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

Overcome current patterns that deplete natural resources

**Nudging** to new patterns

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

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)

<table>
<thead>
<tr>
<th>Player</th>
<th>Sphere of influence</th>
<th>Horizon</th>
<th>Mechanisms</th>
<th>Leading institutions and forums</th>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>Country / Global</td>
<td>Up to 4 years</td>
<td>Strong leadership role • Taxation • Regulation</td>
<td>• United Nations: Conference of Parties (COP)</td>
<td>• Economy wide impact • Public role in energy and infrastructure</td>
<td>• Shortfall of efforts • Monitoring climate pledges • Policy differences • Free rider behaviour • Corruption</td>
</tr>
<tr>
<td>Civil society</td>
<td>Debate</td>
<td>From MT to LT</td>
<td>Public voice of NGOs • Media • Social capital • Deselection</td>
<td>• Oxfam • Amnesty International • Greenpeace • WWF</td>
<td>• Agenda setting • Stimulate citizenship of investors and corporates</td>
<td>• Single issue • Fragmentation • Dependent on goodwill of (local) government</td>
</tr>
<tr>
<td>Investors</td>
<td>Investments</td>
<td>From ST to LT</td>
<td>Long term investors • Investment strategy • Lending strategy • Engagement</td>
<td>• PRI • FCLT Global • GINN • GABV • Equator Principles</td>
<td>• Stimulate corporate sustainability • Stewardship and engagement</td>
<td>• Shortfall of efforts • Monthly benchmarking • Long investment chain • Marking-to-market • Monitoring</td>
</tr>
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</table>
# Players in sustainability (Table 3.1 - Cont’d)

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<tr>
<td>Corporates</td>
<td>Value chain of production</td>
<td>From MT to LT</td>
<td>Key players for transformation • Procurement • Production process</td>
<td>WEF • WBCSD</td>
<td>Reputation building • Sound and stable business practices</td>
<td>Shortfall of efforts • Quarterly reporting • Shareholder value thinking • Lobbying for status quo • Reliability integrated reporting • Relocating production to less strict countries</td>
</tr>
<tr>
<td>Households</td>
<td>Consumption</td>
<td>From ST to LT</td>
<td>Ultimate beneficiaries • Buying decisions • Sharing economy • Electing government</td>
<td>Consumer association</td>
<td>Steer corporates, utilities, housing • Steer investments • Vote for policies</td>
<td>Poverty • Lack of trust in government • Environmental degradation • Free rider behaviour • Human aversion to change</td>
</tr>
</tbody>
</table>
Time horizon and factors in finance

- **Factors**
  - Financial
  - Social
  - Environmental

- **Time horizon**
  - Short-term
  - Medium-term
  - Long-term

- **Traditional 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

But how to rank shareholder and other stakeholder interests?

Shareholders as residual claimants of company

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

Refined shareholder value model
Managers: should balance interests of all stakeholders: shareholders, employees, customers, society and environment.

Integrated value = financial + social + environmental value

Corporate objective: long-term value creation -> company optimises integrated value

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
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 (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

- Quarterly financial reporting by companies
- Variable pay systems based on annual results
- Monthly/quarterly benchmarks measuring investor performance
- Marking-to-market of investments
- Supervisory treatment of illiquid investments
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