
The Business Case For Sustainable Finance: Beyond Public Relations, Ethics, and Philanthropy

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THE BUSINESS CASE FOR SUSTAINABLE FINANCE

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“As the evidence mounts of how important environmental, social, and governance issues can be to the fortunes of corporations, these factors are seen less as the weird preoccupation of an isolated minority and more as the central issues that they really are.”

— MIKE SCOTT

INTRODUCTION

In the finance world, environmental, social, and governance (ESG) factors have, until recently, only been present in the soft domains of public relations, ethics, and philanthropy. Most existing academic literature on

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responsible and ethical investment addresses why finance *should* contribute to ESG needs, not why sustainable finance makes commercial sense. Thus, there is a need for sector-specific, topic-specific, and region-specific perspectives to build and present a systematic business case for sustainable finance. The aftermath of the economic crisis, marked by reflection and analysis of “what went wrong,” offers an unprecedented opportunity to articulate this new rationale.

- In December 2010, the U.S. Department of Justice began proceedings against British Petroleum (BP) for economic and environmental damages following its April 2010 oil spill in the Gulf of Mexico. Among the counts was failure to utilize the safest drilling technology to monitor the condition of its wells.
- Throughout 2010 metro, train, and airline strikes over unsatisfactory working conditions in France, the United States, and Spain caused millions of dollars in losses.
- In September and October 2011, thousands of protesters came out on the streets of New York City and elsewhere under the motto “Occupy Wall Street,” protesting corporate greed, Wall Street’s way of operating, and social inequality.
- The year 2011 also brought floods, tsunamis, tornadoes, typhoons, and mudslides. A United Nations-backed report showed that environmental costs from global human activity equate to an estimated USD 6.6 trillion, or 11 percent of global GDP in 2008.¹
- Finally, 2011 also witnessed the demise of the Greek financial system, which in turn posed a threat to the Eurozone as a whole.

The above events, though seemingly unrelated, illustrate how ESG issues and issues of financial sustainability pose both direct and indirect challenges to the global finance industry, which lies at the heart of the globalized and increasingly interrelated economy.

DEFINING ESG FACTORS AND SUSTAINABLE FINANCE

Numerous attempts have been made to define ESG factors and sustainable finance, terms often used interchangeably. ESG factors are treated here as public interest issues that affect human, societal, and environmental well-being and that are increasingly relevant to business and finance operations. ESG factors and sustainability issues are industry-, region-, and context-specific. Individual financial institutions should draw upon the ESG factors list most relevant to their operational contexts. In other words, sustainability issues cannot be painted with one brush, with universal applicability.

THE STATE OF DEBATE ON SUSTAINABLE FINANCE

The debate around ESG factors and financial sustainability is often accompanied by rhetoric addressing what firms *should* do in the public interest. This largely informs the concept of corporate social responsibility, but it is a discussion to which businesses and, more recently, financial institutions have become increasingly desensitized. One often hears that the private sector—including financial institutions—*should* have a societal responsibility greater than simply making a profit. Private actors, in turn, have fought back with variations of the classical argument that the business of business is business² and that the sector's primary role is its only role. Attempts to impose moral obligations of public character on exclusively money-making private entities have backfired, spurring a superficial debate whereby neither group is convinced by the other's argument. This dialectical construction is inherently unproductive. Rather than solve problems, it presents a series of arguments—none of which address genuine incentives.

It is understandable why financial institutions bristle when asked to sacrifice more than is required by law, even when doing so goes against their financial interest. Nonetheless, when financial institutions remain uninterested in environmental problems that affect all economic stakeholders—including businesses—the public justifiably equates their indifference with irresponsibility. Neither position is flawed, but both lines of argument are ineffective, as reasoning must account not only for one's own version of reality, but also for the interlocutor's interpretation. Thus, for the ESG debate to move forward, opposing sectors of society should recognize their own character by acknowledging the other party's societal role. In this context, commercial incentives remain the most, and perhaps only, convincing argument to a financial institution.

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The articulation of commercial incentives for sustainable finance, however, might meet expected criticism. When it comes to personal well-being, for example, discussing commercial profitability may be seen as materialistic and immoral. In other words, some would submit that money should not drive an entity to do the right thing. However, ethical considerations and

appeals to morality might not be sufficient to facilitate change. Individual ethical persuasion may not surmount to structural challenges such as institutional, legal, or social dynamics and obligations. Ethical arguments might resonate with some financial practitioners, but may not be convincing to others. A pension fund CEO who enjoys spending time in the mountains on weekends may notice adverse environmental effects from global warming and biodiversity loss, and therefore might become personally motivated to change his or her institution's practices. This case, however, will be different for a dynamic CEO in the big city. In order to yield results, persuasion needs to transcend individual ethics and interpersonal value differences into a more universal rationale that speaks on business grounds. A business case that sounds convincing to both executives in the example is needed.

