

Sustainable Finance and the Tragedy of the Commons: Does the investor care?

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Abstract:

Even as the stakeholders work towards making the world a better place to live in, someone is faltering somewhere. The paper considers the ‘myth’ around sustainable finance and how the concept is being used by the fund managers, companies in need of funds and investors in need of higher returns, to make better returns. The paper also tries to study how this is resulting into tragedy of the commons, with companies considered sustainable under the ESG parameters may not be effectively fighting for the cause.

Introduction

Across the globe, human activities end up as greenhouse gases into the atmosphere, in spite of the businesses and governments realizing the potentially disastrous direct impact on climate and the indirect impacts on various resources used by mankind such as fishes, crops and livestock (Sandeep Bhasin, 2019)¹. Investment decisions based on the concept of sustainability is the new trend across the developed and the developing world now. The investors evaluate their investments’ performance purely based on financial measures alone. Hundreds of thousands of professional across the globe work towards finding the best performers in debt and equities, measuring the risk factors, aligning the investment strategies with the objectives of the investors, ensuring better returns. In India alone, the Assets Under Management (AUM) in the Mutual Fund Industry stands at over INR 27 trillion as on June, 2020. As of December 2019, the investments managed by the Portfolio Management Services (PMS) in India stood at INR 17 trillions². As an opportunists, the fund managers decide on behalf of the investors to put the money in stocks or bonds that promises better returns. Most of the these investments, as my understanding goes happen with short-to-mid-term time range, with mid-to-high churning in the portfolio to catch the upswing of the stocks or promises made by specific bond papers. But, there is a small section of investors, who take the investment decisions with an eye to environmental or social issues, not just financial returns. These investors are looking for sustainable financial options.

Socially conscious investing is exploding as a practice and at some point I expect it to be indistinguishable as a product or service or category. All investment practices will consider environmental, social, and governance (ESG) metrics because some of those metrics are financially material, meaning decision-useful pieces of

¹ Sandeep Bhasin, Common Pool Resources - the problem of sustainability, March 2019, Volume 6, Issue 3, pp 228 – 238, Journal of Emerging Technologies and Innovative Research

² https://www.business-standard.com/article/markets/pms-asset-growth-outpaced-client-additions-in-2019-shows-sebi-data-119122301210_1.html

information. Just look at Uber to understand the importance of diversity and product safety or at car manufacturers scrambling to develop a competitive advantage in electric cars as countries seek to decarbonize their economies and fight pollution. In both cases, social and environmental metrics matter for the business's financial success³.

As with many forms of sustainable finance, greenwashing⁴ is a major worry. One potential problem is the data on which the change in borrowing costs depend, major concern being self-reported figures. If not self-reported, another option available with the lenders and borrowers is to rely on ESG scores calculated by specialist data firms and some credit-rating companies such as Standard & Poor's and Moody's. Even as the professionals get into certifying these borrowers, the ESG-raters use opaque methods and rarely agree on which companies are sustainable⁵.

Even as the Borrowers and the Lenders hunt for newer means to implement innovation in the financial sustainability, the investors, in general play a short-to-mid-term game, looking for higher returns. Sustainable finance is trying to address this problem with helping the investors consider silent wars being fought for the future. Green buildings by large conglomerate become a major news to be added in the Annual Reports of these corporates but are these organizations really working towards building a sustainable future for the next generation? This is what needs to be addressed. We can address this only by expanding the horizon to long-term. An example is one of the largest player in FMCG space in India. Even as they spread the news of them taking initiatives in sustainability space⁶, these companies have failed continuously on the ground⁷. Many of these large organizations have used the mandatory Corporate Social Responsibility funds, which were designed originally to be spent on betterment of the society in general, being used for political gains⁸. The concept of ESG, as was conceived, fails to meet its objective, thus leading to Tragedy of the Commons.

