PRINCIPLES OF SUSTAINABLE FINANCE

Chapter 4: Coalitions for sustainable finance
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 4

- understand the role of institutional investors
- explain the functioning of private coalitions
- understand the mechanisms to increase the effectiveness of coalitions
Institutional investors
Institutional investors: the new power brokers

- Exercise power through **engagement** with companies
- Emerging trend: **coordinated engagement**

**Traditional types of institutional investors**
- Pension funds
- Insurance companies
- Investment funds (mutual funds)

**Alternative types of institutional investors**
- Sovereign Wealth Funds (SWFs)
- Hedge funds
Strong rise of institutional investment

Assets as % of GDP

- 1990
- 1995
- 2000
- 2005
- 2010
- 2016

Institutional investors
## Share of institutional in equity

<table>
<thead>
<tr>
<th>Type of institutional investor</th>
<th>Amount (in US$ trillion)</th>
<th>Share in equity markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment funds</td>
<td>24.0</td>
<td>41.1%</td>
</tr>
<tr>
<td>Investment funds (excl. pension funds/insurers)</td>
<td>11.2</td>
<td>19.1%</td>
</tr>
<tr>
<td>Pension funds and insurance companies</td>
<td>22.9</td>
<td>39.1%</td>
</tr>
<tr>
<td><strong>Traditional institutional investors</strong></td>
<td><strong>34.1</strong></td>
<td><strong>58.2%</strong></td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
<td>3.3</td>
<td>5.6%</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>0.9</td>
<td>1.6%</td>
</tr>
<tr>
<td><strong>Alternative institutional investors</strong></td>
<td><strong>4.2</strong></td>
<td><strong>7.2%</strong></td>
</tr>
<tr>
<td>Total institutional investors</td>
<td><strong>38.3</strong></td>
<td><strong>65.4%</strong></td>
</tr>
</tbody>
</table>
System approach to sustainability
Ostrom (1990): individual users behave contrary to the common good of all users by **depleting the common resources**

**Approaches to preserve common good**

**First best:** taxation and/or regulation – international cooperation sometimes possible (ozone layer) but often lacking (carbon tax)

**Second best:** cooperation among key players (rules to govern common good, monitoring and sanctions, clear group boundaries) → coalition of the willing
Shift of perspective

- Focus on improvement in company or value chain (measured by ESG ratings)
- **Inside-out perspective** looks at efficiency of company / sector (numerator)

**Current sustainability practices too incremental**

- Connects nano (personal), micro (company), meso (industry or portfolio) and macro (system) levels to determine company contributions
- **Outside-in perspective** starts with the system boundary (denominator)

**Context-based sustainability**
Footprint method (McElroy, 2008) to measure a company’s sustainability performance:

\[ SP = \frac{AI}{NI} \]

Inputs:

*AI* is net **actual impact** of a company on vital capitals (N, S, H)

*N* is **normative impact** for a company derived from **system thresholds**

<table>
<thead>
<tr>
<th>Sustainable</th>
<th>Ecological quotients</th>
<th>Societal quotients</th>
</tr>
</thead>
<tbody>
<tr>
<td>SP ≤ 1</td>
<td></td>
<td>SP ≥ 1</td>
</tr>
<tr>
<td>Unsustainable</td>
<td>SP &gt; 1</td>
<td>SP &lt; 1</td>
</tr>
</tbody>
</table>
Threshold and allocation approach

Threshold and allocation councils to make it operational

1. Determine system thresholds for various ecological ceilings and social foundations

2. Allocate (proportionally) to individual companies or sectors

Example carbon budget

- Derive overall carbon budget from Paris Agreement
- Set common carbon budget for Fortune 500 companies
- Allocate common carbon budget to individual companies
- Organise monitoring performance of each company $SP \leq 1$
Coalitions for sustainable finance
Investor coalitions on LT sustainable investment

- Develop methods and stimulate companies towards sustainability
- Next phase: coordinated engagement

Example: bank coalitions

- Stimulate sustainable lending
- Prevent competitive race to the bottom (e.g. undercutting standards in project finance)

Companies also form coalitions of the willing to move
### Example of large coalition: PRI

**Asset managers: Principles for Responsible Investment**

<table>
<thead>
<tr>
<th>Company</th>
<th>AUM (US$b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 BlackRock</td>
<td>5,117</td>
</tr>
<tr>
<td>2 Vanguard Group</td>
<td>3,814</td>
</tr>
<tr>
<td>3 UBS</td>
<td>2,771</td>
</tr>
<tr>
<td>4 State Street Global Advisors</td>
<td>2,446</td>
</tr>
<tr>
<td>5 Allianz Asset Management</td>
<td>2,086</td>
</tr>
<tr>
<td>Others</td>
<td>45,766</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>62,000</strong></td>
</tr>
<tr>
<td><strong>Total global AUM</strong></td>
<td><strong>163,000</strong></td>
</tr>
<tr>
<td><strong>Conventional global AUM</strong></td>
<td><strong>108,500</strong></td>
</tr>
</tbody>
</table>