While academic and non-profit circles present various arguments as to why finance should look into ways to improve the impact and sustainability of the industry, it should be noted that unless an entity realizes and internalizes on a micro-level the business benefits of an approach, outside rhetoric rarely results in genuine and meaningful change. (An exception to this is external regulatory pressure to comply, when potential sanctions cannot be ignored by the industry.)

A departure from *should* is to be made. The inventive ratings, securities, and derivatives schemes that precipitated the 2008 financial meltdown represent a clear reminder as to why rules exist to begin with. Therefore, there is no arguing that an industry is constrained by rules and that certain "shoulds" are actually "musts" institutionalized through regulation.

Accepting this logic, the relevant questions are: what are the specific intersections of private capital and public interest, and what are the commercial incentives from the finance industry's point of view that underpin these intersections? The goal here is a discussion of the genuine business arguments for ESG analysis and sustainable finance, rather than an articulation of what the public needs from the finance industry.

IN SEARCH OF THE HOLY GRAIL:

IS THERE A BUSINESS CASE FOR SUSTAINABLE FINANCE?

Major empirical questions challenging the business case for sustainable finance are: beyond reputation and public relations, are there quantifiable commercial incentives for sustainable finance? If a business case indeed exists, are financial institutions moving in that direction already? If they are not moving or are moving too slowly, why?

Rational Choice and Rational Action?

Among the most challenging questions posed by rational choice and rational action theories are those concerning the degree to which sustainable finance is actually practiced. According to theories depicting actors as rational profit-maximizers who act in the most advantageous way possible, if a practice does not take place, it must not be profitable. The greatest test of the business case for sustainable finance, therefore, would be an empirical evaluation of its use by financial institutions.

The rational action argument, however, does not account for behavioral explanations of the limited deployment of sustainable finance. Observing levels of sustainable finance may be a useful starting point for assessing profitability, but sometimes even the “invisible hand” needs a helping hand distributing information. Evidence for this is provided by several unanticipated environmental, social, and governance crises that affected returns, but for which financial institutions were unprepared. Among different actors in the financial system, information regarding the importance of ESG issues is imperfectly distributed. The result is uneven crisis preparedness.

This information gap is a product of multiple dynamics. On a practical level, financial institutions are comprised of individuals with particular views, agendas, and deadlines. Even if driven by the best of intentions, individuals performing their duties on an everyday basis might not have the time or direction to consider additional business-relevant information. Such habits can result in organizational inertia whereby work is carried out in a particular manner, not necessarily because it is the optimal way but simply because it is the status quo. Similar to institutional and individual inertia, groupthink³ and a leadership-imposed model enshrined in financial institutions’ social hierarchies may discourage the expression of a diversity of viewpoints that can allow sustainable finance to flourish.

Furthermore, adequate human resources, sustainability expertise, or institutional positions do not exist in many financial institutions. Even if present, institutional channels do not always allow the entry of sustainability expertise into core operational phases, as sustainability units within financial institutions are reportedly isolated from the mainstream operations flow.⁴ Among investors, fiduciary duty is an extra consideration; investments based on ESG analysis, like all investments, must be compatible with shareholders’ financial interests.⁵ At best, poorly understood ESG analysis could be dismissed as soft, as an ethical public-interest exercise that is commercially irrelevant. At worst, it could be misrepresented as being contrary to shareholders’ financial interest.

The existence of an information gap means that failure to commit from financial institutions does not prove that a business case for sustainable finance is lacking.

THE BUSINESS CASE FOR SUSTAINABLE FINANCE

The business case for sustainable finance is seen through a myriad of lenses that run the gamut of business interests, from that of cost-cutting and risk management to that of expanding portfolios and identifying new opportunities. The business case covers such issues as climate change, natural capital, human rights, poverty reduction, labor standards, social development, corruption, economic and social impact, as well as finance industry sectors such as asset management and investment, banking, microfinance, insurance, and re-insurance.