The Tragedy of the Commons and ESG

The tragedy of the commons is a situation in a shared-resource system where individual users, acting independently according to their own self-interest, behave contrary to the common good of all users by depleting or spoiling the shared resource through their collective action (Hardin, 1968)⁹. The various studies done over the last four decades and more looked at the behaviour of humans through the lens defined by Garrett Hardin, trying to understand why we behave the way we do. With the pressure of innovation and possible differentiation in products being offered in the financial sector, many fund managers started looking at criteria that could work with the investors at large. World's first global green bond fund was launched in June 2019

³ <https://hbr.org/2017/12/can-index-funds-be-a-force-for-sustainable-capitalism>

⁴ Greenwashing is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly

⁵ <https://www.economist.com/finance-and-economics/2020/02/15/companies-are-tying-their-loans-to-measures-of-do-goodery>

⁶ <https://www.foodbev.com/news/unilever-to-invest-1bn-euros-in-sustainability-projects/>

⁷ <https://www.edie.net/news/5/Report--Big-name-brands-failing-to-address-plastic-pollution-crisis--despite-improved-pledges/>

⁸ <https://thewire.in/business/modi-government-csr-political-gain>

⁹ Garrett Hardin, Tragedy of the Commons, *Science* 13 Dec 1968: Vol. 162, Issue 3859, pp. 1243-1248 DOI: 10.1126/science.162.3859.1243

jointly by IFC, a member of the World Bank Group, and HSBC Global Asset Management. The fund targeted “real economy” issuers in emerging markets, increasing access to climate finance and promoting the further development of green bond markets¹⁰. The fund managers targeted at raising \$500 - \$700 million but finally managed to raise \$474 million¹¹.

According to the Global Sustainable Investment Alliance (GSIA)¹², an umbrella group, fully \$23 trillion, or 26% of all assets under management in 2016, were in “socially responsible investments” that take account of Environmental, Social and Governance (ESG) issues¹³. This figure crossed the mark of \$31 trillion by the end of March, 2018¹⁴.

GLOBAL SUSTAINABLE INVESTMENT ASSET GROWTH (2010-2018)



Figure 1: Global Sustainable Investment Asset Growth (2010-2018) - www.gsi-alliance.org

GLOBAL SUSTAINABLE INVESTING ASSET ALLOCATION 2018

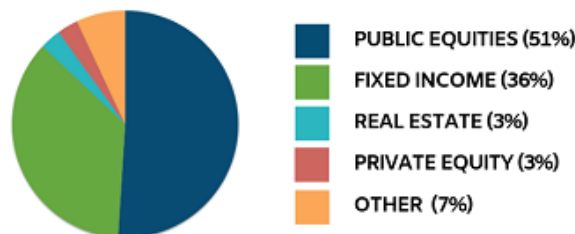


Figure 2: Global Sustainable Investment Asset Allocation (2018) - www.gsi-alliance.org

¹⁰<https://ifcextapps.ifc.org/IFCExt/Pressroom/IFCPressRoom.nsf/0/14FEF5C7A7CACFCF8525840F002CA127>

¹¹ <https://ifcextapps.ifc.org/IFCExt/Pressroom/IFCPressRoom.nsf/0/AD2A1792E469868B8525856E001151B7>

¹² GSIA is a collaboration of membership-based sustainable investment organizations around the world

¹³ <https://www.economist.com/the-economist-explains/2018/04/17/what-is-sustainable-finance>

