Sustainable Investing – Addressing the Backlash

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Sustainable investing has been criticised for its theoretical flaws, unverifiable objectives and excessive fees. Is this backlash justified? The financial system seeks to transfer capital from savers to economic entities that require capital to spend or invest. In doing so, it aims to maximize all participants' utility. Sustainable finance is far from incompatible with this conventional thinking. Why is it proving so contentious?

In this paper, I argue that there is no fatal flaw in the "Sustainable Investing" approach but identify an accumulation of informational failures that is eroding its credibility. The case to improve disclosure and enhance incentives to integrate sustainability criteria into the identification and maximization of the economic surplus is compelling. I consider the nature of these challenges and address whether the private sector can offer a better solution or whether the case for greater regulatory intervention is now too compelling to ignore?

Missing Information

The starting point is the literature of market failures. The standard definition is that market failure occurs when the allocation of a good or service by the free market is inefficient. While there are several types of market failure, perhaps the most significant type involves "information failure", given that all other market failures include some form of information problem.

My question is how do information failures impact the allocation of resources from savers to borrowers? The answer depends on the nature of resources being allocated. I identify two distinct types of resources, economic and financial, and highlight how the materiality of information failures differs across the allocation process.

First, let's consider economic resources allocated by decision-makers at a company management level. The ability of firms to deliver an optimum amount of goods and services is dependent on the functionality of the price-setting mechanism. There are a number of reasons why this mechanism may be flawed when it comes to aggregate, or social, utility maximization. The most obvious is a failure to account for externalities, which may result in goods and services being over- or under-supplied, or not supplied at all.

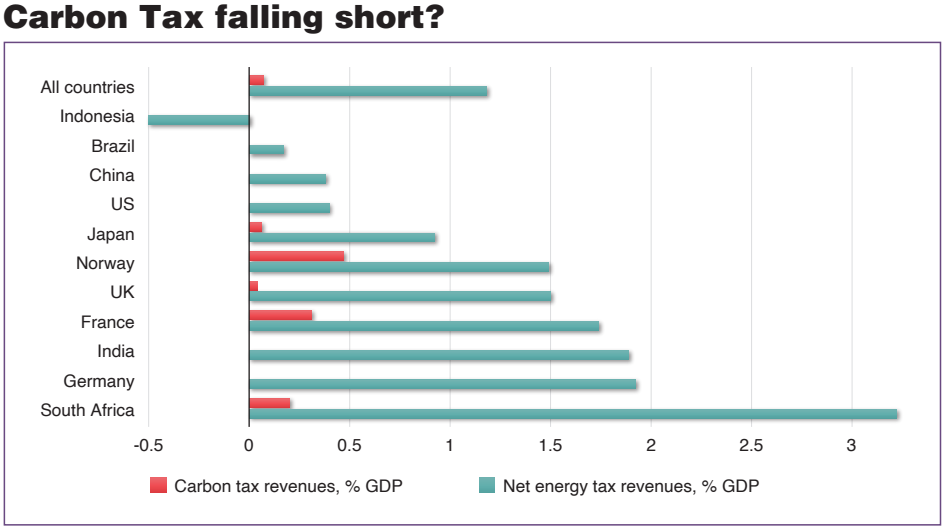
From an economic point of view, the best way to mitigate this problem is to put a price on these externalities. However, data availability issues and difficulties making market aggregate assessments mean it is not always easy to measure the impact of this activity in a way that is socially acceptable given existing conventions.

One example is a carbon tax. Raising the price for carbon-emitting goods and services is an intuitive way to reduce demand and subsequently carbon emissions. However, progress in implementing carbon taxes has been much slower than expected *(Chart 1)*. These taxes have been criticised for their regressive nature with the poorest cohorts of the population more affected. In addition, they must be weighed against other considerations such as the cost of adjustments, which include painful disruptions to economic activity and the risk of structural unemployment.