ESG Analysis as a Predictor of Company Strategy and Management Quality

A perspective arising from the investment community is the argument that ESG analysis is a predictor of a company's strategy and quality of management. Amanda McCluskey, head of Responsible Investment at Colonial First State Global Asset Management, argues that investors may use ESG metrics as a predictor of a company's strategy. By explaining the business-driven, commercially-motivated argument for ESG analysis as a proxy of management quality, McCluskey differentiates this approach from ethical investment. While the latter aims to do good without considering financial performance, in McCluskey's approach, ESG analysis is a pragmatic business indicator that provides insight to investors who are primarily concerned with financial returns.⁶

Avoiding Liability and Litigation Costs

Another side of the business case for sustainable finance is the cost and liability of investment litigation. Mark Vlasic and Peter Atlee of Georgetown University Law Center argue that financial institutions bear significant litigation costs when they are accused of participating in irresponsible investing or for violating ESG norms. They bear the direct costs of litigation when they are sued but, unlike general corporations, they also bear a significant portion of any losses sustained by their investment partners. The 2010 BP Deepwater Horizon explosion and the *Almog v. Arab Bank* cases demonstrate this and suggest why sustainable investing may be in the financial interest of investment institutions.⁷

The Value-Added of Combining Financial and ESG Metrics

The value-added of combining financial and non-financial (or ESG) metrics is a well-established principle in the realm of microfinance. Integrating ESG indicators is accepted as an essential element for mitigating risk and avoiding investment in “unhealthy” institutions, according to Marike de Leede and Harry Hummels of SNS Asset Management in the Netherlands.⁸

*Climate Change and Natural Resource Stresses:
A Catalyst for Innovations in Investment*

Climate change presents an interesting case for financial institutions that are considering new business opportunities. Nick Robins, head of HSBC’s Climate Change Centre of Excellence, asserts there are two parallel trends: first, taking energy out of the economy through improvements in efficiency and, second, taking carbon out of energy by curbing emissions from fossil fuels. Both trends have been structural features in the global economy over recent decades. Greenhouse gas in the upper atmosphere is increasing temperatures, melting ice caps and glaciers, increasing ocean acidification, and raising sea levels. These impacts are fusing with the underlying resource stress in energy, food, and water systems to produce a powerful driver for change. As a result, the transition to a climate economy—one that delivers prosperity while ensuring the security of key climate systems—is creating a new generation of investment challenges affecting both valuations and the stewardship of assets. Policy, technology, and enterprise risks are acute in this arena and require investors to develop a scenario-based approach to future economic trajectories.⁹

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There is also a commercial case for considering the larger relationship between natural and economic capital. Socio-economic security is increasingly reliant on four critical factors: energy, water, food, and climate. However, the natural capital that underpins them is under extreme stress, causing crucial and relevant externalities that should be part of mainstream analysis and decision-making, submits Richard Burrett, Partner at Earth Capital Partners LLP and Senior Associate at the University of Cambridge Programme for Sustainability Leadership. Furthermore, the U.S. Wetland

Mitigation Banking and the Reducing Emissions through Deforestation and Forest Degradation (REDD) models demonstrate the tangible commercial value of biodiversity capital to financial institutions.¹⁰

Compliance with Human Rights and Labor Standards

Compliance with human rights and labor standards also affects returns and may be a cost-cutting strategy in line with investors' fiduciary duty to shareholders. In addition to cutting costs, the business case arguments for human rights and labor standards compliance are largely centered around preventing financial losses arising from internal supply chain issues, mitigating the risk in associating with criminal organizations, and avoiding potential negative externalities related to a "social license to operate."¹¹

The theory of universal ownership adds another dimension to this argument.¹² According to universal ownership theory, a portfolio investor benefiting from a company that externalizes costs might experience a reduction in overall returns due to the externalities' effects on other investments in the portfolio. "Universal owners" therefore have an incentive to reduce negative externalities, such as decreasing labor productivity, across their investment portfolios. For highly diversified investors, a negative externality is not really external because it reappears in another part of the portfolio, and therefore has internal ramifications.

For example, while a company might be able to externalize the cost of water pollution or care for injured workers, to the state, its decisions have a negative net impact upon quality of life, human capital, labor productivity, and economic growth. For a universal owner whose portfolio returns are closely linked to overall economic growth, one company's harmful actions may be profitable for the company itself but detrimental to the profitability of the portfolio. The human rights and labor policies of a company affect the overall competence, health, and productivity of the labor force and therefore influence the investor's overall portfolio. Understanding this, many investors engage a company on human rights and labor standards issues demanding that the company stop the harmful activity or otherwise adjust its behavior, even when the adjustment would actually raise costs. The rationale is that adjusting behavior in that particular case would be positive for the economy at large and the investor's portfolio as a whole.

