodological inconsistencies of strategies across different markets make it difficult to incorporate indices into portfolio construction. Data providers have been trying to overcome cost issues through industry consolidation, but it is not yet known whether the consolidation process will lead to product innovation and address the issues around the informative value of ESG risk assessments in EMs.

Furthermore, metrics being used by indices to assess company sustainability performance are still evolving, and most fail to adequately link sustainability performance to financial returns. Indices can be instrumental in collecting consistent data on ESG related issues, which can then help support academic research potentially showing the channels through which sustainability relates to financial performance (IFC, 2011).

3.1 Turkey's Economy

Turkey is a small emerging market, frequently referred to as a “satellite” market, compared to the economies of Brazil, Russia, India, and China (BRIC). Even though Turkey is not among larger emerging markets, it draws attention from the global investment community for two reasons: First, it has demonstrated steady growth over the past decade. The real GDP per capita in US\$ at constant prices since 2000, reached 8,492 in 2012 from 6,119 in 2000. Second, Turkey is the largest EM to join the European Union (EU). Turkey is also an accidental member of OECD like Mexico, and a member of G20.

Turkey has a functioning market economy. Based on IMF estimates of worldwide GDP in 2013, Turkey is the world's 18th largest economy with US\$ 786 billion. The size of the population is close to 76 million, and it is projected to reach 84 million in 2025. Unlike other countries in the Central and Eastern Europe region, Turkey has a young population; the proportion of the population under the age of 24 is 44%. This represents a demographic potential that can contribute to economic growth.

Despite the turbulence and consequent slowdown in economic activity, Turkey is expected to grow close to 4% in between 2013 and 2015. This performance is among the best compared with peer countries, although it comes with a deteriorating deficit and higher-than-desirable inflation. In 2023, Turkey posted a larger than expected current account deficit of US\$65 billion. This figure corresponds to almost 8% of the GDP compared to 2.27% in 2009. Financing of the deficit largely depends on short-term inflows with the share of FDI and other long-term inflows accounting for 50% of total deficit financing.

The underlying structural issue is the savings rate. Figure 3.1 below provides a comparative picture of Turkey's domestic saving performance. The savings rate in Turkey is, by international comparison, low and has kept declining from an average of 23.5% of GDP in 1990s to 13.7% in 2009, considerably lower than the domestic savings rate in e.g. China (54.17%), India (29.84%) in the same year. According to IMF analysis, the level of growth consistent with a stable current account is in the 2.7 to 3.5% range. In other words, growth above this speed limit would lead to a wider current account deficit. In order for Turkey to sustain its growth at around 4%, it needs to raise its domestic savings to about 18% while reducing its dependence on volatile external financing¹.

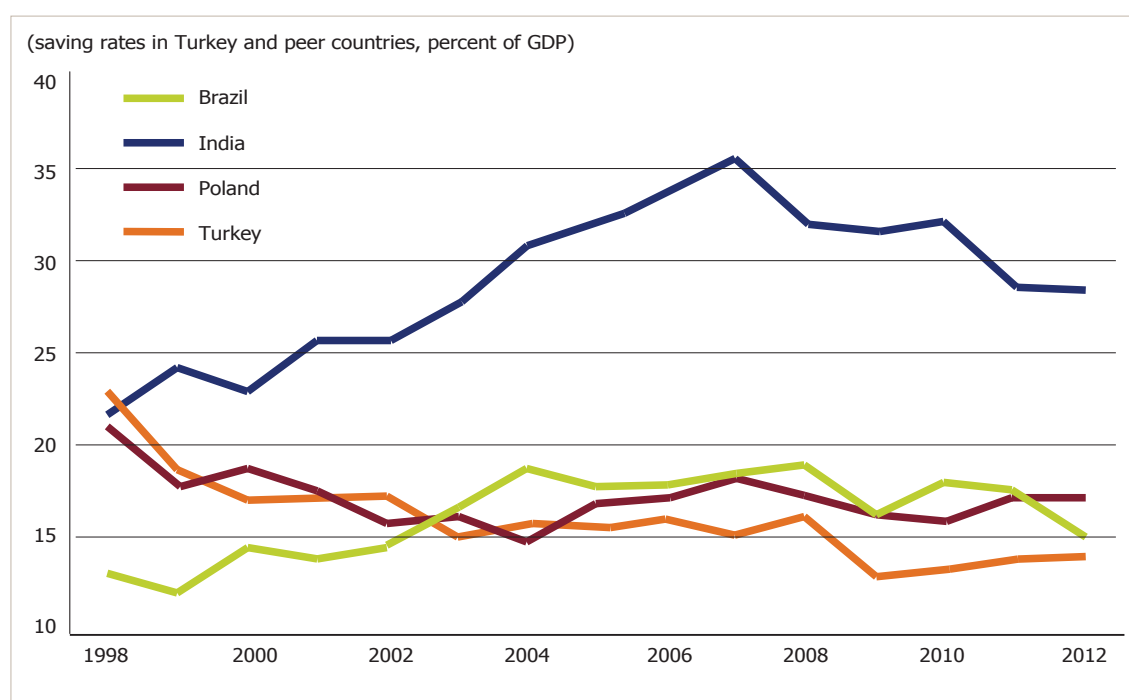
As of end September 2013, total savings in Turkey was US\$674 billion; out of which bank deposits is the major component with US\$423 billion. Domestic account holders hold 78% of the total savings.

In contrast to many EMs, Turkey is a net commodity importer. Approximately, US\$35 billion worth of oil and natural gas each year has to be imported, which corresponds to almost 5% of GDP. Turkey's imports are mainly commodities and intermediate goods, whereas 90% of total exports are industrial goods. Therefore, promoting Turkey's competitiveness in international markets is a key factor for sustainable growth.

An analysis of the capital and financial account of the balance of payments shows that, although FDI followed a downward trend throughout 2009 due to the global financial crisis, this remained the most stable financing item of the current account deficit. Capital flows in the form of portfolio investments, which turned outward in the second half of 2008 due to the global turmoil, turned inward again in 2009. Portfolio investments have generally followed an unstable trend since 2006.

¹ See <http://blog-imfdirect.imf.org/2014/01/13/turkey-how-to-boost-growth-without-increasing-imbalances/>

Figure 3.1: Turkey's domestic savings (Source: IMF)



“Turkey’s geographical location, young population, and vibrant private sector provide the necessary base for a promising outlook. In addition, the reforms of the last ten years, together with the strengthening of the macroeconomic policy framework during that period, create the necessary foundations for Turkey to reach its goal of becoming a high-income economy. However, Turkey will have to address expeditiously its competitiveness challenges and reduce its external deficit. These two aspects are intimately linked. Raising domestic savings, maintaining a strong nominal anchor through a normalized monetary framework, and ensuring that structural reforms result in attracting more foreign direct investment, are all the critical components that will assure Turkey’s place as one of the world’s most promising emerging economies.” December 20, 2013 Ernesto Ramirez Rigo (IMF)

A key sustainability issue in Turkey is small to medium size firms’ access to finance. Small and medium-size enterprises account for 76.7% of employment, almost 40% of investments, 26.5% of total value-added to the economy, and 25% of bank credit. Analysis of firm dynamics in Turkey however shows that SMEs are the slowest growing group in the economy. Moreover, SMEs are growing at a slower rate in Turkey than in several comparator countries in the Eastern Europe and Central Asia region. Turkish firms are more dependent on bank financing to fund their investments in fixed assets than are their peers in other countries. This is especially true for medium-size firms where bank financing accounts for 47% of total funding (Seker and Guilherme Correa, 2010).

3.2 Turkey’s Capital Markets and Investment Climate

While Turkey’s economic growth rate is higher than any other OECD country, capital markets are still underdeveloped. Turkey has a low savings rate and serious limitations on capital formation. Market capitalisation as a percentage of GDP is far below both the world average and OECD average². Istanbul currently ranks 47 among 83 global financial centers in the Global Financial Centers Index (GFCI). Shanghai and Shenzhen rank 20th and 18th respectively, Sao Paulo 38th, Mumbai 76th, and Johannesburg 50th in GFCI.

In our earlier report (IFC, 2013) we summarized Turkey’s capital markets as follows:

“Low domestic savings are largely directed toward short-term deposits and fixed-income instruments— predominantly government bonds. Equity investments represent a very small share of portfolio investments partly due to historically high interest rates. Private pension funds are growing fast, but they are still in their infancy. Although International portfolio investments have historically dominated equity investments in Turkey, their average holding period is less than a year. An estimated 30 to 50% of shares held by foreign investors are held by hedge funds. These figures

reflect international investors’ perceptions of Turkey’s risk profile.

Despite the shallowness of the stock market and low floatation rates, individual investors’ and hedge funds’ trading activities keep stock markets highly liquid, meeting the fundamental investment criteria for international portfolio investments and allowing Turkey to finance its current account deficit. Intensive trading activities gravitate around a small fraction of listed companies, however.” (IFC, 2011)

This picture has not changed since then. Turkey has a mid-sized equities market. In 2013, only 124 companies out of the 1000 largest firms (88 out of the top 500) were listed in stock exchanges. As of end-2013, market capitalization of BIST-All was at US\$235 billion (representing an annual decline of 23%) with 216 firms listed excluding investment funds and unit trusts. Average free float of the firms traded at the BIST-All is 29% indicating a shallow market. According to OECD (2013), at the end of 2012 only 16% of the firms had a free float ratio above 50%. Among the 20 largest companies in terms of market capitalisation none had a free float ratio above 50% and 5 had free float ratio below 5%.