A second type of resource is purely financial in nature with professional investors the primary guardians over the allocation of financial assets. Market failures here relate more to the general issue of imperfections in information availability that means buyers and

CHART 1

Carbon Tax falling short?



Source: "Pricing Greenhouse Gas Emissions", OECD 2022

sellers fail to agree upon optimum allocations. Here the most pertinent information problem is not externalities – which both parties may be ignorant of – but an unfair information advantage for one stakeholder over others. This so-called information asymmetry can result in inefficient outcomes or no provision at all.

The appropriate way to mitigate this type of challenge is to establish contractual obligations that minimize the advantage of uneven information and mitigate costs associated with the delegation of decision-making authority to agents, known as agency costs.[1]

Of course, these legal contracts are contingent on future conditions and can never be fully complete or perfect in nature. As a result, the ability to reduce agency costs is enhanced by a mix of governance architecture and agreed best practices – often through the adoption of soft-law regulation such as Corporate Governance or Stewardship Codes.

Agency problems are not constrained to firm ownership and management either. In recent years, greater attention has paid to informational problems across the investment chain too. Asset owners and service providers in the investment chain face similar information challenges and associated agency costs which can have an accumulated effect. To mitigate this problem, governance architecture and responsibilities have been extended throughout the chain, with increased recognition that sustainability investment begins with savers, i.e. end-investors and beneficiaries who contribute the funds invested in the market.

The Market Solution

If we accept that information failures occur frequently across the asset allocation chain, does it make sense to expect markets to efficiently direct the flow of money to sustainable outcomes?

A key decision criterion is whether the private sector has greater capacity to reduce these informational problems. To answer this question, I start with a simple observation that information efficiency is a function of cost of information and market conditions, such as competition and ease of entry.[2]

Regarding the first of these determinants, recent research suggests significant time and financial resources are required to meet the data provision, compilation and analysis necessary for Sustainable Investing. The brunt of the burden has been borne by the corporate sector. For example, costs associated with disclosure requirements under new European Union legislation due to come into place in 2023, the so-called Corporate Sustainability Reporting Directive, is estimated at no less than 3.6 billion euro, with 1.2 billion euro in one-off implementation costs alone.[3]

Asset managers and other supplies in the investment chain are also being forced to invest heavily in disclosure provisions. Again, events in Europe provide a useful example with the implementation of the European Commission's Sustainable Finance Disclosures Regulation (SFDR) for asset managers having been delayed partly because of the cost associated with the acquisition of data needed to comply.

In the past, these up-front costs have proven prohibitively high, resulting in ad hoc and inconsistent disclosures in this area. However, a combination to technological advances and shifting generational preferences mean the market for information associated with Sustainable Investing has developed relatively rapidly in recent years.

Demand for better quality information about how firms, asset managers and service providers integrate sustainability consideration into their decision-making has grown exponentially. Sustainable Investing-related funds totalled $18.4 trillion in 2021 and are expected to grow to $33.9 trillion by 2026.[4] In response, there has been a concerted effort to improve disclosure and assurance standards.

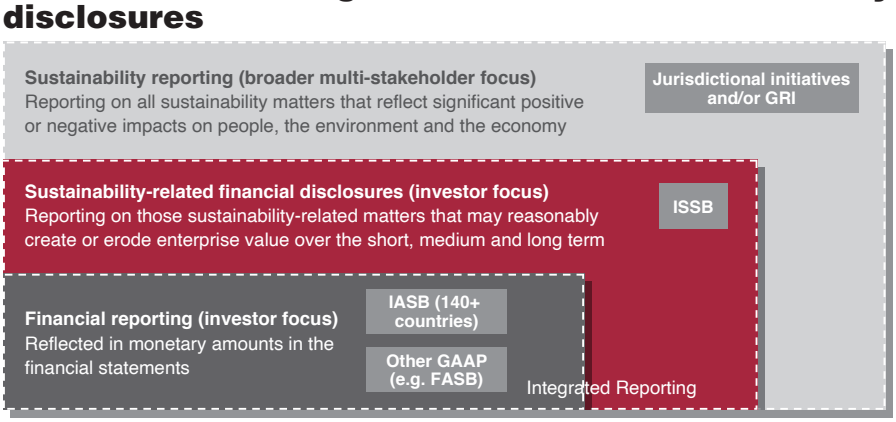
In November 2021, the IFRS announced the merger of the Climate Disclosure Standards Board and the Value Reporting Foundation – which houses the Integrated Reporting Framework and the SASB Standards – and the formation of the International Sustainability Standards Board (ISSB). The ISSB has a clear mandate to provide a global baseline of sustainability disclosures and enable companies to provide comprehensive sustainability information for investors. It has since introduced a new building block approach to sustainability disclosure, with high-quality standards designed to complement jurisdictional initiatives *(Chart 2)*.