Incentives for ESG-Conscious Investing

In emerging markets, there are risks associated with investing and

lending that require investors to look beyond stock-specific issues and take a more holistic approach to risk management, note Rory Sullivan, Senior Research Fellow at University of Leeds, and Helena Vines Fiestas, Co-Head of SRI Research and Head of Sustainable Thematic Research at BNP Paribas Asset Management.¹³ There is a compelling business case, then, for sustainable finance as those investors that take an informed and proactive approach are more likely to avoid risk and financial loss and make successful investments. This is the case in China where, due to acute incentives for compliance with state environmental and social regulatory pressures (as well a host of development challenges), there is an increasing awareness and alignment of ESG factors within the financial sector and the broader economy. Ben Ridley, head of Public Policy – Sustainability Affairs for Asia Pacific region at Credit Suisse AG, argues that the state’s central economic and fiscal control provides commercial barriers and incentives to the finance sector in order to achieve policy and regulatory compliance. The ongoing development of what is broadly referred to as “sustainable finance” in China presents a unique opportunity to study the implementation successes and challenges and provides a number of case studies. These may demonstrate how environmental and social risks can translate into financial impacts for financial institutions in the country.¹⁴

Broad socio-economic and climate sensitivity conditions in South Africa also provide themes to be considered from a creditor or investor’s point of view, explains Madeleine Ronquest, Head of Environmental and Social Risk at FirstRand Group Ltd. The effective management of these risks includes incorporation of ESG factors into financing and investment,¹⁵ including consideration of climate change sensitivities, water and health issues relevant to the local context.

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CONCLUSION

While ESG issues may initially seem to be of concern to the public only, various perspectives from financial institutions worldwide point to the materiality of these issues to the financial sector. Changing landscapes are redefining and deconstructing the way that ESG issues are understood

to affect business and the economy, and they can no longer be dismissed as secondary concerns. Perhaps the strongest evidence for the business case for sustainable finance, however, is the growing level of interest and practice among large financial institutions, a testament to the commercial incentives latent in paying heed to ESG concerns. ■

ENDNOTES

- 1 *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, United Nations Principles for Responsible Investment & United Nations Environment Programme Finance Initiative, 2010, <www.unpri.org/files/uop_long_report.pdf> (accessed March 15, 2012).
- 2 Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," *The New York Times*, September 13, 1970.
- 3 See Irving L. Janis, *Groupthink: Psychological Studies of Policy Decisions and Fiascoes*, 2nd ed. (Boston: Houghton Mifflin, 1983).
- 4 See diagram in *Translating ESG into Sustainable Business Value — Key Insights for Companies and Investors*, United Nations Environment Programme Finance Initiative, 2010, 8.
- 5 *Fiduciary Responsibility - Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment*, United Nations Environment Programme Finance Initiative, 2005. The report underlines that professional investment advisors and service providers may have a far greater legal obligation to incorporate ESG issues into their investment services or face "a very real risk that they will be sued for negligence" if they do not.
- 6 Amanda McCluskey, "ESG Analysis as a Predictor of Quality of Management in Investment Decision Making," in Iveta Cherneva, ed., *The Business Case for Sustainable Finance* (Routledge, 2012).
- 7 Mark V. Vlasic & Peter Atlee, "Litigation Expenses: Sustainable Investment Through Costly Liability," in Cherneva.
- 8 Marieke de Leede & Harry Hummels, "Microfinance and the Creation of Shared Value: Delineating the Investment Case for Non-Financial Analysis in Microfinance," in Cherneva.
- 9 Nick Robins, "Sizing the Climate Economy," in Cherneva.
- 10 Richard Burrett, "Putting a Value on the Priceless: The Business Case for Natural Capital in Finance," in Cherneva.
- 11 Iveta Cherneva, "The Business Case for Human Rights and Labor Standards Compliance in Finance," in Cherneva.
- 12 For universal ownership theory see *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, United Nations Principles for Responsible Investment & United Nations Environment Programme Finance Initiative, 2010.
- 13 Rory Sullivan & Helena Viñes Fiestas, "Responsible Investment, Poverty Reduction and Development: Better Returns," in Cherneva.
- 14 Ben Ridley, "The Business Case for Sustainable Finance in China," in Cherneva.
- 15 Madeleine Ronquest, "The Business Case for Sustainable Finance in South Africa" in Cherneva.