Similar to other emerging markets, in 2013, BIST-100 Index went down by 7% in US\$ terms. While the index declined, the average daily trading volume increased by 24% during the same period in US\$ terms. Foreign institutional investors, which hold 36% of the free float, had only 4% share in total turnover. Domestic individuals – so called ‘day traders’, drive the market liquidity in Turkey with a 59% share while they hold around only one-fifth of the free float. The average holding period of foreign investors is 389 days, while domestic investors hold their shares for 46 days on average in 2012 (TUYID & MKK, 2013).

Banks are not only the much bigger financiers of businesses in Turkey than are capital markets, but they are also the largest users of capital markets. Further details on Turkey’s Capital Markets are presented in the Appendix B.

Domestic Institutional Investments

Institutional stock market investments in Turkey are channeled through pension funds, mutual funds, and investment funds. At the end of 2012, there were 35 asset management companies in operation in Turkey. 3% of the assets under management belong to individuals, 88% belong to institutional investors and 9% belong to corporations. Four portfolio management firms affiliated with four business groups – namely Is Asset Management, Ak Asset Management, Garanti Asset Management, and Yapı Kredi Asset Management affiliated with Is Bank Group, Sabancı Group, Dogus Group and Koc Group respectively – have a combined market share of 71%.

At the end of 2012, total portfolio of mutual funds was US\$ 16.7 billion³. Only 4.4% of total mutual funds are formed by equities. Two different types of mutual funds, Type A and Type B, exist in Turkish capital markets. Type A mutual funds are required to invest at least 25% of their assets in equities that are issued by

² According to the World Bank, in 2011, BIST market capitalization as a percentage of GDP was 26%, whereas the world average was 69% and OECD average was 75%.

³ State pensions are based on a pay-as-you-go system, and substantial losses generated by this system add to public sector deficits funded directly by the treasury.

Turkish companies. Type B mutual funds have no such obligation. There are 564 mutual funds in Turkey as of 2012-end, of which 455 were Type B. There were 41 foreign mutual funds whose total value of participation certificates in circulation in Turkey was as little as US\$ 30 million as of 2012 December-end.

Turkey has no experience in exchange-traded funds (ETFs). As of the end of 2012, 16 ETFs were sold to public and put into ISE Fund Market. The total value of these funds was a mere US\$ 208 million. Nine of them were based on various stock exchange indexes, four of them were based on gold and silver indexes and three of them were based on notes and bonds indexes. There is yet no sign of innovation in the ETF market.

The figures above demonstrate that the size of equity investments remain to be a major barrier for SI to take hold in Turkey, emphasizing the role of international institutional investors, albeit by definition less effective in monitoring; no change from 2010.

3.3 Legal Framework

The legal tradition in Turkey is characterised by civil law. The legal and regulatory framework was in continuous improvement until 2013, driven by EU accession process that started in October 2005. During this process, Turkey has made significant changes to its legal and regulatory framework and continues to do so.

One of the most fundamental developments since 2010 has been the enactment of the New Commercial Code (TCC) that governs the company law in Turkey. TCC set the foundations for the New Capital Markets Law (CML, 2012), which brought capital markets regulations into full compliance with EU directives. In drafting the TCC, the legislature has embraced an innovative and reformist approach, departing from conventional approaches and historical legacies that have been in force for more than 50 years. However, the final version of the law that became effective in July 2012, deviated from the original version substantially, an outcome of extensive lobbying of interest groups against some of the novel aspects of the Code.

TCC introduces a number of changes that are relevant from an investor's standpoint. Fiduciary duties are not fully covered by the law, and the board is there to serve the best interests of the firm and its shareholders in a contractual relationship. The key legal aspect of the TCC is the superiority of the company; directors owe their duty to the company not to the shareholders. They may be liable for their actions even when they simply implement the general assembly decisions if they harm the company.

In business practice however, the Turkish companies are organised around a profit seeking aim and value maximization. TCC removes the ultra-vires principle for companies. Accordingly, a limited liability company may be established for all economic areas of activity unless specifically prohibited by law. The directors and officers of a corporation may be liable for the environmental and social wrongdoing of the firm in case where negligence, fraudulent intent and diligence are proven under the Criminal Law (Eroglu, 2013). The civil liability for damages caused to third parties by a corporation lies on the corporation.

In Turkey, directors are not personally liable for the transactions and contracts concluded on behalf of the company. They are, however, jointly liable towards the company, individual shareholders and the creditors if the duties imposed on them by the law or the articles of association are not fulfilled intentionally or through neglect. Insider trading and market manipulation are criminalized.

In comparative examination, the TCC differs the most from other company laws in relation to its recognition of business groups. The TCC imposes some liabilities on the parent firm if it exercises its controls over the subsidiary unlawfully. TCC provides one of the most advanced liability regimes, at least on paper, for business groups (Eroglu, 2013). The success of these regulations remains to be seen since secondary regulations and court decisions will determine their effectiveness.

The rights of the stakeholders are not cited in the TCC or CML.

CMBT's Corporate Governance (CGG) Guidelines has a section on stakeholders, which calls the firms to disclose their policies, related to the treatment of the stakeholders on a "comply or explain basis".

Business interest heavily influences regulatory process in Turkey. For example between October 2011 and February 2012, CMBT issued a series of revisions to a communiqué, which required listed firms to comply with some of the provisions recommended by CMBT's CGG moving towards the direction of a mandatory approach. Anecdotal evidence suggests that the frequent revisions are attributable to the lobbying efforts of large firms (predominantly the banks). Similarly, a Law Decree was enacted in 2012 one day before the effective date of the TCC to narrow down the scope of compulsory independent audit requirements from all joint stock firms to roughly largest 1%.

3.4 Key Sustainability Challenges for Turkey

The Justice and Development Party's (Adalet ve Kalkınma Partisi – AKP) election victory in 2002 against a background of a series of economic crises was underpinned by an election manifesto that committed the party to extensive policy reforms. Since 2001, the Turkish economy has benefited from in-depth structural reforms in many key areas, including banking, privatization, education, and energy. In mid-2000s, Turkish economy was booming and the EU accession process remained an important anchor.

During the early years in power AKP also pushed through important democratic reforms. The second phase of AKP government after 2007, however, has been less impressive in terms of political stability, reform orientation, and economic performance. During this period, Turkey also suffered from the effects of the global financial crises, which exposed structural weaknesses, including dependence on external financial resources against weak domestic savings that had previously been disguised by the favourable global liquidity surplus.

Political stability achieved under AKP has been instrumental to

help Turkey achieve investment grade status. Fitch Ratings and Moody's Investors Service promoted Turkey to investment grade in 2012 and 2013 respectively. Yet, S&P kept Turkey's rating below investment grade (Bloomberg, 2014). The political unrest that started in mid 2013 triggered by a clash between government and environmental activists, followed by the allegations of grand scale corruptions involving members of the government and the prime minister heightened Turkey's external vulnerability. Turkish money was devalued beyond the levels that can be attributed to the global financial conditions and major rating institutions downgraded the outlook of Turkey's sovereign credit rating to negative since the end of 2013.

Acemoglu⁴ attributes this fluctuating performance to the fact that Turkish economic and political institutions are still far from being fully inclusive. He argues that even though economic opportunities have become more widely available to small and medium-sized businesses, businesses are still greatly beholden to the state; "the government or the state can still pick winners...". Indeed, the failure of various governments to formulate long-term economic policies in the past provided a fertile ground where symbiotic relations between the business and the state led to rent-seeking behaviour. The social norms built around this tradition have been deeply rooted in the political institutions and are difficult to change⁵.

Particularly worth noting is the polarization of media in the hands of conglomerates with a wide range of business interests. Less competition and business involvement also cause the reporting quality to degrade⁶.

4 See the blog on Why Nations Fail: <http://whynationsfail.com/blog/2013/2/27/the-political-economy-of-turkey.html>

5 This is not unique to Turkey. A key sustainability indicator for firms in developing countries is the extent to which their businesses depend on state. This indicator is a proxy of the level of exposure of the firm to political risks. This risk in fact is multiplied and dispersed to other sectors through business group structures.

6 See European Commission report on the topic: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+MOTION+B7-2014->

According to the World Bank Doing Business Report, of which one of us is a long-term contributor, Turkey still has a long way to go to be a good place to do business or to seek justice compared to its rivals despite the significant improvements of the past decade (WB, 2014). These macro level challenges to sustainable development are still waiting for reform and undercut Turkey's economic growth potential.