- Allianz AM
- SSGA
- UBS
- Vanguard
- BlackRock
- Others
Example of dedicated coalition: FCLT

Asset managers: Focusing Capital on the Long Term Global

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<th>AUM (US$b)</th>
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<td>5,117</td>
</tr>
<tr>
<td>2 State Street Global Advisors</td>
<td>2,446</td>
</tr>
<tr>
<td>3 APG</td>
<td>498</td>
</tr>
<tr>
<td>4 Schroders</td>
<td>490</td>
</tr>
<tr>
<td>5 CPPIB</td>
<td>279</td>
</tr>
<tr>
<td>Others</td>
<td>982</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>9,812</strong></td>
</tr>
<tr>
<td><strong>Total global AUM</strong>*</td>
<td><strong>163,000</strong></td>
</tr>
<tr>
<td><strong>Conventional global AUM</strong></td>
<td><strong>108,500</strong></td>
</tr>
</tbody>
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- CPPIB
- Schroders
- APG
- SSGA
- BlackRock
- Others
Why join a coalition?

- Peer effect: membership of key competitors
- Outside pressure: consumers and NGOs
- Reputation: to be seen as leader in sustainability
- Collective advocacy: coalition can push governments
- Collective engagement increases success rate of ESG engagement
Assessing coalitions

Assessment criteria:

1. **Clearly defined boundaries**: which % of sector covered?
2. **Rules restricting use common good**: how ambitious?
3. **Collective choice arrangements**: can members affect rules?
4. **Monitoring**: effective reporting on progress meeting rules
5. **Sanctions and rewards**: are violations punished?
6. **Conflict resolution**: have members access to arenas?
## Assessment of some coalitions

<table>
<thead>
<tr>
<th>Coalition</th>
<th>Coverage (in %)</th>
<th>Sustainable finance typology</th>
<th>Collective-choice arrangement</th>
<th>Monitoring</th>
<th>Graduated sanctions or rewards</th>
<th>Conflict-resolution mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRI</td>
<td>38.0%</td>
<td>1.0 / 2.0</td>
<td>Yes, six principles for responsible investment and mandatory reporting</td>
<td>Yes, assessment reports</td>
<td>Only for the board</td>
<td>No</td>
</tr>
<tr>
<td>FCLT Global</td>
<td>6.0%</td>
<td>1.0 / 2.0</td>
<td>No, but collective goal to encourage long-term behaviour in business and investment</td>
<td>Partly, demonstrated commitment to long term value creation for new members</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>GIIN</td>
<td>0.05%</td>
<td>3.0</td>
<td>Partly, activities to support impact investing</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Equator Principles</td>
<td>30.0%</td>
<td>1.0 / 2.0</td>
<td>Yes, principles for managing environmental and social risk in projects</td>
<td>Yes, requirement to report, but no verification content</td>
<td>No, compliance is responsibility of members</td>
<td>No</td>
</tr>
<tr>
<td>GABV</td>
<td>0.07%</td>
<td>2.0 / 3.0</td>
<td>Yes, principles of sustainable banking</td>
<td>Yes, scorecard to measure impact of banks</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>WEF</td>
<td>31.0%</td>
<td>1.0 / 2.0</td>
<td>No, but mission based on stakeholder theory</td>
<td>No</td>
<td>Only for the managing board</td>
<td>No</td>
</tr>
<tr>
<td>WBCSD</td>
<td>18.9%</td>
<td>1.0 / 2.0</td>
<td>Yes, principles of sustainable development</td>
<td>Yes, council reviews annual sustainability report of members</td>
<td>Yes, cease of membership if non-adherence</td>
<td>Partly, crisis management</td>
</tr>
</tbody>
</table>
What is the most effective way of engagement?

1. Individual *deep* engagement versus *collective* engagement?

2. How do you measure *progress* on engagement?
Conclusions

- **Institutional investors** are new power brokers
  - Can steer companies towards sustainable business practices

- **System approach** is crucial
  - It is not sufficient that companies do their best (efficiency)
  - They should stay within system threshold (effectiveness)

- **Coalitions** of sustainable finance
  - Sustainability leaders in finance and in business form **coalitions of the willing** to move forward