PRINCIPLES OF SUSTAINABLE FINANCE

Chapter 3: Governance and behaviour

Overview of the book

Part I: What is sustainability and why does it matter?

1. Sustainability and the transition challenge

Part II: Sustainability's challenges to corporates

2. Externalities - internalisation
3. **Governance and behaviour**
4. Coalitions for sustainable finance
5. Strategy and intangibles – changing business models
6. Integrated reporting - metrics and data

Part III: Financing sustainability

7. Investing for long-term value creation
8. Equity – investing with an ownership stake
9. Bonds – investing without voting power
10. Banks – new forms of lending
11. Insurance – managing long-term risk

Part IV: Epilogue

12. Transition management and integrated thinking

Learning objectives – chapter 3

- explain behavioural biases against change
- understand the changing objective of corporates
- explain the role of corporate governance steering companies behaviour
- explain how markets reinforce short-termism
- understand the design of incentives for long-term thinking

Behavioural biases

Linear consumption and production

Bottleneck to transition is not technical but societal:
can we **change** our consumption and production patterns?

12 RESPONSIBLE CONSUMPTION AND PRODUCTION

Overcome current patterns that **deplete natural resources**

1. Competitive consumption (keeping up with the Joneses)
2. Linear production (take, make, use and waste)
3. Reinforced by lobby of incumbents

Nudging to new patterns

1. Collaborative consumption (sharing or peer-to-peer economy)
2. Circular production (renewable energy, re-use of materials)

Investors also have behavioural biases

Assets are priced as **extrapolation** of recent past (thus assuming no transition)

But **revolutionary changes** to business models and phase transitions can and do happen

Scenario analysis (Chapter 2): useful tool to **broaden and lengthen the horizon**

New approaches needed:

1. From **short** to **long** term (this chapter)
2. From investing in the **market index** to **fundamental analysis** of investee companies (Chapter 7)

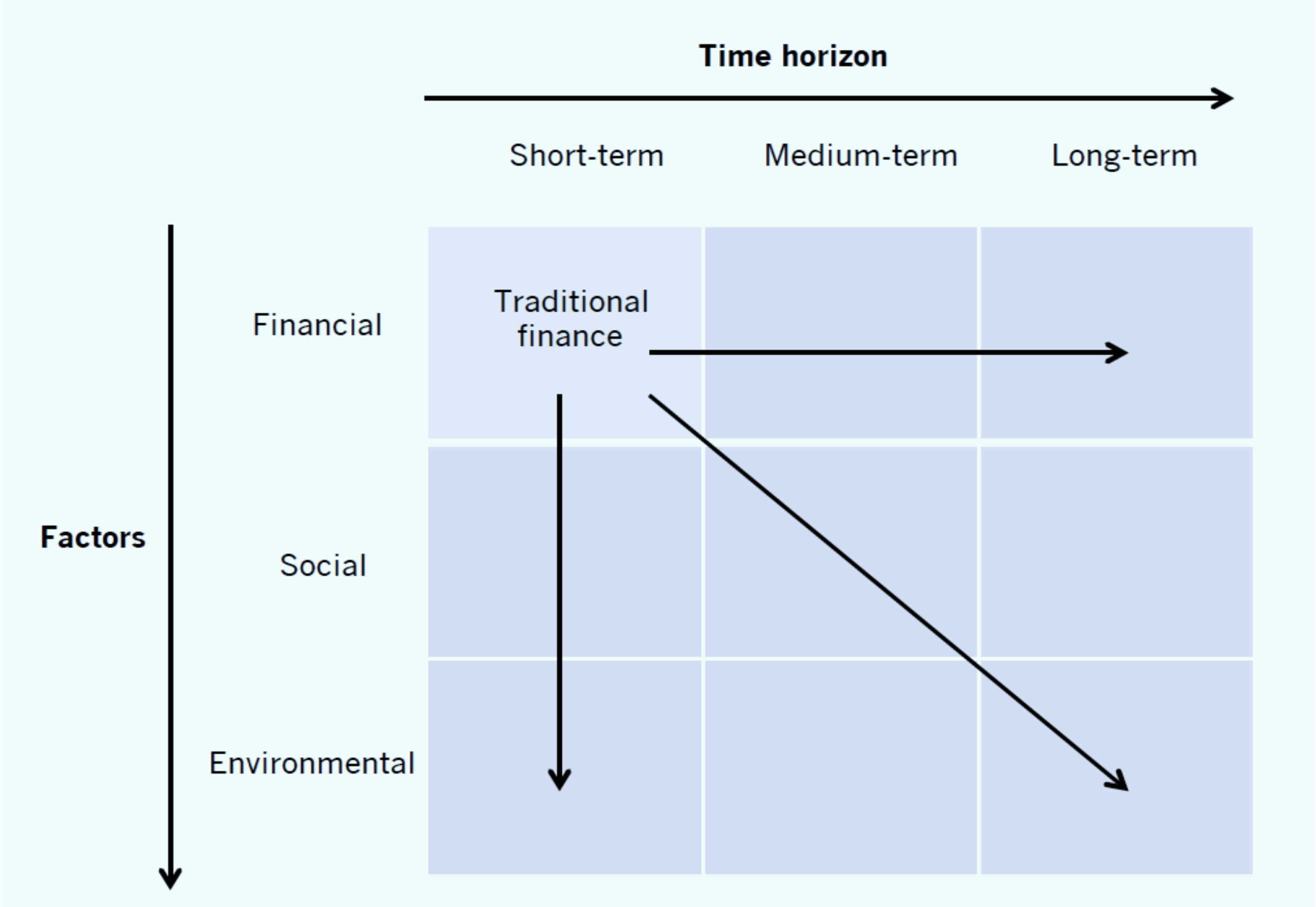
Players in sustainability (Table 3.1)

