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

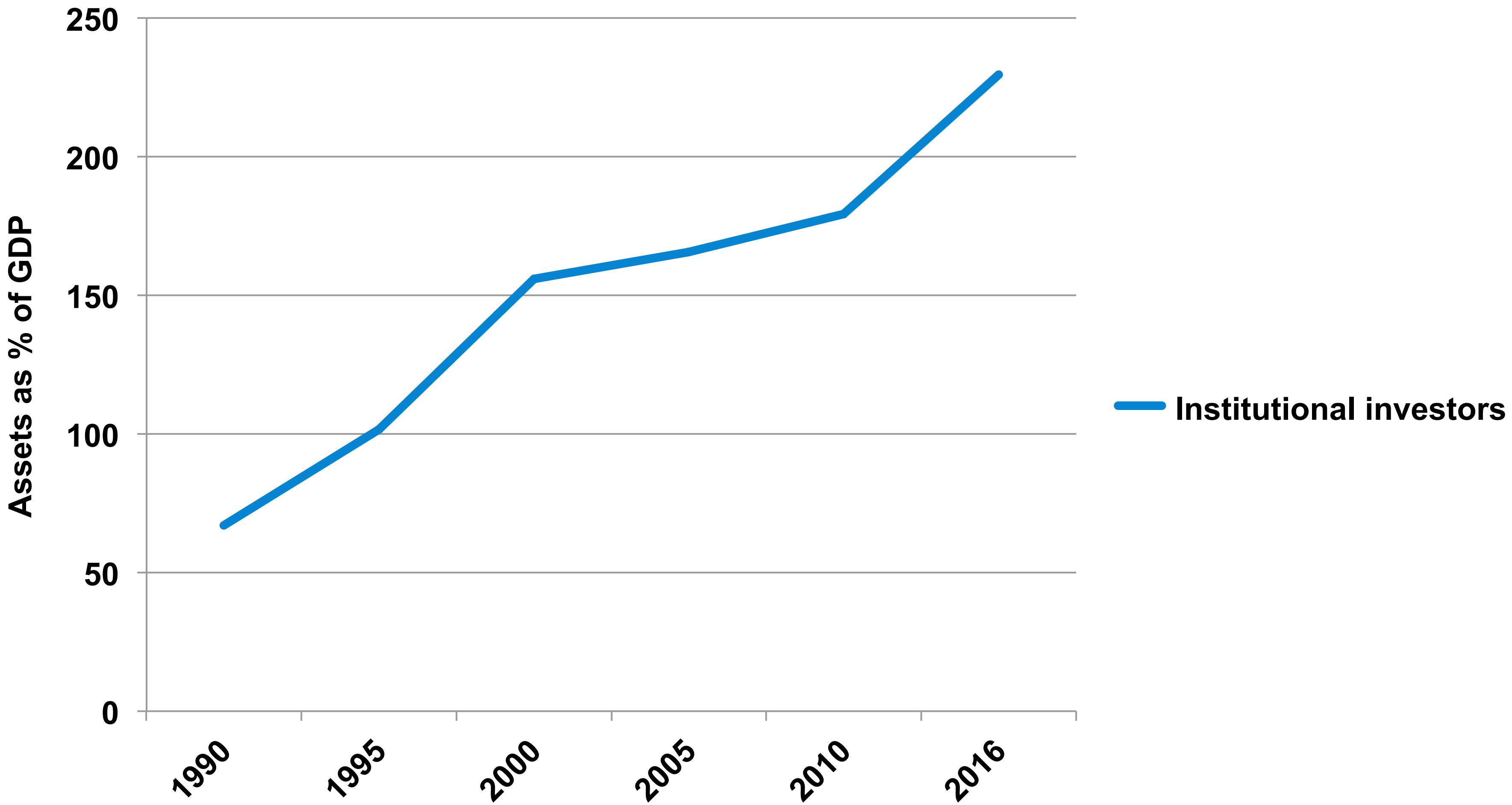
Institutional investors

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



Share of institutional in equity

Type of institutional investor	Amount (in US$ trillion)	Share in equity markets
Investment funds	24.0	41.1%
Investment funds (excl. pension funds/insurers)	11.2	19.1%
Pension funds and insurance companies	22.9	39.1%
Traditional institutional investors	**34.1**	**58.2%**
Sovereign wealth funds	3.3	5.6%
Hedge funds	0.9	1.6%
Alternative institutional investors	**4.2**	**7.2%**
Total institutional investors	**38.3**	**65.4%**

System approach to sustainability

Tragedy of the commons

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

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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**

Context-based sustainability

- 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**)

Footprint method

Footprint method (McElroy, 2008) to measure a company's sustainability performance:

$$SP = \left({AI}/{NI} \right)$$

Inputs:

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

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

	Ecological quotients	Societal quotients
Sustainable	$SP \leq 1$	$SP \geq 1$
Unsustainable	$SP > 1$	$SP < 1$