A New Force: Civil Society

In our earlier report (IFC, 2011), we analysed the civil society organizations in Turkey and noted that Turkey had long been deprived of strong civil society initiatives due to frequent disruptions of democracy by military interventions. We report two developments since then. On one hand the civil society has become a vibrant force through both formal structures and informal networks with active use of social media; on the other hand government's democratization efforts are stalled. Some has presented the developments as a sign of democratic maturity; "Large numbers of people pouring into the street in several Turkish cities, ... , may be Turkish democracy's coming-of-age moment."⁷

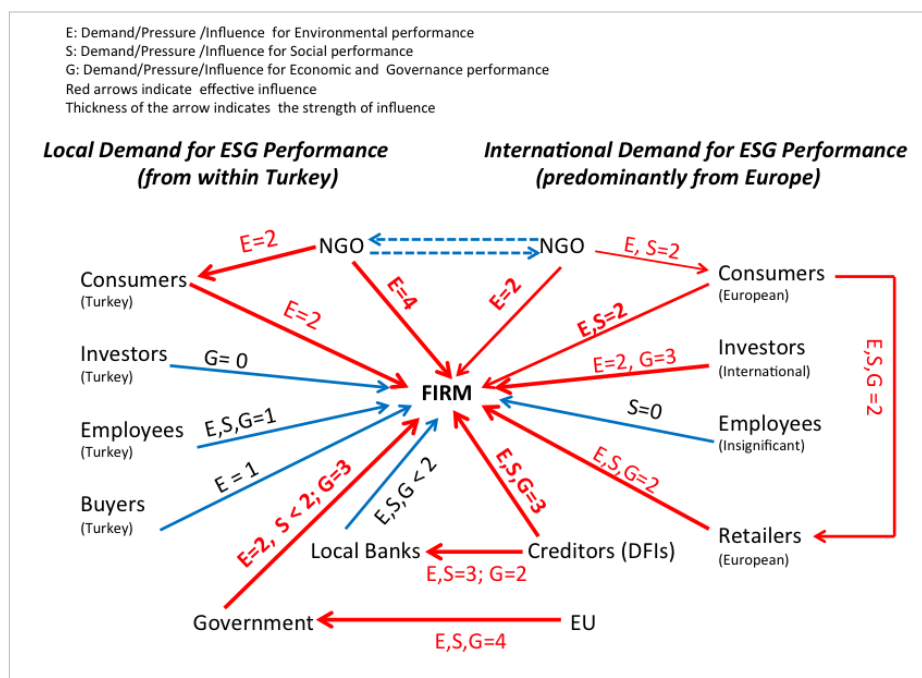
Turkish Companies and Conglomerates Under Spotlight

Over the past few decades, significant transformation has occurred in the nature of Turkey's economic system. Turkey has completed its integration with the global financial system - a process that also exposed Turkish corporations and society to external influences, predominantly from Europe. We present a revised version of the diagram that we used in the 2011 report to show the sources and strength of pressure for ESG performance on Turkish firms here in Figure 3.2. According to our own judgement, the revised picture reflects a stronger

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7 New York Times, 5 June 2013: http://www.nytimes.com/2013/06/06/opinion/development-wont-ensure-democracy-in-turkey.html?pagewanted=all&_r=1&

Figure 3.2: Demand for Sustainability, revised from (IFC, 2011)



demand from NGOs, formal or informal, and the consumers, and a stronger demand from the government and the regulators. The domestic landscape presented on the left side of Figure 3.2 shows that the growing pressure from the NGOs, the government and the regulators on the firms are still not resonated with domestic investors.

Disclosure

Turkey has taken considerable steps forward in improving the quality of disclosure since 2001, starting with improvements in banking regulation. The current legal and regulatory framework builds on initial reform components, including CGG issued in 2003 by the CMBT, directives related to audit and accounting standards and practices issued in and after 2003 by CMBT, the new banking law and directives issued by the Banking Regulatory and Supervisory Agency (BRSA), and adoption of International Financial Reporting Standards (IFRS) in 2005 for listed companies. Although compliance with the CGG is voluntary, reporting on compliance on a comply-or explain basis is mandatory. CGG covers a wide range of corporate practices in four categories: shareholder rights, financial disclosure, board composition and processes, and stakeholder relations. The last section includes recommendations with respect to companies' environmental and social policies.

Ararat and Balic (2008) suggest that Turkish firms respond to the mandatory disclosure regulations but do not address governance issues and environmental and social areas adequately where standards are not mandatory. An analysis of voluntary disclosure reveals irregularity in reporting, which suggests that ad hoc reporting may be related to particular external stimuli, for example, a loan agreement or need to appeal to a particular investor or buyer.

We however observe an improvement in the quality and upsurge of voluntary reporting after 2010. Due, in part, to the spill over effect of global initiatives, sustainability reporting has recently become more common. Some of the international standards/platforms of reporting and further analysis of Turkish disclosure are summarized below:

Carbon Disclosure Project (CDP) is an international initiative advocating that businesses disclose impacts on the environment and natural resources on behalf of institutional investors. In the first year of the project in Turkey, those companies included in the ISE-50 index (now BIST-50), representing 50 of the largest companies by market capitalization, were invited to respond to CDP's information request. Of the 50 companies contacted, 10 responded to the CDP questionnaire. The CDP-Turkey office notes that coverage has been expanded to ISE-100 in 2011, and 39 companies have disclosed through CDP in 2013⁸.

The Global Compact Turkey Network was officially launched in October 2001 and is currently one of the 10 largest networks in the world. According to the UN Global Compact web site⁹, there are 276 signatories, out of which 172 have become members in 2010 and after. About half of the signatories, 140

⁸ See CDP-Turkey Web-site

⁹ Access date: March 25, 2014

are businesses. Most of the business members are SMEs. 112 of those 140 business members are active, indicating a quantum leap in reporting from only 11 in 2009.

GRI has also been getting more popular in Turkey. The GRI G3 Reporting Guidelines and Template were translated to Turkish in 2008. GRI Indicator Protocols have also been available in Turkish since October 2009. That year nine firms issued a GRI based report. According to GRI Web site, the numbers have substantially increased since then to 29 in 2010, 22 in 2012 and 36 in 2013.

The Corporate Register is a reference point for CSR reports and resources worldwide, provided entirely online. This site contains more than 55,000 reports from nearly 11,000 companies around the world. There were nine reports registered in 2009 from Turkey, which overlaps with the GRI count in the same year. The number in 2013 reached 44, out of which 36 overlap with GRI reports.

The integration of ESG concerns into lending policies, together with the advisory functions of these organizations, is likely to be an effective instrument for enhancing economic development in Turkey.

Corporate Governance

Corporate governance is regarded as the most important pillar of sustainability by investors (EIRIS, 2009). Whether a firm manages its environmental and social risks is directly related to the quality of its governance. UN PRI's Clearinghouse, which facilitates investors' collaborative actions against malpractices of investee firms, is reported that the actions gravitate around corporate governance issues by 35%, followed by environmental issues by 26% and social issues by 17% (UNEP FI and UN Global Compact, 2010).

Corporate governance issues are contingent on ownership structures. Controlled firms have different governance issues than dispersedly owned firms (Bebchuk and Hamdani, 2009). Turkey is characterized by concentrated ownership in the form of family-controlled, diversified business groups. 13 holding companies and their eight affiliated banks account for an estimated 40% of the market capitalization of the BIST. 11 of these 13 holding companies are controlled by 11 leading families. The cross shareholdings between those firms affiliated with a business group and a full list of firms affiliated with that group or controlled by the same shareholder are not fully transparent.

The concentration of control raises concerns about insiders using intragroup transactions to exploit minority shareholders. As is common in many other EMs, such transactions can be used for asset stripping, transfer pricing, and other corporate governance abuses.

Ararat, Orbay and Yurtoglu (2010) report that holding companies held majority control of 54 of the 122 companies that constituted the ISE 100 in 2006 and 2008. The mean ownership was equal to 48.34% of the outstanding shares. Combining all ownership stakes under the control of the ultimate owner, the

true fraction of control rights of families is about 56% of the outstanding shares. The first three largest shareholders own together about 63% of the equity on average.

External mechanisms of corporate governance, such as the market for corporate control, do not function in Turkey due to highly concentrated ownership structures. Voluntary actions by individual companies therefore constitute an important mechanism to reduce the extent of agency problems. Since 2005, listed firms are obliged to issue a corporate governance compliance report, explaining their level of compliance with the CGG of the Capital Markets Board. Although the guidelines contain more than a 100 provisions, reports give little insight into the governance of firms since the regulator does not monitor them. The boards of banks are subject to separate legislation and stricter monitoring with respect to both the composition and the committee structure of their boards, as well as the qualifications of board members.

A survey conducted by Deloitte Turkey (2009) provides some insight into the role of the boards in Turkey. According to the survey, 30% to 40% of directors agreed that their boards had no role in CEO succession planning or in their CEO's performance evaluation, while more than 80% agreed that their board contributed to the CEO's performance by providing advice, evaluating financial performance, formulating long-term strategies, and identifying potential opportunities and risks. The results suggest that important decisions are made outside of the board by the controlling shareholders.

Yildirim-Oktem and Usdiken (2010) surveyed boards of 299 listed and unlisted firms affiliated with ten family-controlled business groups. They report that family members occupy roughly 20% of board positions, and an additional 47% of directors are salaried managers employed by the holding firm or in firms controlled by the same family. Outsiders occupy 33% of the remaining board positions. Only 10% of outsiders hold external management positions, and 40% do not have a full-time occupation. Perhaps related to these findings, Ararat, Orbay, and Yurtoglu (2010) report a negative relationship between independent board members and firm performance.

In 2012 CMBT issued a communiqué that introduced significant changes to the CGG. The changes that became effective immediately include a requirement of a minimum of 1/3 of the board consisting of independent members and a mandatory Corporate Governance Committee, which may assume the roles of nomination, and remuneration committees that are also required. The role and responsibilities of independent board members are defined more clearly and they included approval of related party transaction. The outcome of these changes has not yet been investigated.