¹⁴ <http://www.gsi-alliance.org/newsletter/latest-newsletter/>

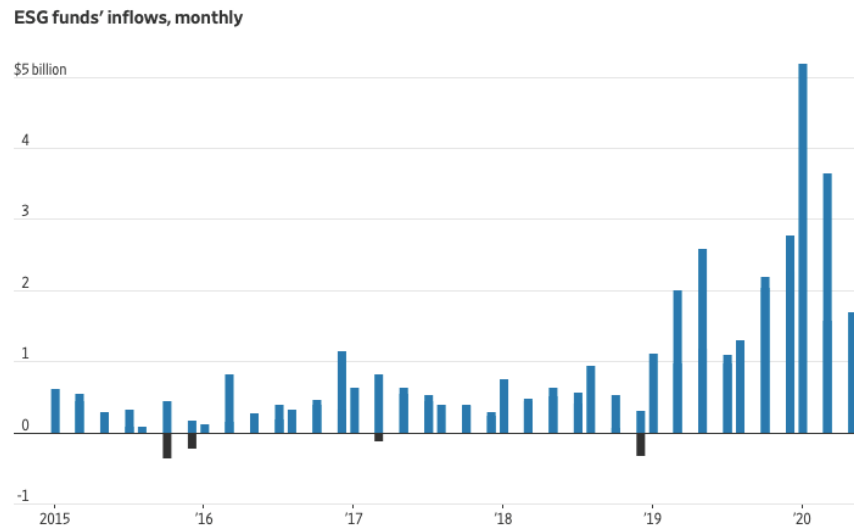


Figure 3: Monthly inflow in the ESG funds – www.wsj.com

Such sustainability-linked loans are now getting onto a favour from investors and issuers across the globe, especially the developed world markets. The first such loan was issued in the year 2017; in just two years, the issuance had increased to \$122 billion (BloombergNEF, 2018)¹⁵. This segment of investments now make up a quarter of sustainable-debt issuance, which is just over 1% of global debt issuance. In the first four months of 2020, investors poured a record of at least \$12.2 billion into funds that say they invest in environmental, social and governance practices¹⁶. Once considered to be a niche investment, ESG funds have multiplied in recent years, as awareness has increased around topics such as climate change and boardroom diversity. Since the start of 2015, the total number of U.S. open-ended and exchange-traded ESG funds across all asset classes has nearly tripled. At the end of April 2020, there were 307 available funds that significantly emphasized ESG factors or themes¹⁷.

Even though this in comparison, is less than the green bonds, which tie the proceeds of bond issues to investment in environmentally friendly projects, the newfangled loans are quickly catching up. We may note that the sustainability-linked loans are not linked to specific projects. The borrowers are assessed based on their performance on some Environmental, Social and Governance (ESG) measures. It may be noted that this flexibility makes these loans are so popular amongst the borrowers and the issuers alike. We can't deny the fact that companies, especially those looking at the share market to raise capital, find this option a reason for good public relations, especially in their Annual report. From the investors' perspective, the definition of an ESG investment matters the most. For example, Of the most heavily invested ESG related stocks, Microsoft and Tesla feature right on top (April 2020).

¹⁵ <https://about.bnef.com>

¹⁶ <https://www.wsj.com/articles/esg-investing-shines-in-market-turmoil-with-help-from-big-tech-11589275801>

¹⁷ <https://www.wsj.com/articles/esg-investing-shines-in-market-turmoil-with-help-from-big-tech-11589275801>

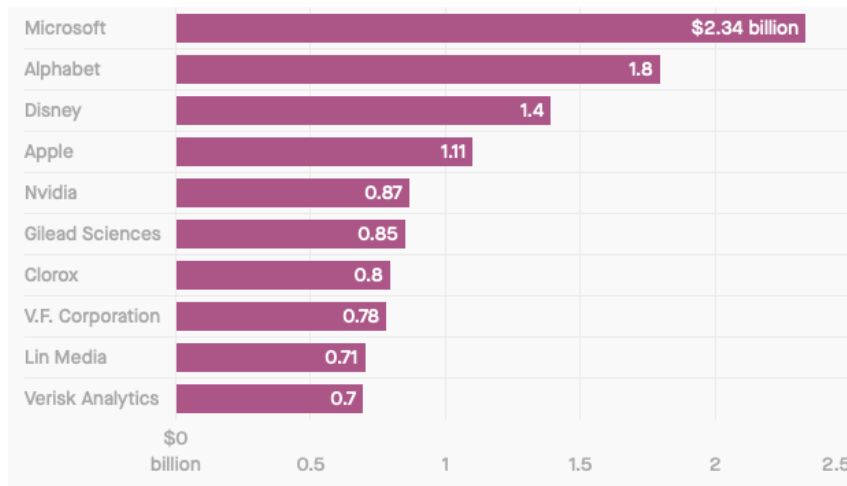


Figure 4: Top ESG based stocks invested in by the fund managers in 2019-20¹⁸

We may also note that many firms in industries blamed for the ‘world’s ills’ have issued loans. The single biggest issuer in the year 2018-19 was Shell, an oil giant, with \$10 billion linked to reducing its carbon footprint. Other borrowers include big players from fast-food chains and airlines. Interest rates may be nudged down by around 0.05-0.1 percentage points for good behaviour¹⁹. Taking this forward, with pressure on the firms to raise money, some manage to create a dissonance in the minds of the investors by creating a new category of funds. One such case is of Cadent Gas Limited, which issued a bonds worth \$560 million termed as Transition Bonds²⁰, a nomenclature that is used for companies that are still cleaning up their businesses. From the investors’ perspective, these companies still manage to qualify for ‘do-good’ pool of investment opportunities under ESG parameters.