Player	Sphere of influence	Horizon	Mechanisms	Leading institutions and forums	Opportunities	Threats
Government	Country / Global	Up to 4 years	Strong leadership role • Taxation • Regulation	• United Nations: Conference of Parties (COP)	• Economy wide impact • Public role in energy and infrastructure	• Shortfall of efforts • Monitoring climate pledges • Policy differences • Free rider behaviour • Corruption
Civil society	Debate	From MT to LT	Public voice of NGOs • Media • Social capital • Deselection	• Oxfam • Amnesty International • Greenpeace • WWF	• Agenda setting • Stimulate citizenship of investors and corporates	• Single issue • Fragmentation • Dependent on goodwill of (local) government
Investors	Investments	From ST to LT	Long term investors • Investment strategy • Lending strategy • Engagement	• PRI • FCLT Global • GINN • GABV • Equator Principles	• Stimulate corporate sustainability • Stewardship and engagement	• Shortfall of efforts • Monthly benchmarking • Long investment chain • Marking-to-market • Monitoring

Players in sustainability (Table 3.1 - Cont'd)

Player	Sphere of influence	Horizon	Mechanisms	Leading institutions and forums	Opportunities	Threats
Corporates	Value chain of production	From MT to LT	Key players for transformation • Procurement • Production process	• WEF • WBCSD	• Reputation building • Sound and stable business practices	• Shortfall of efforts • Quarterly reporting • Shareholder value thinking • Lobbying for status quo • Reliability integrated reporting • Relocating production to less strict countries
Households	Consumption	From ST to LT	Ultimate beneficiaries • Buying decisions • Sharing economy • Electing government	Consumer association	• Steer corporates, utilities, housing • Steer investments • Vote for policies	• Poverty • Lack of trust in government • Environmental degradation • Free rider behaviour • Human aversion to change

Time horizon and factors in finance



Role of finance

How can financial firms steer business towards sustainable business practices?