Measured by existing standards of good corporate governance, it is fair to argue that Turkish companies are run in line with the interests of their insider/owners. Minority shareholders and stakeholders do not have much influence in the decision-making processes. This picture has the following implications for the sustainability of businesses and their attractiveness for SI:

- Interfamily conflicts frequently place businesses at risk by diverting management attention from business to family matters. These conflicts tend to become more frequent as firms become older, and control is gradually shared between successive generations. Succession issues disrupt businesses as they lead to a reallocation of control within the family.
- The overlap among owners, board members, and executive managers makes it difficult to separate the powers and accountability of management from those of the board and the controlling shareholders. This overlap creates challenges for the engagement activities of minority shareholders.
- Growth opportunities are not fully used if they require external finance because families are reluctant to dilute their shares and forego their private benefits.
- The controlling shareholders' desires to maximize profits for the whole business group sometimes conflict with the objective of maximizing the profitability of individual companies. Although these issues apply to all EMs where family ownership and business group structures are common, these structures are more persistent in Turkey because business groups also include major banks.

"Doing Business" report series by World Bank measures 3 dimensions of investor protection; (i) Disclosure Index – measures approval and transparency of related-party transactions, (ii) Director Liability Index – measures the liability of directors for self-dealing, and (iii) Ease of Shareholders Suits Index – measures shareholder's ability to obtain corporate documents before and during litigation. Turkey's score in 2013 for Protection of Shareholders Rights as an average of these three indices puts Turkey 70th among 185 countries.¹⁰ Turkey performs well in Disclosure with a score of 9 out of 10, but is not a top performer among emerging markets. Turkey scores badly in Director Liability and Ease of Shareholder Suits Indexes as seen from Table 4 below. Turkey's overall score is 5.7 whereas some competing markets score higher. For example South Africa scores 8, Malaysia 8.7, India and Indonesia 6.

Families as owners of diversified conglomerates can play an important role in the development of sustainable firms due to their long-term perspectives. They have the potential to play a leadership role in promoting the sustainability agenda as "National Owners" with investments in diverse industries, in a way similar to Universal Owners. The upsurge in embracing "sustainability" by family controlled conglomerates in Turkey, at least at discourse level, maybe a demonstration of such awareness.

Environmental Issues

Turkey faces significant environmental challenges from conservation of ecological quality to averting climate change, with its rapid economic development and population growth. Residents of Turkey display high concerns about environmental threats (Rydzewski, 2013). Engagements with the EU have been

¹⁰ See Doing Business 2013, World Bank. Available at <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf>

instrumental in development of environmental policies, however significant environmental problems remain. Most pressing environmental issues in Turkey include increasing emissions and high-energy demand, land and forest degradation, loss of biodiversity, air pollution, water scarcity and quality.

Turkish Statistical Institute's Greenhouse Gas Emissions Inventory shows 124% increase in CO₂e emissions between 1990 and 2011. Energy sector is responsible from emitting 86% of total emissions in Turkey. In response to increasing emissions, Turkey adopted the National Climate Change Action Plan (NCCAP) in 2010, which sets out mitigation and adaptation objectives and strategies until 2020. NCCAP was supported by new regulations regarding monitoring greenhouse gas emissions in 2012, which will come into effect by 2016. Operators subject to the new regulations, which will capture 50% of national GHG emissions, will be required to monitor GHG emissions arising from their operations and submit verified monitoring plans to the ministry (CDP Turkey, 2013). Currently, Turkey participates in voluntary carbon markets and aims to establish a mandatory carbon market by 2015 (MoEU, 2011).

Despite such positive developments, Turkey did not report any reduction targets in the second commitment period under the Kyoto Protocol. NCCAP lacks an overall GHG emissions reduction target. Such lack of commitment poses challenges for the private sector companies to develop strategies and set targets to minimize their emissions. Furthermore, without binding targets, the emissions in Turkey are likely to increase given economic development targets, population growth, and high-energy demand. 49 new coal plants are proposed in Turkey to meet the energy demand, which places the country among the top four countries (following China, India, and Russia) with coal plants. Plans for nuclear power plants in the Black Sea and the Mediterranean regions and numerous hydropower plants create significant causes of concern for the environment as well. Further efforts to utilize Turkey's renewable energy potential and improve energy efficiency strategies are required to limit the increase in emissions from the energy sector (EC, 2013).

Rapid loss of natural habitat in Turkey calls for urgent solutions. Yet, Turkey amended its regulations on the environment and introduced additional exemptions to the environmental impact assessment (EIA) requirements. Several large infrastructure projects including nuclear power plants, hydropower plants, the third bridge and new airport projects in Istanbul are now excluded from EIA (EC, 2013).

Climate changes are already being seen in Turkey and are expected to intensify over coming decades including temperature increase, decrease in annual precipitation amounts, intense precipitation events, droughts and hot spells leading to water stress, and increased risk of flooding (IFC, 2013). A large part of Turkey is in danger of desertification due to erosion, diminishing flora, climate changes and improper use of water resources (IFC, 2011).

Turkey's administrative capacity for environmental issues has been weakened during the past few years as a result of reorganizations in the government regarding organization

structures of ministries including reorganization and staff changes in Ministry of Environment and Urbanization and Ministry of Environment and Forestry. Climate Change Department, which was established in 2010, was merged with Air Management Department in 2013 and the Climate Change Adaptation Program was closed during the merger. Such changes and lack of competence in specialized units and administrative capacity pose challenges for pursuing robust environmental policy in Turkey (SUCGFT, 2014).

Overall, companies in Turkey faces business risks resulting from physical changes in the environment and also from the uncertainty with regards to a strategic regulatory roadmap that guides policymaking.

Social Issues

Engagements with the EU have been an anchor and set the direction of change for social policies and the legal framework over the past decade.

Full protection of labour rights under the labour law in Turkey has not been achieved due to low enforcement and undeclared work despite efforts to harmonize the country's legal framework with EU member states. There are concerns regarding union membership rights and right to strike and lockouts. There are high thresholds for entering into collective bargaining imposing significant barriers for workers to engage in collective action. A series of events that started in 2012, which involved employees of an airline company being fired for participating in a strike followed by a law prohibiting strikes by aviation workers, were significant cause for concern regarding labour rights in Turkey. The law was withdrawn due to external and internal pressure against the ban.

75,000 occupational accidents were reported in official statistics in 2012, representing a 8% increase from 2011. These official statistics however do not cover the informal sector, which has less stringent health and safety measures. The new law on occupational health and safety, published in 2012, is expected to significantly improve standards in Turkey. Yet, enforcement levels will determine its success. In Turkey, 99% of labour force is employed by small and medium enterprises, therefore enforcement and inspection processes should account for the existing employment structure.

Unemployment is among the most pressing economic and social issues. The total employment rate of 45.4% is relatively low compared to international counterparts. In 2012, unemployment rate rose to 9.5%, while youth unemployment rate rose to 20.7% in January 2013. The participation of women in the labour market remains extremely low by international standards, 29.5% in 2012, and has decreased in comparison to the early 90s (around 35%). Turkey is advised to improve employment services for youth, improve women employment rates, and reduce informal employment (ILO, 2013).

4.1 Sustainable Investing in Turkey

Institutional investors in all markets drive sustainable investments. The level and quality of sustainable investments are directly related to the quality of the investment environment and the depth and breadth of the investment management industry. The SI industry based on explicit use of ESG criteria is yet to emerge in Turkey as local pension funds and insurance industries reach critical size and maturity. Currently foreign institutional investors are the main source of SI. Three local asset management companies, Ak Asset Management, Garanti Asset Management and Logos Asset Management are signatories to the UN PRI. Our original report, "Sustainable Investment in Turkey, 2010" estimated the portfolio investments that somehow takes ESG factors into consideration in 2010 at US\$ 1.4 billion as the sum of portfolio investments by local UN PRI signatories and 2% of foreign institutional investments (IFC, 2011). We estimate this figure to be around US\$ 3 billion in 2013 using the same approach and assuming that the investments that takes ESG factors into consideration in EM has doubled in 2013 compared to 2010 as in developed markets.

Table 4.1: Estimate of Sustainable Portfolio Investments in Turkey (December 2013)

Category	Investments in Equity (US\$ Billions)	Total SI (US\$ Billions)
Portfolio Investments of UN PRI Signatories in Turkey	0.82	0.82
Portfolio Investments of International Institutional Investors	84.6	2.20*
Total		3.02

(*) 4% of (Total Investments by Foreign International Investors - Holdings by Hedge Funds)
Source: Interviews with Fund Managers.

Private pension funds and insurance companies, which drive sustainable investment in other countries, have a minor role in promoting sustainable investments in Turkey. Pension funds market, which has been growing steadily since its inception in 2003¹ has the potential for driving the expansion of SI in Turkey in the long term. Yet, currently only 14% of the pension fund investments are in equities. Encouraging pension funds in investing in sustainable companies through BIST's SI could be instrumental in driving sustainable investments in Turkey. Ownership structures, however, poses challenges for pension funds to adopt SI strategies. The asset management firms affiliated with largest business groups manage the assets of the largest pension firms that are affiliated with the same business group on exclusive basis. The assets are largely invested in pension funds owned by the affiliated banks. As a result, pension firms have little influence on how their assets are being invested (IFC, 2011).