While we still try and understand the efficacy of these investment vehicles, one thing that raises the question is where exactly does the responsibility of selection of vehicle(s) stop(s). As with any investment option, here, again, we are left with the ‘faith’ factor: the faith that the issuer of the bond or the fund manager has done her study at length to avoid any issues that would raise further questions on the investment decisions.

Is it a tragedy?

As I understand, most of the investments under the category of sustainability driven ESG funds and bonds work on the assumption that the investors are looking for a better world to live and they have the monies to support this initiative. Bankers, government officials and other stakeholders are trying to compile guidelines for this new asset class, even as The coronavirus pandemic and resulting economic downturn has prompted a wave of bond sales as companies look to build up their cash as a buffer in more uncertain times²¹.

¹⁸ <https://qz.com/1803716/microsoft-is-the-biggest-recipient-of-esg-rsi-stock-fund-investment/>

¹⁹ <https://www.economist.com/finance-and-economics/2020/02/15/companies-are-tying-their-loans-to-measures-of-do-goodery>

²⁰ <https://www.wsj.com/articles/companies-try-new-tactic-to-tap-climate-sensitive-investors-11593356400>

²¹ <https://www.wsj.com/articles/companies-try-new-tactic-to-tap-climate-sensitive-investors-11593356400>



Figure 5: Spreads over comparable government bonds on green bonds and on investment-grade bonds with maturities of 7–10 years

Even as these companies try and use the ‘novelty’ of ESG as a means to attract the investors in these tough times, the investors, especially those who have a desire to change the social norms, are genuinely worried about the ecological impact of modern life or consider business ethics as the barometer for sustainable future growth, while also generating high returns, stay active in the market to invest in these companies. But does this really work the way it is envisaged?

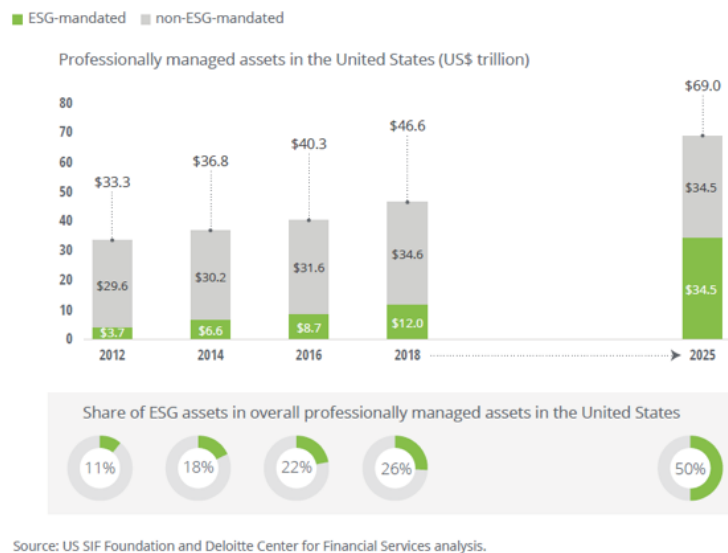
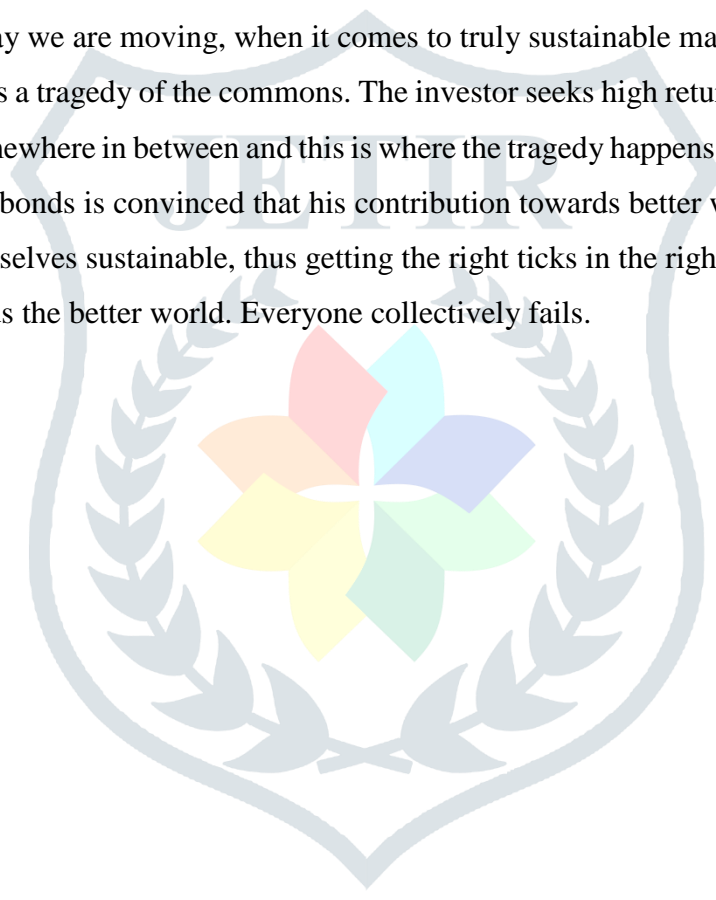


