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Towards a shareholder-driven transition to a green economy

Communication | Editorial | Invited contribution | **Perspective** | Report | Review

Darius Sultani
Judge Business School
University of Cambridge
ds888@jbs.cam.ac.uk

Abstract

Recent announcements by large asset management firms have indicated an increased emphasis on sustainability within the investment mainstream. This article argues that shareholders have a central role in driving the transition to a green economy and it explores the key reasons why their impact on listed enterprises is crucial. It is concluded that in order to support this development from a policy perspective, information standards must be adopted to promote transparency for the right audience. Furthermore, policy makers should direct measures towards passive investments as well. Ultimately, well-coordinated, environmental, social, and governance (ESG) investments can be leveraged as a central tool to mitigate the effects of climate change.

With his CEO letter in early 2020, Larry Fink, CEO and Chairman of BlackRock, has captured the investment world's attention. Emphasising the financial risk of climate change, he announced that the world's largest fund manager will focus on a more sustainable portfolio and an increased transparency in the investment process [1]. In doing so, BlackRock seemingly shows a strong commitment to putting sustainability at the core of its operations. Clearly, the announced strategy alone will not disrupt the entrepreneurial environment on a larger scale. In fact, due to their predominantly passive portfolio structure, a potential divestment would directly affect less than 0.01 per cent of BlackRock's total assets [2]. Nevertheless, the letter raises hopes that both investors and asset managers will follow their lead in establishing an environmentally responsible mindset at the heart of the financial sector.

The case for a shareholder-driven transition to a green economy

Despite the urgency to act upon the threat of climate change, the results of existing approaches to the overwhelming challenge have been incremental, at most. There are two key reasons for that inertia. Firstly, markets have consistently failed to put a price tag on environmental externalities of economic behaviour. As a result, growth has been fuelled by the overprovision of greenhouse gas-emitting and polluting products

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at prices below their actual social cost [3]. It is the risk of this unsustainable system that, according to Fink [1], 'markets have not reflected'. The second reason lies in the short-term orientation of both the economic and the political environment: corporate decision makers are still incentivised to quickly meet shareholders' expectations and politicians are under pressure to achieve results before the next election occurs. In this myopic system, considerations of sustainability, which require a larger time horizon, have been upstaged or neglected completely.

With large asset management corporations like BlackRock, a new group of players has entered the stage. They could finally bring powerful levers to the table and enable the change that policy makers have aspired to for years. As a result, Fink's letter might mark a crucial turning point in the young history of human answers to the climate crisis: it paves the way for a shareholder-driven transition to a green economy.

Environmental activists have often referred to the financial sector as a main contributor to climate change [2]. Therefore, the idea of relying on them to shape the green transition might sound ironic. Indeed, the financial sector has not been designed to promote sustainability and many corporate leaders still share the impression that investors see environmental goals as compromises to their returns [4, 5]. However, the idea to harness finance for good is by no means new. Building on Rudolf Steiner's vision to create non-conventional financial institutions for an anthroposophical cause, the first social banks were founded in Europe in the mid-seventies and a decade later the concept of socially responsible investing picked up momentum in the US and Japan as well [4]. Furthermore, organisations across the world have promoted the opportunities of green finance. Among others, the United Nations Environment Programme (UNEP) [6] published a roadmap on sustainable financial systems, the OECD [7] informed on investment channels to enable institutional investments in green energy, and the UK Government recently released its pioneering strategy on green finance [8]. Although these ideas had a positive impact, they were, as Jones [4] points out, 'not yet transformational'.

The power of the investment mainstream

This time, the situation has a different momentum. Previous forms of shareholder activism relied on alternative investments by progressive individuals [4]. Over the years, however, sustainable investment assets have risen globally as illustrated in Figure 1. Today, environmental, social, and governance (ESG) issues seem to have become assimilated by the investment mainstream [5]. Moreover, instead of policy proposals and regulation pushing for sustainable investments, it seems to be the shareholders' intrinsic motivation to proactively advocate a green financial sector. As a result, they might become the motor of a green transition. There are three reasons to support this view.

Firstly, demand for ESG investment products is rapidly increasing. As investors start to care about the impact of their money, asset managers are encouraged to design more sustainable portfolios in the first place [5]. In particular, the willingness of major institutional investors to stand in for ESG values has put pressure on the financial sector and plays a role in Fink's ongoing advocacy of sustainable investment. A few months before his announcement, the Government Pension Investment Fund of Japan – one of the world's largest pension funds – had shifted a considerable share of their assets away from BlackRock to emphasise their ESG-based mission [2]. As millennial investors have shown to be even more concerned about having a positive impact, this development is expected to continue further [12].