Significant regulatory and structural barriers prevent the local fund management industry from growing and playing a role in SI. Lack of independent fund management and the dominance

¹ At the end of June 2013, the number of pension fund investors increased by 19% to 3.7 million, while the asset size reached US\$11.9 billion by a 4% increase.

of banks are important barriers. Anecdotal evidences reveal that regulator's efforts to improve competitiveness in the fund management industry have been blocked by the lobbying efforts of incumbent banks.

Long-term investments by foreign institutional investors were expected to play an increasing role in SI when Turkey achieved investment grade status in 2011, but the withdrawal of investments from EMs at the global scale towards the end of 2013 also affected Turkey. At the time this report was written, analysts did not expect a downgrading in 1st quarter 2014, however the role international institutional investors will play in SI in Turkey will depend on the global financial conditions and the attractiveness of EMs.

4.2 Corporate Governance Compliance Disclosure and the CG Index

Corporate governance compliance reporting (CGCR) is mandatory in Turkey; however, the reporting standard issued by the CMBT is limited. Compliance reports issued by the listed firms remained short and uninformative during the initial years, but in 2009 they showed a drastic improvement in their coverage and content (on-going research by Ararat, Black, and Yurtoglu, 2013). In our view, current regulation, which can be improved based on the past experience, provides a solid institutional basis for disseminating ESG disclosure, but it has limitations. Below we provide summary background information on the CG Index.

After the launch of CGG, CMBT had considered four alternatives to promote improvements in the governance of listed companies; i) indexing based on rating by independent rating agencies, ii) separate market, iii) indexing based on rating by the CMBT itself, and iv) award systems.

A separate market would require a longer period of preparation whereas a benchmark index consisting of qualifying firms could be launched as soon as there would be sufficient number of qualifying companies. CMBT opted for an index based on qualification of companies by international rating agencies or their licensees. Nationally Recognized Statistical Rating Organizations (NRSRO) were expected to offer CG rating services in Turkey. That would mean that the US Securities and Exchange Commission (SEC) would monitor their activities. Furthermore, the qualified companies would appeal to US based institutional investors. CMBT also had the opinion that compliance with the Guidelines would be a proxy for compliance with internationally accepted standards.

Turkey has a unique category of CG rating firms. CG rating agencies licenced by CMBT and regulated based on a special directive, have the purpose of rating the compliance of Turkey's listed firms with CMBT's CGG. Rating firms are free to develop their own compliance rating methodology provided that they apply the CMBT defined weighing to four components of the Guidelines. Currently, Shareholders Rights and Disclosure and

Reporting components have 25% each, Stakeholders Relations has 15% and Board Structure and Processes has 35% weight in the final score.

The first two rating agencies licensed by CMBT were Core, a subsidiary of Fitch, and Deminor. At the time of certification, Fitch had sold Core to DNV, a Danish group of companies with competence in certification. Around the same time frame Deminor was sold to ISS, global market leader in proxy services. In parallel to these developments, the NRSROs unanimously decided to end offering CG rating services and incorporate CG assessments into credit rating. Anecdotal evidence suggests that NRSROs considered CG “rating” to be a high risks business exposing the agencies to significant reputational risks without an attractive return. CMBT responded to this situation by releasing the requirement of “international rating methodology” for CG rating. This has later led to the incorporation of local rating agencies. ISS, under Risk Metrics brand, is licenced to offer CG rating services, however their added value as an international agency is limited since this regulated rating is a measure of compliance with CMBT’s guidelines rather than a measure of CG quality.

Firms, listed or unlisted, can voluntarily decide to have their CG compliance rated by commissioning one of the rating firms licensed by CMBT. The firm pays for the rating. Unsolicited ratings or ratings by unlicensed firms are not permitted. The disclosure of the score and the assessment report is optional and within the authority of the rated firm. The market has no means of being informed about scores below the qualifying threshold.

During the first three years after the launch of CG index and the decree on CG ratings in 2005, three Turkish companies commissioned CG rating agencies. One of the leading banks commissioned Core in 2005, which later led to disqualification of Core by CMBT on the basis of malpractice since the score was considered to be unrealistically high.

Although globally recognized rating agencies are permitted to conduct CG ratings in Turkey, Risk Metrics is currently the only international rating firm that has applied for and granted a licence by CMBT. The local agencies tend to be fairly small; their main source of revenue is solicited CG ratings. The total market for CG rating business is estimated to be around US\$500K. Some of these firms also offer credit rating services, but there remain few projects as independent credit rating market is still in its infancy in Turkey.

The average CG rating of the companies in 2010 was 81.01 out of a maximum 100. The 2013 average score is 89.84 indicating considerable improvement in compliance with the CGG.² The differences between scores are minimal. Some companies with a reputation for good governance are not included in the index, as they have chosen not to be rated. The ratings are not truly comparable since rating methodologies developed by rating firms are different.

² These high scores do not reflect the average ranking of Turkish firms in international research. For example, GMI's average score of 17 Turkish companies is 3.62 out of 10 in 2010. This difference also shows the differences between locally set guidelines and international standards.

“Too often... controlling shareholders have the opportunity to engage in abusive behaviour, a circumstance that can be exacerbated in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse. For example, the case of Satyam Computer Services in India in 2009 demonstrates how a controlling owner can perpetrate fraud and serve the owner’s interests at the expense of minority shareholders. Similar examples exist in other markets. In 2008, Sibir Energy in Russia agreed to engage in property transactions to accommodate one of the company’s largest shareholders. In Gome Electrical Appliances in China, the company’s chairman and controlling shareholder was convicted in 2010 of manipulating the company’s stock—and has attempted to control the company from prison. Business group structures that bring together diversified businesses under the common control of a controlling shareholder add further complexity to concentrated ownership. In many countries, most firms are affiliated with a business group that is controlled by an owner through a complex web of ownership structures.”

Source: “Corporate Governance in Emerging Markets,” Harvard Law School Forum on Corporate Governance and Financial Regulation, George Dallas & Melsa Ararat, August 2011.

For companies included in BIST Corporate Governance Index, the annual listing/registration fee is discounted by 50% for the first two years, 25% for the following two years, and then 10% of the tariff. The BIST CG Index initially included only 6 firms; and currently (January 2014) includes 48 firms. The performance of the index is not significantly different than its peers (see Sengur, 2011).

The CG Index experience is a very valuable experience. We conducted structured interviews with 10 asset managers with the highest equity holdings in BIST in 2013 to understand whether CG Index was considered value relevant by them. Most of the 10 interviewees were not aware of the index. Those who were familiar with the CGG and the compliance reporting said they would look into the mandatory compliance reports, but the CG Index had little value to them. According to the interviews we conducted, the rating methodologies were not transparent, the evaluation reports were not easily accessible, and the index was biased towards those firms that opted for a CG rating.

Although CG Index had reputational benefits for companies, there is no evidence that suggests that it was used for investment purposes or that the firms included in the index had attracted more investors. On the other hand, the rating process has definitely contributed to the improvement in CG standards of rated firms as demonstrated by the increase in scores over the years³.

³ See TKYD Website.

How pension funds can help: the case of France

France's supplementary pension fund for public-sector employees, *Établissement de Retraite Additionnelle de la Fonction Publique (ERAFP)*, is a perfect example of how pension funds can support sustainable firms. Established in 2004, ERAFP receives annual net inflows of EUR 1.5 billion and is already worth EUR 14 billion. Its governance policy requires ERAFP to manage all assets in accordance with five socially responsible considerations:

1. Respect for human rights and the rule of law
2. Promotion of social progress
3. Promotion of democratic labour relations
4. Respect for the environment
5. The practice of good governance and transparency.

ERAFP's adoption of a responsible investment policy is founded on twin convictions:

- Investments made solely for maximum financial return ignore the social, economic and environmental consequences, and
- Responsible investment filters enable better evaluation of the medium- to long-term risks and identify businesses that will generate future growth.

Source: *Northern Trust, 2014*

Lack of transparency on the methodologies and reports, inaccessibility of comparable CG quality information for all investable companies, deficiencies in rating agencies' reputational risks, incomparable ratings, and conflict of interests associated with the commercial nature of the relationship between the rating agency and the firm are some of the shortcomings of the CG Index⁴.

More importantly, portfolio managers we interviewed noted that the compliance with CMBT Guidelines has little value to them since they cannot assess whether CGG are compatible with international standards, and whether compliance scores are driven by compliance with more or less important criteria. Only the 2003 version of CGG are available in English.

⁴ For a discussion on the CG rating by international agencies see Ararat and Yurtoglu (2007), *Different Approaches to Differentiating 'Better Governed' Companies Market Segmentation in BOVESPA and Rating Based Indexing in ISE, FOCUS 5, 57-77* available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=989806.

4.3 Borsa Istanbul Sustainability Index

BIST, after becoming one of the first five signatories to the UN SSE Initiative, launched the Sustainability Index Project in August 2010. Just before the launch of the Project, "Sustainable Investing in Turkey" study sponsored by International Finance Corporation (IFC, 2010) was published. Despite this early start, the project was stalled due to pending decisions and organizational changes that took place both in BIST and CMBT.

The Project was revived in 2013. A meeting that brought together the key stakeholders⁵ identified the outstanding issues that should be addressed in order to move forward with the Sustainability Index Project. At the time following major decisions were pending:

- Who should rate the companies (local or international rating agencies)?
- What should be the main construct of the rating methodology (international/comparable criteria or Turkey specific/customized criteria)?
- What should be the universe of firms to be included in the Index (BIST 30, BIST 50, BIST 100, or all listed companies)?
- What should be the basis for inclusion (voluntary or automatic)?
- Should assessments be based on publicly disclosed information or based on firms responses to a questionnaire?
- Who should pay for the rating (firms or BIST)?
- Index methodology (simple ranking, qualification over a threshold score, inclusion of top performers or tilting the reference index according to the sustainability scores).