From the investor side, nearly all major asset managers now integrate Sustainable Investing into their process in some form. In addition, new products and services have been created with greater transparency is relation to ESG ratings, indices, and fund components.

Another important development is the increase in verification of data between these two critical sources of information. For example, it is now possible to compare a firm's assessment between its current

CHART 2

New standards for global baseline of sustainability disclosures



Source: ISSB's proposed IFRS® Sustainability Disclosure Standards, 2022

and committed net-zero trajectory with an investor's assessment of the same gap. As the quality and amount of information increases, logic dictates that the efficiency of the market mechanism should too.

More to Be Done?

The recent developments are certainly a step in the right direction. However, there is still much more that could be done to improve the availability and accuracy of information required for Sustainable Investing. I cover some of the potential enhancements in the next section.

I begin by focusing on technology solutions. According to a recent Oracle ESG global study, 91% of business leaders are currently facing major challenges in making progress on sustainability and ESG initiatives.[5] This primarily reflects challenges in obtaining ESG metrics from third parties, a lack of data, and time-consuming manual reporting processes.

There is considerable scope for AI technology to increase the granularity of firm reporting and identify data gaps related to sustainability issues. AI-related technology is also a vital tool for tracking ESG criteria within portfolios. This includes not only the filtering of existing data but the improvement time-consuming manual reporting processes.

Another important tool for those in the financial chain is the use of scale to provide a broader and more consistent set of addressable issues with firms. The widespread adoption of Sustainable Investing approaches is constrained by associated costs, especially for lower cost solutions such as ETFs. It can also increase asset managers' susceptibility to home-biases and reinforce a preference for low-hanging fruit. This is not compatible with global investment mandates that portfolio managers are entrusted with. Greater efforts to deploy systematic practices that can address Sustainable Investing practices across multiple jurisdictions are necessary to ensure that principles are applied fairly across decision criteria *(Chart 3)*.

Another tool in the fight for lower costs is the need to outsource more costly components of the Sustainable Investing process either explicitly to specialist functions or implicitly to activists. However, outsourcing does not come without risk. For example, ESG ratings that rank companies by how they are performing on sustainability factors are often opaque, with ratings providers incentivised to integrate non-public data into their proprietary scoring. There can also be methodological issues relating to metrics weighting, materiality and how to consider missing information. Unsurprisingly, this can lead to large inconsistencies in assessments of sustainability scores across providers – undermining rather than enhancing information efficiency.

The Power of Regulation

Of course, it would be naive to think progress in the Sustainable Investing I have discussed so far has been mainly market led. It is also a reflection of a concerted campaign by governments across the world to aggressively deploy sustainability-related regulation and standard-setting.

In the next section I consider the impact of regulatory efforts to date and seek to answer whether government regulation offers a more effective solution to improving sustainability of economic activity. I also seek to answer whether the private sector can ever truly be a reliable partner in efforts to improve the sustainability of economic activity.