- **Corporate governance**: stewardship and engagement
- Need to include social and environmental dimensions
- From **short-term** to **long-term**

Objective of the corporation

Shareholder model (SF 1.0)

- Objective is **maximising shareholder value**
- **Unforeseen circumstances**: shareholder interest overrides

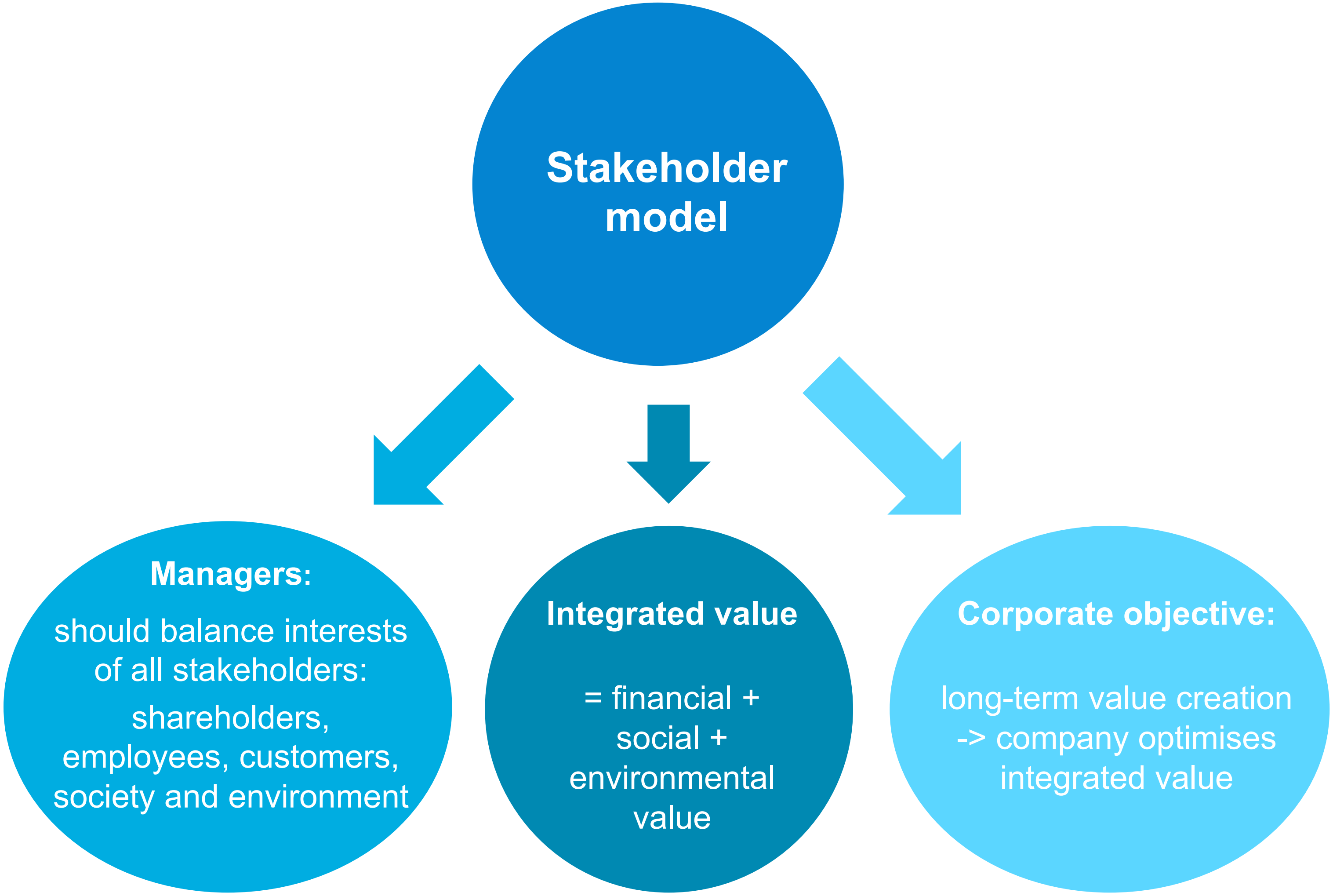
Shareholders as **residual claimants** of company

But **how to rank** shareholder and other stakeholder interests?