BIST made the decisions to work with an internationally reputable agency with experience in emerging markets, deploy an international rating methodology based on internationally comparable criteria, include all the companies in the selected universe automatically in the rating, use public disclosure for assessments. BIST also decided to pay for the rating services. Ethical Investment Research Services Limited (EIRIS) is contracted as the research partner. Firms scored above a threshold value will be qualified for the Index.

The first round of assessments covered BIST-30 Index constituents only.

⁵ Sabanci University Corporate Governance Forum received funding from the British Embassy Prosperity Fund Programme in June 2013 to help revive the project and support the successful development and launch of the BIST Sustainability Index.

Reflecting on the experience of CG Index, BIST adopted a totally different approach to building the Sustainability Index. However, despite the upsurge in sustainability related disclosure and the willingness of companies to support the process, some firms opposed to automatic inclusion of all the firms in the selected universe, expressed a strong preference for optional ratings and/or requested more time to prepare. Some others were not happy with the use of public disclosure and expressed a preference for the survey approach. The firm representatives involved in the consultation process were mostly corporate communications experts or sustainability officers in staff roles with limited exposure to investor preferences. The lack of interest from Investor Relations officers in the consultation may be indicative of firms' perception of sustainability as a matter of public relations or social responsibility rather than a matter of financial performance.

In order to involve investment professionals, a workshop was organized after the first round of ratings to bring local and international asset managers, business associations, BIST and the firms together for the first time. The turn up of invitees from domestic asset management firms was at 100% making them the most interested stakeholders. The participants were positive about the prospects of the Index. Overall there was an agreement on the potential benefits of Sustainability Index for companies, investors, the exchange, and the society, and also on the key obstacles and enablers for a successful implementation⁶.

While CG Index was mainly a regulatory undertaking by the CMBT with little stakeholder involvement, SI Index project was relatively more transparent. However, while the business associations and listed firms were engaged from the very beginning, institutional investors were involved in the project at a much later stage⁷.

⁶ See the Sabanci University Corporate Governance Forum's workshop report: Promoting Sustainable Development, The Way Forward for a Sustainability Index in Turkey: <http://cgft.sabanciuniv.edu/sites/cgft.sabanciuniv.edu/files/SU%20CGFT%20Sustainability%20Index%202014%20-%20Promoting%20Sustainable%20Development%20Report.pdf>

⁷ In our assessment of the relative underperformance of CG Index compared to more successful examples (Ararat, Yurtoglu, 2007), we noted the involvement of institutional investors as the key determinant of success.

Based on the analysis of SI challenges and prospects in EMs and Turkey specifically, our conclusions about how SI can be promoted with the help of enhanced ESG disclosure and indices through stock markets are as follows:

(1) There are certain prerequisites for SI through stock markets to take root in an emerging economy.

- The size and depth of stock markets: At the macro level, country's credit rating and saving rates are significant determinants of the size of equity investments. The number of investable stocks must be high enough to allow non-financial criteria to be considered in stock selection without sacrificing diversity benefits and floatation rates should be sufficiently high to increase sensitivity of the firms to investor preferences.
- The size and competitiveness of the local investment industry: Foreign institutional investors have limited role in monitoring EM firms, as their investment in an individual firm is a tiny fraction of their total investments. Furthermore their monitoring costs are higher than local investors that have a better understanding of the local context. In countries where there is sufficient level of financial assets accumulated in pension funds, beneficiaries have incentives and power to put pressure on asset managers to direct their savings into sustainable firms. In other countries like Turkey, where fund industry is not mature and independent enough, the governments must create those incentives.

(2) In the absence of global standards for sustainability rating and accounting, information intermediaries such as rating agencies play an important role in assessing and disclosing firms' sustainability performance. However, business models used by those firms in developed markets are not suitable for EMs. First of all, the EMs are less efficient in pricing sustainability and sustainability information. Second, the demand for sustainability information is lower, but the cost of assessment is higher due to lower disclosure standards.

There is a need for innovation. Governments and stock exchanges can intervene, and create incentives in the initial stages to promote SI. The trend to transform stock exchanges to for-profit listed firms makes it harder for exchanges to play that role by having stricter listing rules, funding research or creating incentives that would not pay back in the short term. These limitations indicate the need for innovation even further.

(3) It has become evident that investors are the group that will determine the uptake of sustainability indices and sustainability disclosure for SI in all markets. Product development for SI through stock exchanges however is still in infancy especially in EMs. The efforts of regulators and exchanges to create the supply of sustainability information should be coupled with complementary initiatives and instruments to channel the demand from investors' side. In some countries, pension funds have an obligation to consider the sustainability of the investee firms when making investment decisions. Disclosure requirements for pension funds could be enhanced to promote sustainable investing.

(4) Sustainability disclosure encouraged by indices must be further supported by enhancements to regulatory framework. Regulators can identify overlapping themes in different regulations to manage sustainability issues better and to make sure that improved standards do not create unacceptable cost disadvantages to firms.

(5) Given the availability of sustainability disclosure and development of similar indices in other emerging economies, ESG data will be increasingly available for EMs. Increased availability of ESG data together with standardization of ESG ratings will enable international index builders (e.g. MSCI, S&P, etc.) to develop regional and/or EM-focused sustainability indices. Companies included in such indices will therefore attract SI. S&P's Emerging Markets Sustainability Index is an indication that this is starting to happen. Global indices however cover the largest firms in EMs. For smaller firms, local initiatives matter more.

(6) Specifically for Turkey, domestic investors are potentially the most important players in promoting SI. Potential domestic investors that might use SI products include beneficiaries of pension funds and insurance firms. While individual investors hold majority of domestic investors' share in equity, anecdotal evidence suggests that high wealth individuals in Turkey have largely stayed away from capital markets. These potential investors might be encouraged to invest in products developed based on the upcoming Sustainability Index or products that use the underlying data if right products are developed and marketed.

- However, the size of the market requires a collective approach to product development and marketing. Leading asset management firms can collaboratively develop SI products (e.g. mutual funds, ETFs, fixed income instruments using sustainability information). Given potentially low initial demand in SI products, such collaborative development and marketing may better justify the costs associated with SI product development.

- Differentiation of sustainable small and medium size enterprises (SME) is key to provide incentives for innovation and improved access to long-term finance by these firms. Customized ESG criteria for SMEs in Turkey can be used for differentiation. Criteria can involve community impact considering that most of these firms are in smaller cities. Simpler rating or reporting systems may help sustainable SME to stand out and attract external capital. Tax-exempt status can make SME investment more attractive for institutional investors and individual investors from the local community. An investment protection fund or an insurance scheme guaranteeing initial investment protection can also be helpful.

SI will not take root in a market unless there are incentives for long term investing tailored to unique needs of each market. Market based solutions such as indices and voluntary disclosure initiatives must be complemented with regulations and structural improvements to create a competitive asset management industry, competitive markets and informed citizens who would invest their savings into stock markets. EM stock exchanges can and are playing an important role to facilitate a coordinated effort to make this happen.

On the other hand, investors have the opportunity not only to improve their financial returns, but also contribute to the health of the national economy by investing in firms with sustainable business models, and offering products and services, which can enable a sustainable and inclusive economic development.

APPENDIX A: SUSTAINABILITY INDICATORS

Environmental Performance Index (EPI)

The EPI is developed by Yale University (Yale Center for Environmental Law and Policy) and Columbia University (Center for International Earth Science Information Network) in collaboration with the World Economic Forum and the Joint Research Centre of the European Commission. The 2014 EPI ranks 178 countries on 20 performance indicators tracked across 9 issue categories covering both environmental public health and ecosystem vitality. These indicators provide a gauge at a national government scale of how close countries are to established environmental policy goals. The EPI's methodology facilitates cross-country comparisons as well as analysis of how the global community is doing collectively on each particular policy issue. Sub-categories of the index are valuable in pointing out the key environmental issues unique to each country. For instance, Turkey scores badly on fisheries, biodiversity and habitat, and climate and energy. Most pressing environmental issues are forests and water resources in Brazil, air quality and water resources in China and India, fisheries and agriculture in Russia, fisheries and forests in Mexico and South Korea, and fisheries and water resources in South Africa. Further details of the index and country performances for different policies issues can be found from the EPI website: <http://epi.yale.edu/epi>.

The Global Competitiveness Index

The World Economic Forum (WEF) defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. In other words, more competitive economies tend to be able to produce higher levels of income for their citizens on a sustainable basis. The productivity level also determines the rates of return obtained by investments (physical, human, and technological) in an economy. Because the rates of return are the fundamental drivers of the economy's growth rates, a more competitive economy is one that is likely to sustain its growth in the medium to long run.