The Case for Intervention

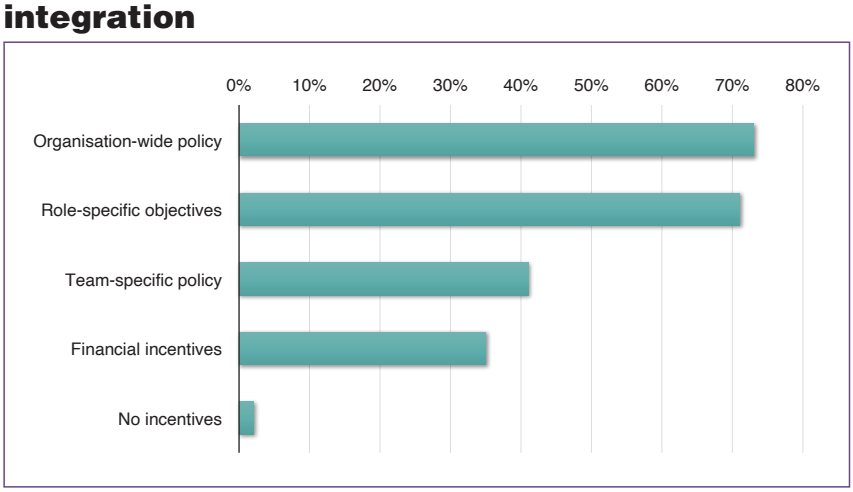
Given that sustainability problems are rooted in information-related market failures, I believe it is correct to be concerned about markets' ability to address the sustainability challenges of our time. The evidence in recent decades in favor of more aggressive government intervention to correct market failures is as numerous as it is compelling. Examples include the failure of fiduciary duties to mitigate market excesses that led to the largest financial crisis since the 1930s or the rapid rise in global greenhouse emissions and projected global temperature increases *(Chart 4)*.

In the area of Sustainable Investing, a raft of regulatory initiatives has been introduced including in key areas such as taxonomy and disclosure regarding issuers, environmental, social and governance (ESG) fund products and rating agency and benchmarks. While we have seen a divergence in approach by jurisdictions, no major economy has stood still. The EU has taken a lead through the renewed Sustainable Finance Strategy, an integral part of the European Green Deal, which will cover ESG data and ratings.

Initiatives in the United States are based upon the principles-based

CHART 3

Incentives to encourage Stewardship integration

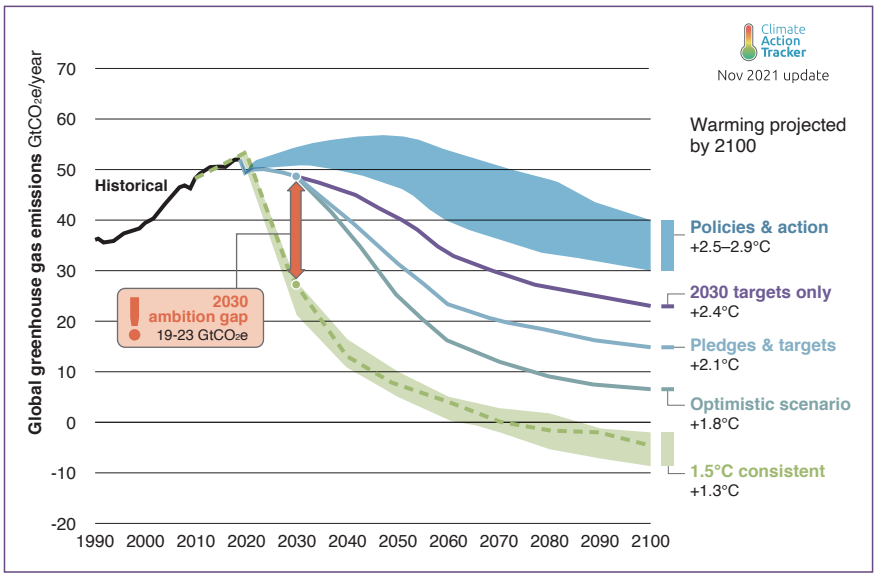


Source: Influence of UK Stewardship Code on practice and reporting, July 2022 FRC