- Managers should cater to all stakeholders as a **means** to maximise firm value (enlightened value maximisation)

Refined shareholder value model

Stakeholder model (SF 2.0)



New business language

Integration of social and environmental dimensions is **dynamic**

- **Anticipation** of regulation / taxation (e.g. carbon tax)
- **Reputation** – pressure from NGOs / consumers
- **Future-proof**: transition to SDGs by 2030 (e.g. Energiewende)

New approaches based on **integrated value** (I = F + S + E)

- Impact of F + S + E on **value drivers of business model** (Chapter 5)
- Incorporating S + E into **NPV rule for investment decisions**
- **Integrated reporting** (Chapter 6)

Corporate governance

Corporate governance

Cooperate governance deals with **conflicts of interests** between **owners/shareholders** and **managers** of a firm

- Type of conflicts differ
  - Anglo-Saxon – **widely held ownership:** does the manager put in enough effort for shareholder? ➔ often shareholder model (SF 1.0)
  - Mainland Europe and Asia – **controlling shareholders:** how to protect minority shareholders? ➔ often stakeholder model (SF 2.0)

Corporate governance & sustainability

Try to get the best of both worlds

- Accountability of shareholder model (take-overs)
- Broad approach of stakeholder model (all stakeholders)
- **Societal test** of take-overs: see next slide

Fiduciary duty of investors towards clients/beneficiaries: clarify that sustainability factors must be incorporated

Engagement of investors with investee companies: dialogue on broad range of ESG issues (remember externalities are linked to companies)

Take-over contests

Kraft Heinz (**shareholder model**) vs Unilever (**stakeholder model**)

- Without protection, shareholder model will win ➔ SF 1.0

Proposal:

Societal cost-benefit test to obtain integrated value of joint companies, based on F, S, E (e.g. using integrated value methodology of SF 2.0)

➔

Only if **sum is positive** (in comparison to integrated value of stand-alone companies), take-over can go ahead

➔

Independent advisor gives a **fairness opinion** on outcome

Governance models

- **Executive contracts and compensation**: incorporate sustainability as KPI (key performance indicator)

- **Type of shareholders**: long-term investors (e.g. pension funds; Ch 4)

- **Reporting**: integrated reporting (Chapter 6)

- **Non-executive monitoring**:
  - widen remit of audit committee towards integrated reports, or
  - create sustainability committee: to monitor creation of social and environmental value by management

Organisational forms

Alternatives to publicly listed company:

Private company: private equity owner appoints management and can intervene directly

Cooperation (group of people like suppliers or customers): working for mutual benefit (but cannot raise fresh equity)

B corporation: certified company meeting social and environmental standards (but no legal status)

Social enterprise with a social or environmental goal

Governmental organisation with a public objective: run for the public good, but profit motive (for operational efficiency) missing

Horizon – from ST to LT thinking

Tragedy of the horizon

Tragedy of the horizon (Carney, 2015) is major obstacle to sustainable finance:

- Costs of action are now, while benefits remain in the future
- Impact of social and environmental issues in **long term** …
- ... but managers and investors operate in a **short-term** framework

Short-term practices

Market efficiency and carbon risk

Efficient markets hypothesis (Fama, 1970)

- Stock prices incorporate **all relevant information**
- On average reflect LT fundamental value of firm
- Stock price is indicator for asset selection and investor performance (Chapter 7)

Market efficiency and carbon risk

Adaptive markets hypothesis (Lo, 2017)

- Degree of market efficiency depends on **evolutionary model** of individuals adapting to a changing environment
- Prices reflect as much info as **number and nature distinct groups** of market participants allow
- If **small number** of groups or **new risk** ➔ market less efficient
- Can explain why new risks (carbon) are not yet fully priced

Mechanisms to reduce short-termism

Long-term oriented pay structure for executives

- Deferred reward principle
- Clawback provisions

Reporting on **long-term goals**

- Avoid single focus on short-term financial results
- And report on developments on all goals: F + S + E

Long-term performance measures

- Measure based on 3 or 5-year moving average

Discussion: barriers

What is the most important **barrier** to sustainable finance?

1. Value: **shareholder value** versus **stakeholder value**

2. Horizon: **short term** versus **long term**

Conclusions

- **Transition** to sustainable economy
  - Requires overcoming behavioural bias business + consumers
  - Key challenge is to move from ST to LT thinking

- **Corporate governance** defines focus of firm
  - From shareholder model ➔ financial value (F)
  - To stakeholder model ➔ integrated value (I=F+S+E)

- Several **incentives** reviewed
  - New theory: from efficient markets to adaptive markets
  - Longer term reporting and LT executive pay