Most pressing issues for each country differ based on the local context. For instance, Turkey should focus on building up human resources through better primary education and healthcare, higher education and training, increasing the efficiency of its labour market, and reinforcing the efficiency and transparency of its public institutions. Brazil's most pressing challenges include increasing concerns about government efficiency, corruption, and low trust in politicians, quality of overall infrastructure and education, and its fairly closed economy to foreign competition. India's challenges include insufficient infrastructure (transport, ICT, and energy), poor public health and education levels, and low public trust in politicians. Russia has poor assessment of public institutions, shows a lack of innovation capacity, has significant inefficiencies in the goods, labour, and financial markets, in addition to lack of business sophistication low rates of technological adoption. China's pressing weaknesses include corruption, security issues, and low levels of accountability and ethical standards among businesses. Mexico's most pressing challenges are lack of domestic competition, a skills gap due to a poor-quality educational system and labour market rigidities. South Africa scores low on the diversion of public funds, the perceived wastefulness of government spending, and public trust in politicians, and security issues. Korea's assessment is weakened by the quality of its public and private institutions, the rigidity and the inefficiencies of its labor market, and its poorly functioning financial market. Further details on company assessments and rankings can be found from the index website: <http://www.weforum.org/issues/global-competitiveness>

Human Development Index (HDI)

Published by the Human Development Report, HDI is a composite index measuring average achievement in three basic dimensions of human development— a long and healthy life, knowledge, and a decent standard of living. The Human Development Report is an independent publication commissioned by the United Nations Development Programme (UNDP). Contributors to the report include leading development scholars and practitioners, working under the coordination of UNDP's Human Development Office. The HDI represents a push for a broader definition of well-being and provides a composite measure of three basic dimensions of human development: health, education, and income. Further details are available from: <http://hdr.undp.org/en/statistics/hdi>

Ease of Doing Business (Rank)

Economies are ranked on their ease of doing business, from 1 to 189 by the World Bank Group. A high ranking on the ease of doing business index means the regulatory environment is more conducive to starting and operating a local firm. This index averages the country's %ile rankings on nine topics, made up of a variety of indicators, giving equal weight to each topic. The rankings are from the Doing Business 2013 report, where all rankings are benchmarked to June 2013. Turkey ranks the 69th, and, as such, it is significantly easier to do business in Turkey than in Brazil (116), India (134), and Russia (92) and somewhat easier than in China (96). Further rankings and details are available from: <http://www.doingbusiness.org/rankings>

Corruption Perceptions Index

The annual Corruption Perceptions Index (CPI), first released in 1995 by Transparency International (TI), has been widely credited with putting the issue of corruption on the international policy agenda. The CPI ranks more than 170 countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys. TI is a global civil society organization against corruption. The 2013 CPI measures the degree to which public sector corruption is perceived to exist in 177 countries around the world. The index scores countries on a scale from 100 (very clean) to 0 (highly corrupt). Turkey scored 50 in this survey, ranking it as perceived to be less corrupt than most of the selected emerging economies with the exception of South Korea. Further details are available from: <http://www.transparency.org/research/cpi/overview>

APPENDIX B: TURKEY'S CAPITAL MARKETS

B.I Market in comparison

As of end-2013, market capitalization of BIST-ALL was at US\$ 235 bn, representing an annual decline of 23%. Free float of the companies traded at the BIST-All is 29% indicating a shallow market. Market capitalization amounts to around 43% of GDP whereas the free float corresponds to 14% of GDP. Therefore, banks are not only the much bigger financiers of businesses in Turkey than are capital markets, but they are also the largest users of capital markets. For example, banks accounted for 29% of the total market capitalization as of the end of 2013 and for 45% of all trading volume.

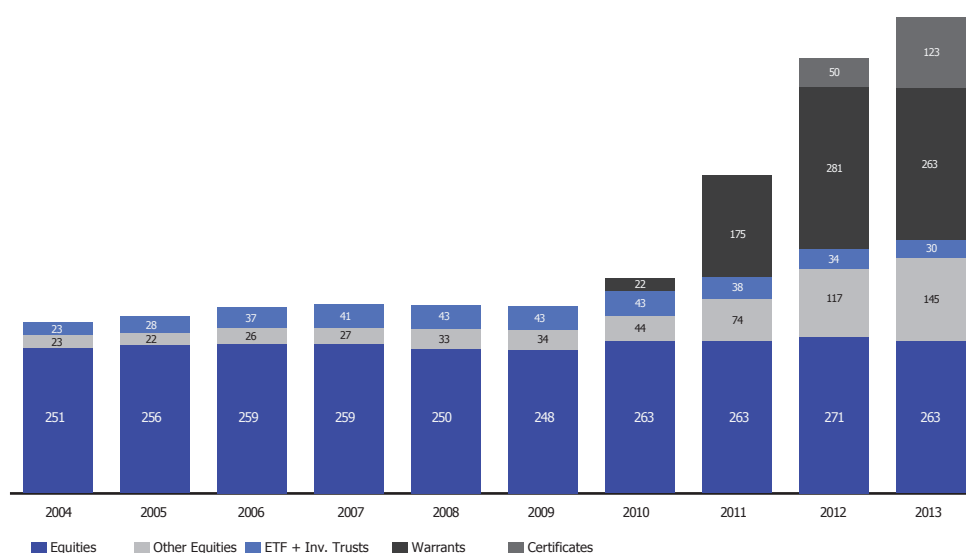
At the end 2013 there were 216 companies listed in BIST excluding investment funds and unit trusts ranking BIST the 36th among the exchanges with respect to the number of firms listed. In terms of market capitalization, BIST ranked the 29th with US\$311 billion corresponding to a 40% Market Capitalization/ GDP ratio. With respect to trading volume, BIST ranked 19th with US\$430 billion at the end of 2013. BIST however ranks the 2nd among exchanges with 214% with respect to the turnover ratio (ratio of equity trading volume to market capitalization).

Capital Markets Background

- 1982** Capital Markets Board established.
- 1985** Istanbul Stock Exchange (ISE) established.
- 1995** Settlement & Custody Bank formed.
Istanbul Gold Exchange (IGE) established.
- 1997** Banks are forbidden to trade equities.
- 2001** TSPAKB (Association) established.
Investors' Protection Fund established.
- 2002** Private pension system established.
- 2005** IFRS adopted for financial intermediaries and listed companies.
Turkish Derivatives Exchange established.
Dematerialization of equities completed.
- 2006** Dematerialization of corporate bonds & mutual funds completed.
- 2007** Mortgage Law passed.
- 2009** Automated Disclosure Platform introduced.
Istanbul International Financial Centre strategy announced.
- 2010** First warrant issued.
- 2011** Forex regulation passed.
- 2012** New Capital Markets Law passed.
ISE demutualised and merged with IGE under Borsa Istanbul.
- 2013** Borsa Istanbul announced strategic partnership with Nasdaq.
Borsa Istanbul and TurkDex merged.

Source: TSPAKB

Figure B.1: Number of Securities on BIST



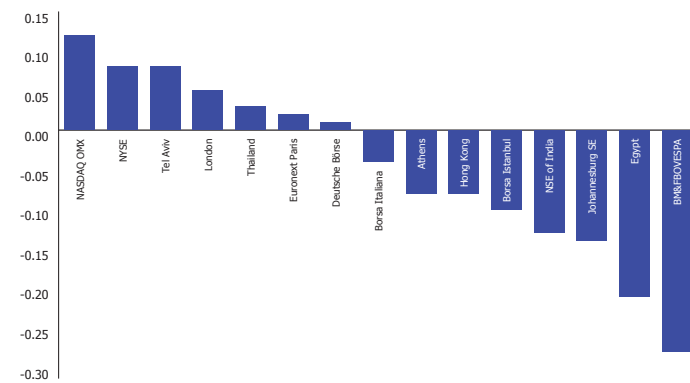
Source: The Association of Capital Market Intermediary Institutions of Turkey, January 2014.

B.2 Market Return

Moderate growth expectations in developed countries coupled with fading sovereign debt problems in the European Union resulted in capital outflows from emerging countries to developed countries during 2013. In the same period, BIST-100 Index went down by 7% in US\$ terms.

A downward trend was observed in the other emerging markets as well. While the index declined, the average daily trading volume increased by 24% during the same period in US\$ terms. BIST's total equity trading volume was US\$430 billion at the end of 2013.

Figure B.2: Selected Market Returns (US\$ Based-2013/06 YTD)



Source: WEF, TSPAKB.

B.3 Equity Market Liquidity

In Turkey, only brokerage firms are allowed to trade equities. In 2013, 100 brokerage firms traded in the equity market and the first 10 of them generated half of the total volume.

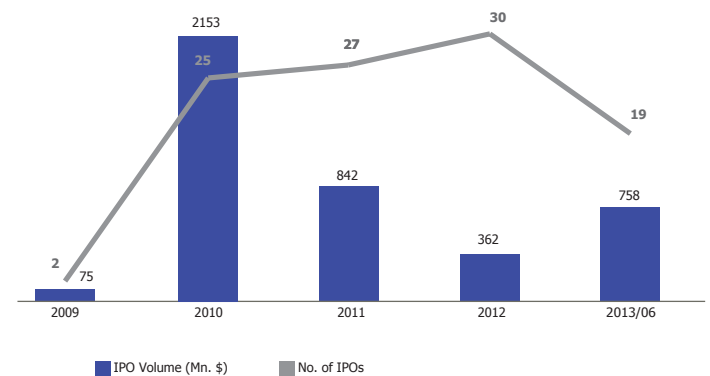
Domestic individuals drive the market liquidity in Turkey with a 59% share while they held around only one-fifth of the free float as of the end of 2013. Foreign corporations, which mainly include foreign banks and brokerage firms, created 16% of the trading volume. Foreign institutional investors, which hold 36% of the free float, had only 4% share in total turnover.