CHART 4

2100 warming projections

Emissions and expected warming based on pledges and current policies



Source: Climate Action Tracker (2021). 2100 Warming Projections: Emissions and expected warming based on pledges and current policies. November 2021

approach to overseeing disclosure of non-financial information by publicly-listed companies. The SEC is addressing Sustainable Investing through several avenues, including enhancing disclosures related to ESG factors considered by funds and advisers, and to also expand the regulation of the naming of funds with an ESG focus.

In Japan, while there are no specific regulations that directly address Sustainable Investing, ESG disclosures or business operation, a number of laws and regulation touch on issues relating to corporate disclosures and improving the long-term investing landscape. Japan has also compiled the world's first Code of Conduct for ESG Evaluation and Data Providers. The Financial Services Agency has also recently published its proposal for sustainability disclosure with enhancements on emissions and gender diversity disclosures in the pipeline.

More Regulatory Work

In much the same way that private sector progress on sustainable-related issues has been insufficient, government regulations remain insufficient to meet stated sustainability goals. Next I look at what more could be done on the regulatory front to improve the availability and accuracy of information required for Sustainable Investing.

One critical consideration is the establishment of clearer obligations of agents across the financial chain. As stated previously, there has been a growing awareness of the accumulation of agency costs across the investment chain. This is certainly the spirit of the recent shift in soft law codes to outcome-orientated targets. However, a more explicit formulation of fiduciary duties along the investment chain may avoid a buck-passing mentality.

Another problem in reporting activity that extends across firms and financial agents is a selection bias. This can result in disclosure not being truly representative of day-to-day activity. To counter this problem, financial agents should be mandated to report on their sustainable-related work on a more systematic basis, allowing for random sampling that is more representative of firm activity.

An important question is whether these goals should be driven by legislative efforts or soft law practices? There are plenty of examples of legislation of socially unacceptable activity. This can be achieved through either blanket bans or through the taxation of products and services with high social costs or the subsidisation of socially beneficial activity.

A common feature of government intervention across jurisdictions has been a preference to cooperate with market participants to improve standards and best practices. In particular, regulators have engaged with large institutional investors to improve market functioning. In contrast, legislation has widely been considered only as a last resort.

Unsurprisingly, this has led some to conclude that these regulations have been applied in a way that is consistent with a status quo framework, rather than providing a comprehensive alternative view of the role of financial markets in society. To some this is a missed opportunity to head off an inherent conflict between profit-maximizing financial agents and an allocation of resources that is optimum for a sustainable society.

In the next section, I consider the origins of this conflict and how it sits within a wider economic framework.

Markets as Specialists

To understand why some argue financial market objectives and socially optimum objectives are irreconcilable one must migrate further into financial market theory. The conventional view embedded in finance theory is that investors should always adopt practices to maximize firms' profits and shareholder wealth.[6] This partly reflects the principle of specialization familiar in other fields of economics.

Through this prism, the introduction of sustainability goals serves to undermine the price discovery mechanism. This is because under a unified objective assumption, prices are a pure reflection of the financial fundamentals. If the assumption investors seek to maximize financial returns is invalid, it is less clear what prices will be informative about.

For example, a decision to remove single-use plastic from a company's supply chain may represent a positive buy signal for a sustainable investor but represent a sell signal for a traditional investor. Because the two investor groups seek to learn different

information from the price, they trade differently on similar signals. This cross-purposing can serve to raise the cost of capital and reduce the economic surplus.

Unsurprisingly, much of the criticism of Sustainable Investing concepts such as ESG has related to the importance of non-financial objectives in the allocation of financial assets. Both Texas and Florida have sought to limit state fund managers from investing in funds or companies that make investment decisions based on sustainability factors. In Florida, the State Board of Administration adopted a resolution updating their fiduciary duties to direct them only to weigh "pecuniary factors".