Figure 6: ESG mandated funds are expected to make up to 50% of all managed assets in the United States

Does the investor care?

As emerging technologies, such as Artificial Intelligence enable better-quality ESG data and the regulatory landscape becomes clearer, institutional, and retail investors are expected to increasingly demand that ESG factors be applied to a greater percentage of their portfolios. In this scenario, ESG assets should continue to grow at a 16

percent compound annual growth rate (CAGR), totalling almost US\$35 trillion by 2025²². Having said that, we must understand that most of the ESG based investment options are from companies that are directly or indirectly contributing to the pollution across the globe, for example, the technology-based giants²³ or leading oil companies²⁴. Tesla is one of the favourite ESG based stocks for the investors but their records on reducing the pollution is not all that great²⁵. Do these companies really qualify to be ESG based investment options? Or are we just considering the promises these companies make keeping an eye on the future²⁶, while taking the investment decisions? As an investor, one looks for future growth prospects of the company under consideration. With the pollution-related regulations across the globe coming into existence, the companies try and meet these norms by displaying they care for the environment. Unfortunately, this may not be the whole truth: for example, one of the favourite ESG-based stocks Tesla uses (a lot of) plastic²⁷, while making that highly sought after car that works perfectly on the sustainability parameters. The fact that merely 7% of the plastic is actually recycled²⁸ speaks a lot about which way we are moving, when it comes to truly sustainable manufacturing initiatives. With these facts all around us, it is a tragedy of the commons. The investor seeks high returns, the companies seek high investments. They meet somewhere in between and this is where the tragedy happens. Every Investor, who invests in the ESG-based stocks or bonds is convinced that his contribution towards better world is high; the companies work towards keeping themselves sustainable, thus getting the right ticks in the right boxes. Everyone thinks the other will contribute towards the better world. Everyone collectively fails.



²² <https://corpgov.law.harvard.edu/2020/03/11/advancing-esg-investing-a-holistic-approach-for-investment-management-firms/>

²³ <https://www.huckmag.com/art-and-culture/tech/the-tech-industry-has-a-serious-sustainability-problem/>

²⁴ <https://www.wilderness.org/articles/blog/7-ways-oil-and-gas-drilling-bad-environment>

²⁵ <https://www.wired.com/2016/03/teslas-electric-cars-might-not-green-think/>

²⁶ <https://blogs.microsoft.com/blog/2020/01/16/microsoft-will-be-carbon-negative-by-2030/>

²⁷ <https://www.plastivision.org/blog/the-role-of-plastic-at-teslas-gigafactory/>

²⁸ <https://mitte.co/2018/07/18/truth-recycling-plastic/>