B.4 Primary Market

The global financial crisis limited the number of public offerings and in 2009 there were only two IPOs amounting to US\$76 million. With favourable market conditions and the support of the IPO campaign, the primary market revived in 2010. In 2013, 19 IPOs took place with a total size of US\$758 million. The issue sizes of the two biggest IPOs were US\$361 million and US\$142 million respectively.

Following the revisions in relevant regulations, the corporate bond market exploded since 2010. In 2013, 299 bonds were issued. Major issuers were banks.

Figure B.3: Initial Public Offerings

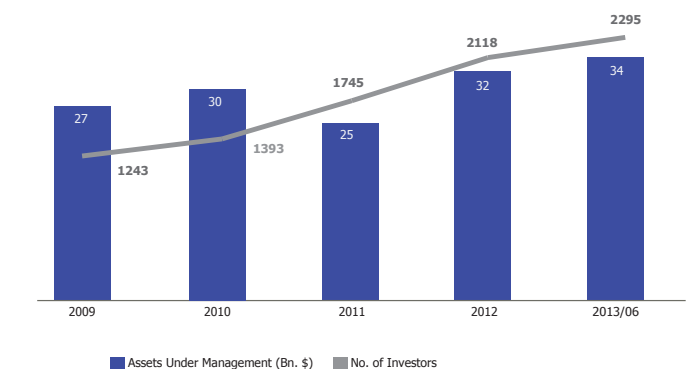


Source: Borsa Istanbul, TSPAKB.

B.5 Asset Management

Asset management services are provided by portfolio management firms and brokerage firms in Turkey. Total assets under management by professionals are around US\$35 billion in total as of the end of 2013. Out of this amount the assets under management by brokerage firms account for US\$2.6 billion. Managed equity funds have 9% (US\$225 million) share of total assets under management by brokerage firms. Total assets under management by portfolio management companies on the other hand account to US\$34 billion. 588 institutional investors own 89% of this amount. Average portfolio of institutional investors is around US\$12 million in brokerage firms, versus US\$54 million in portfolio management companies.

Figure B.4: Asset Management at Portfolio Management Companies



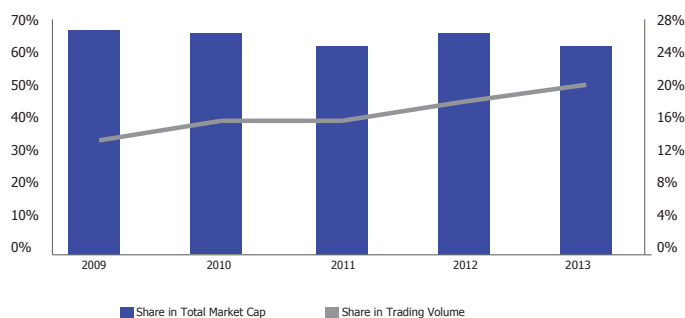
Source: CMB, TSPAKB.

B.6 Investors

As of end September 2013, total savings in Turkey was US\$674 billion, out of which bank deposits continue to be the major component by US\$423 billion. Domestic investors hold 78% of the total savings. Total investments in equities were US\$98 billion in the first nine months of 2013. The shares of the mutual funds in total savings remained unchanged at 4%. Low saving rates continues to be a structural problem in Turkey.

Both global and local developments improved the total equity holdings in 2012. Total portfolio size after increasing to US\$120 billion at the end of 2012 from US\$79 billion in 2011, deteriorated back to US\$92 billion with unfavourable market conditions as of end-2013. Foreign investors hold approximately 62%, while foreign institutional investors hold 45% of the equity portfolio. Foreign corporations, which include banks and brokerage firms, rank second among the foreign investors with an 18% share. Domestic investors' share in equity holdings slightly increased to at 38% at the end of 2013, majority of which was held by individual investors.

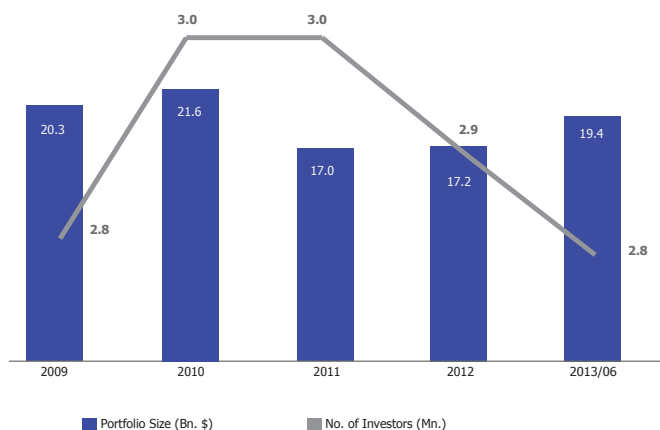
Figure B.5: Foreign Equity Investors in Borsa Istanbul



Source: CRA, Borsa Istanbul, TSPAKB.

The total size of mutual funds was only US\$19.4 billion as of end June 2013, representing a marginal increase from US\$17 billion at the beginning of the year.

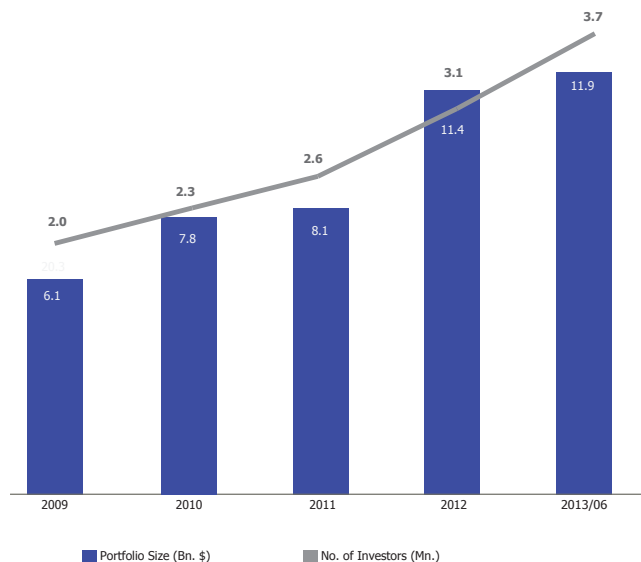
Figure B.6: Mutual Fund Investors



Source: CRA, TSPAKB.

Despite the global financial crisis, pension funds market is showing a steady growth since its inception in 2003. At the end of June 2013, the number of pension fund investors increased by 19% to 3.7 million, while the asset size reached US\$11.9 billion by a 4% increase thanks to the recent tax incentives implemented by the government.

Figure B.7: Pension Fund Investors



Source: PMC, TSPAKB.

APPENDIX C: BIBLIOGRAPHY

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Notlar

[illegible]

Sabanci University Corporate Governance Forum

Sabanci University Corporate Governance Forum (CGFT) has been founded in 2003 with seed funding from Turkish Industrialists' and Businessmen's Association (TUSIAD). Over the years CGFT has become an internationally recognized interdisciplinary center of excellence on corporate governance and sustainability. The Forum supports the policy development process by undertaking projects that bring together various stakeholders and facilitate dialog on key social issues by providing intellectual support underpinned by scientific research. As an independent platform, CGFT is in the best position to bring all relevant parties together and support the process to establishing a sustainability index in Turkey. CGFT is the host of Carbon Disclosure Project (CDP) in Turkey and works closely with the World Bank Group on governance and sustainability issues. CGFT scholars authored the 'IFC Sustainable Investment in Turkey 2010 Report' and 'IFC Sustainable Investment in Emerging Markets 2011 Report'.

Sabanci University Corporate Governance Forum has been actively supporting BIST's Sustainability Index Project by providing intellectual support and by helping the rating process undertaken by EIRIS.

cgft.sabanciuniv.edu

The United Nations Sustainable Stock Exchanges (SSE) Initiative

The Sustainable Stock Exchanges (SSE) Initiative is a UN initiative started in 2009, aimed at exploring how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and ultimately performance, on ESG issues and encourage responsible long-term approaches to investment. The SSE is co-organized by the United Nations Conference on Trade and Development (UNCTAD), the United Nations Global Compact Office, the United Nations-backed Principles for Responsible Investment (PRI) and the United Nations Environment Programme Finance Initiative (UNEP-FI).

Currently, nine exchanges have become partner exchanges to the SSE initiative, including NYSE Euronext, NASDAQ OMX, BSE Ltd., Borsa Istanbul (BIST), BM&FBOVESPA, the Johannesburg Stock Exchange (JSE), the Egyptian Exchange (EGX), the Nigerian Stock Exchange, and Warsaw Stock Exchange. SSE has been supporting BIST's efforts to launch a sustainability index, and have been the project partner to the project led by Sabanci University and funded by the British Embassy. SSE is also the event partner for the workshop organized within the scope of this project.

www.SSEinitiative.org

UK Prosperity Fund Programme

Prosperity Funds launched to tackle climate change, strengthen energy security and promote an open global economy in key emerging economies. Since its launch, the fund has supported 500 projects across a network of 14 countries and regions around the world. Turkey is one of the 8 countries that the Fund has a dedicated program. Supporting the process for establishing the Sustainability Index in Turkey closely matches with the programmes' focus areas, as the index will contribute significantly to the promotion of a sustainable, efficient and open economy in Turkey.



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