However, according to economic theory this problem should not be so difficult to solve. As stated previously, the investment chain serves to maximize the utility of both savers and borrowers through dynamic allocation efficiency.

We have become used to using wealth generation as the common goal of investors, but this is not always a sufficient benchmark to measure investor utility or the economic surplus. Recent evidence indicates that investors derive pecuniary and non-pecuniary benefits from investing in assets. Economists are now taking seriously the possibility that investors might value positive societal externalities in utility, or disutility, in addition to wealth.

This is not a problem for traditional models if Sustainable Investments require a trade-off between financial and societal returns. However, it is not always the case. There is also an important role for Sustainable Investing decisions that cannot be understood through a zero-sum game framework, i.e. where investors avoid non-sustainable activities even when there is no price impact.[7] This raises a final, and much neglected, information problem. Are we accurately measuring end-beneficiaries' utility derived from financial assets, and how it changes over time and with changes in tastes?

The information problem associated with sustainable finance makes it hard for the standard proxy for utility curves, so-called indifference curves, to capture utility maximization. Indifference curves are extremely useful in understanding dynamic allocation but they cannot perfectly replicate utility curves, especially when investors are free to reconsider their plan based on shifting preferences.

It is important to build a clearer picture of financial well-being preferences and how they evolve over time. For example, the EU's MIFID II regulations include a sustainability preference assessment to ensure clients better articulate their interests. Of course, it will take time and information to test whether this added requirement improves the ability of financial agents to allocate resources in a way consistent with end-beneficiaries' preferences. If it proves effective, it will provide a template for how to better integrate utility maximizing criteria that can be used across the investment chain and in other jurisdictions. This may upset conventional finance thinking but would remain consistent with the spirit of dynamic utility maximisation preference central to economic theory.

Conclusion

Progress on the adoption of Sustainable Investing practices has been stymied by high short-term costs associated with information provision, compilation and analysis when compared to the potential longer term and uncertain benefits. This reflects a number of information-related market failures that have rightly triggered government intervention. However, the improvement in the market for sustainable information cannot be explained solely by regulatory action. Technology and changing preferences mean that the private sector has reduced the cost of information and improved the operation of the market for Sustainable Investing-related information.

The prospect of the public and private sector working hand-in-hand to further reduce the impact of information failures has not convinced everyone. However, if the uniform wealth maximization objective embedded in financial literature is relaxed it becomes much easier to accept a greater degree of social responsibility in financial agents' decision-making.

Of course, it is easier to make commitments to Sustainable Investing goals than it is to implement them. The capacity to verify investment outcomes with investment goals is critical and to track credibility gaps so that those who free-ride or engage in greenwashing are not allowed to flourish.

1 **Jensen, M., Meckling, W.** (1976). "Theory of the firm: Managerial behavior, agency costs and ownership structure", *Journal of Financial Economics*, Vol. 3, Issue 4, pp. 305-360.

2 **Eugene F. Fama**, 1970. "Efficient Capital Markets: A Review of Theory and Empirical Work", *The Journal of Finance*, Vol. 25, No. 2, Papers and Proceedings of the Twenty-Eighth Annual Meeting of the American Finance Association New York, N.Y. December, pp. 383-417.

3 EC staff working document accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups, 2013.

4 PwC's Asset and Wealth Management Survey, 2022.

5 "No Planet B: How Can Businesses and Technology Help Save the World?" 2022 ESG Global Study, Oracle.

6 **Friedman, M.** (1970). "The Social Responsibility of Business Is to Increase Its Profits." *New York Times Magazine*, Sept.13, 1970, pp. 122-126.

7 **Zerbib, O** (2022). "A Sustainable Capital Asset Pricing Model (S-CAPM): Evidence from Environmental Integration and Sin Stock Exclusion", *Review of Finance*, Vol. 26, Issue 6, pp. 1345-1388. JS

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