Financial Incentives for Improved Sustainability Performance

The Business Case and the Sustainability Dividend

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Key Questions

• Is it in a company’s financial interest to improve its environmental and social performance?
• Do financial markets recognise and reward such improvements?
• What are the barriers?
• What is needed to address the barriers?
The Business Case

• Theoretical case
• Case studies of companies
• Multi-company statistical studies
  – Accounting returns
  – Financial market performance
Cost Advantages of Sustainability

- Clean technologies are more efficient
- Recycling, reduces raw materials cost
- Good working conditions mean higher productivity and few disputes
- Being prepared for regulatory change
- Reduced risk of compensation and damage suits
- Reduced cost of capital and insurance premiums
- Reduced transactions costs
Market Advantages of Sustainability

- Access environmentally sensitive markets
- Secure higher prices for products
- Retain existing markets as they become more sustainability sensitive
- First mover advantages
- Investment in the “survival economy”
Reputation Advantages

• Less risk of consumer boycotts
• Licence to Operate
  – Good relationships with regulators
  – Good relationships with community
• Motivating factor for employees
• “Insurance value” — more supportive responses from stakeholders if there is a problem
• Investor perceptions
The Business Case Theory

Cost Advantages - Highly relevant to mining

Market advantages – only relevant for niche products eg diamonds

Reputation advantages - Most relevant for:
- Community relations
- Ability to attract employees
Case Studies

Useful as illustration of potential benefits of addressing sustainability

BUT:

• Potential rather than actuals
• Incomplete costs and benefits
• Cherry-picking
• No positive mining case studies – only negative ones
Linking Financial and Environmental Performance

**Positive Linkage** (Hart and Ahuja 1996)
- Emissions efficiency against ROS, ROA and ROE

**Negative Linkage** (Jaggi and Freedman 1992)
- Emissions efficiency against net income, ROA, cashflow/equity ratio

**No Positive Linkage but No Penalty** (Cohen et al 1997)
- 8 environmental variables eg superfund sites, fines against ROA and ROE

**No Significant Linkage** (Louche 1998)
- CO2, Energy use, water use and waste against ROA, ROE, and earnings per share
The Link with CSR

Positive Linkage (Verschoor 1998)
- Financial performance rankings for companies with or without codes of ethics

Partially Positive Linkage (Berman et al 1999; Waddock and Graves 1997)
- KLD rankings against ROA

No linkage (Aupperle et al 1985)
- CEO orientation to CSR against ROA

Financial performance leading CSR (Preston and O’Bannon 1997)
- Fortune corporate reputation rankings against ROA, ROE, and ROI
Shortcomings

- Limited set of sustainability issues
- Conflicting results
- Mainly in the US and of US operations
- Limited evidence for external impacts eg environment
- Direction of causation unclear
- Not very relevant to mining challenges eg overseas operations
Do Financial Markets Reward Sustainability Performance?

Surveys of financial institutions
- More interest in commercial lending than asset management
- More interest in risks rather than opportunities

Statistical studies of links between sustainability performance and financial market indicators
- Cost of capital studies
- Event studies
- Longer-term studies
- Hidden value/hidden cost studies
Cost of Capital Studies

Environmental Performance and Systematic Risk
- TRI emissions and environmental management system (Feldman et al 1997)
- Superfund liability (Garber and Hammit 1997)
- Evidence stronger for large companies

Reputation and Perceived Risk
- Fortune AMAC reputation rankings (Srivastava et al 1997)
- AMAC mainly driven by financial variables
Event Studies

• Strong evidence for US that environmental events affect company market value
• Also affects value of other companies
• Less conclusive outside of US eg Canada
• Social events less well-studied
  – studies mainly on product recalls and law violation and not on “external” social issues
Implications of the Event Studies

• Investor response influenced by the context e.g. regulatory system
• Not clear whether decline in market value reflect losses incurred by the companies
• Does market reaction come too late?
• Will companies with systematic approaches to sustainability be rewarded?
Studies of “Long”-Term Impact

- 4 studies show evidence of a long-term link
- Emphasis on reputation and intangible asset value
- Strengths:
  - One examines standards for non-US operations
- Main weaknesses:
  - 3 address environment only
  - Direction of causation unclear
Hidden Value/Hidden Cost

- Most studies not in public domain
- One published study (WRI Repetto and Austin 2000)
  - Forward-looking scenario approach
  - Assess company exposure to environmental risk
  - Differences between companies not reflected in their financial statements
  - Evidence of hidden costs
  - Financial analysts can benefit from addressing environmental issues
What are the Barriers?

• According to surveys of financial institutions:
  – Lack of comparable data
  – Difficulty to translate sustainability issues into financial terms
  – Perception that environmental issues are not material to profitability
Translating Sustainability Issues into Financial Terms

• Not just a case of lack of information
• Forward-looking approach needed
• Subjectivity of assessing risks
• provide a methodology
• But the mining sector is more challenging
• Scenarios of society’s expectations rather than just regulatory change
Demonstrating That Sustainability Issues Are Material

- Needs more than better methods or data
- Empirical studies of the business case are not conclusive
- Address factors that drive the business case:
  - regulation
  - reputation
The Role of Regulation

• Many studies of the business case imply regulatory action
  – Response of investors to environmental events depends on the nature of the regulatory system
  – WRI scenarios focus on regulatory change
  – Concerns about reputation relate to increased attention from the regulatory authority

• The business case depends on the regulatory system and is not a substitute
The Role of Reputation

• Important where regulation is weak
• But why? - Can’t expect consumer reaction
• Investor reaction only if:
  – Other stakeholders likely to react
  – Reputation loss is contagious
• Financial institutions may have closer consumer connection than mining sector
• Regulations on disclosure affect extent of reputation contagion
Conclusions

• Financial institutions have an important role in leveraging change in the mining sector
• Don’t rely too much on the business case
• Need to create the right conditions
  – Improvements in reporting necessary but not sufficient
  – More effective enforcement of:
    • environmental and social regulation
    • Company disclosure on risk management
  – Greater transparency