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

Coalitions for sustainable finance

Investor coalitions on LT sustainable investment

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

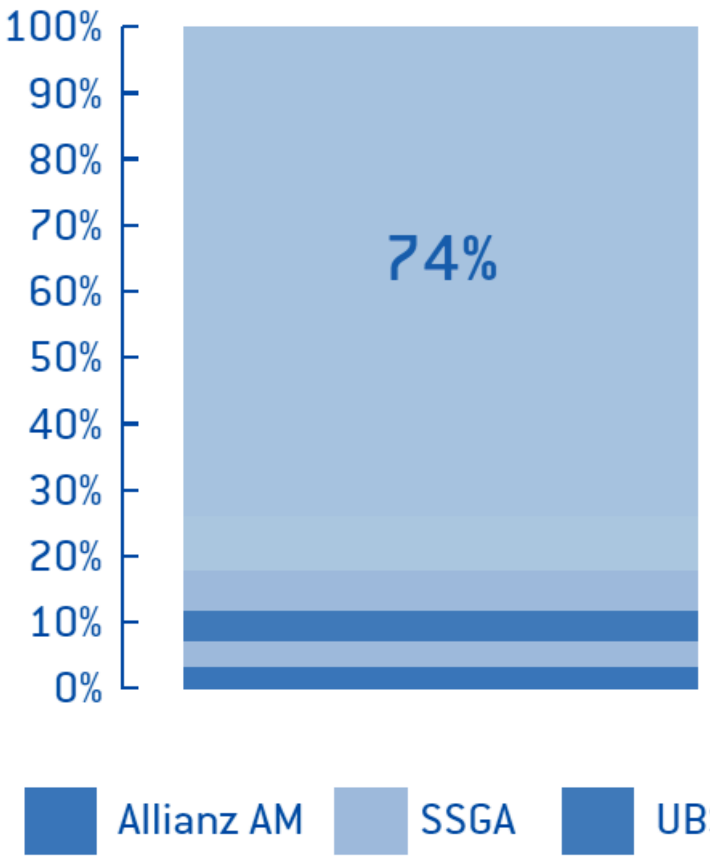
Companies also form **coalitions of the willing** to move

Example: bank coalitions

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

Example of large coalition: PRI

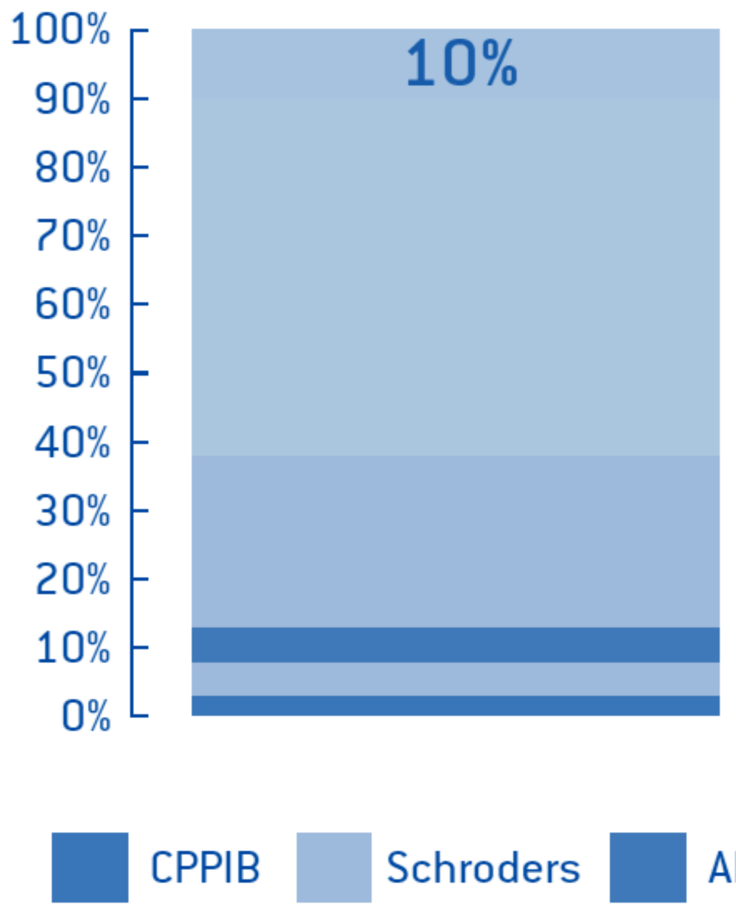
Asset managers: Principles for Responsible Investment



Company	**AUM (US$b)**
1 BlackRock	5,117
2 Vanguard Group	3,814
3 UBS	2,771
4 State Street Global Advisors	2,446
5 Allianz Asset Management	2,086
Others	45,766
Total	**62,000**
Total global AUM*	**163,000**
Conventional global AUM	**108,500**

Example of dedicated coalition: FCLT

Asset managers: Focusing Capital on the Long Term Global



Company	AUM (US$b)
1 BlackRock	5,117
2 State Street Global Advisors	2,446
3 APG	498
4 Schroders	490
5 CPPIB	279
Others	982
Total	**9,812**
Total global AUM*	**163,000**
Conventional global AUM	**108,500**

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

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

Discussion: engagement

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