Secondly, shareholder activism has become more fashionable and since investors' intentions have started to align across industries, it might be more influential than ever [5]. Studies imply that its impact on the environmental and social behaviour of listed firms is effective. Neubaum and Zahra [13] found evidence that activism by long-term institutional owners has a positive effect on corporate social performance. Building on previous ideas of stakeholder salience, they argue that large owners exert power by 'monitoring and [. . .] challenging executives', and that corporate decisions regarding sustainability would therefore be aligned with the shareholders' pref-

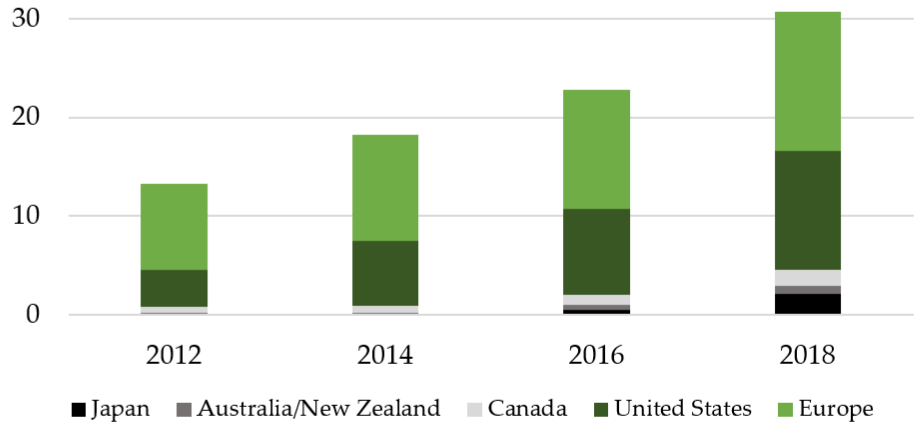

Figure 1: Sustainable investment assets by region in trillion US-$ (Data: [9–11].)

erences (pp. 112-114) [13]. By this mechanism, investors can exert influence on firms to provide more environmentally conscious products and services. This view is supported by findings showing an improved governance on green innovation in predominantly institutionally-owned firms when external shocks such as changes in the regulatory environment occur [14].

Thirdly, a high concentration in the investment market accelerates the green transition even further. There are two aspects to this argument. On the one hand, as Eccles and Klimenko [5] point out, the top ten asset managers hold more than a third of the global externally managed assets. As there is no way for them to hedge against climate change, they are forced to think more long-term and mitigate effects on the global economy. On the other hand, a few major investors can coordinate better to design their portfolio in a more sustainable way. Such a harmonisation of long-term interests tends to affect corporate social performance of firms positively [13]. Taking into account that concentrated ownership has been found to be beneficial for innovation in general [15], leveraging these effects will be crucial to drive the green transition at the required pace.

Policy implications

With these opportunities in mind, the question remains as to how the regulatory environment should be designed for the financial sector to facilitate the rise of the green economy. Here, transparency by both shareholders and stock companies has been identified as a key factor [16]. From the early days of responsible investing, information provision has been a constant and relevant pattern in its development [4]. Once implemented, a transparent financial system does not only enable efficient monitoring, but also fosters collaboration between investors, for example through project exchange networks as suggested by the OECD [7]. Therefore, initiatives like the Task Force on Climate-Related Financial Disclosures should be endorsed across the world, as done by the UK Government in 2017 [8].

However, information is purposeless to investors as long as it is primarily released for non-financial stakeholders like NGOs [5]. Current ESG assessments are predominantly qualitative and come in a variety of forms. In order to make investments comparable, the message needs to be conveyed in a language that financial decision makers are able to comprehend quickly and intuitively [17]. Thus, environmental and social impact ought to be measured in a way that is comparable to other metrics of business analysis [17]. To tackle this problem, joint standards need to be developed and put into use. They can build on existing approaches like the ESG metrics advocated by leading scholars in the U.S. [18], or the work of the European Union, which recently agreed on a taxonomy for sustainable investments [19].

Whichever measures will be taken, they must cover the vast portion of passive investments as well. Therefore, indexing companies have to be taken into consideration by the regulator as they are the ones who automatically choose assets for mainstream managers [20]. If these entities have to live up to transparent ESG standards as well, there is hope that a competition for sustainable passive portfolios will arise. As a result, they are encouraged to adjust their algorithms towards more sustainable assets.

Conclusions

To conclude, although announcements alone are not going to have any transformative effect, they promote the shareholder-driven transition to a green economy. If investors and asset managers can leverage the learnings from almost five decades of non-mainstream sustainable investing, they have the potential to induce a major shift in corporate decision-making. The main factors in their future impact are a growing demand for ESG products, the power of shareholder activism, as well as a highly concentrated investment market. Policymakers should embed this momentum in an environment of transparency and common standards. In that, there is hope to induce far-reaching changes across industries and to have found an effective tool to strive for climate change mitigation.

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About the Author

Darius is a member of Darwin College and an MPhil candidate in Technology Policy at Judge Business School, University of Cambridge. He has a background in engineering from FAU Erlangen-Nuremberg, UC San Diego, and TU Munich. Darius' interests lie in environmental economics, sustainable innovation systems, and the interactions between public and private institutions. He is also a peer reviewer for the CJSP.

Conflict of interest The Author declares no conflict of interest.