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MAKING SUSTAINABLE FINANCE SUSTAINABLE

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Abstract The purpose of this paper is to highlight some issues and proffer solutions that can make sustainable finance become sustainable. One, there should be greater focus on how some aspects of finance can contribute to sustainability. Two, light-touch regulation may be needed to grow the relatively small sustainable finance sector. Three, there is a need to adopt a bottom-up approach to grow the sustainable finance sector. Four, voluntary ESG disclosures and related sustainability reporting should be encouraged. Five, short-term financial instruments can complement long term instruments in sustainable financing.

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Introduction

The purpose of this paper is to highlight some issues and proffer solutions that can make sustainable finance become sustainable. I begin by defining the sustainable finance concept. Next, I review the literature on sustainable finance. Thereafter, I highlight the issues that might make sustainable finance become sustainable.

What is sustainable finance? The European Commission defines sustainable finance as finance that takes into account environmental, social and governance (ESG) considerations when making investment decisions in the financial sector, thereby leading to increased longer-term investment into sustainable economic activities and projects (EC, 2020).

ICMA (2020) defines sustainable finance as finance that incorporates climate, green and social finance while also adding wider considerations concerning the longer-term economic sustainability of organisations and the stability of the overall financial system in which they operate. These definitions of sustainable finance have two things in common which is the emphasis on 'long-term' orientation and sustainable financing. Fatemi and Fooladi (2013) support this idea. They argue that the short-term orientation, which is dominant in mainstream finance, cannot lead to the creation of sustainable wealth. They propose a shift from short-term orientation towards long term orientation in sustainable finance.

Sustainable finance is becoming a big issue in the financial sector of developed countries and emerging economies. The main idea behind sustainable finance is that finance should make an appropriate contribution to sustainability. The current rally for sustainable development began with climate change mitigation and control, and transitioned to sustainable finance, and then transitioned to green finance and green bonds. Several factors have led to the move towards sustainable finance such as the need for finance to contribute to environmental sustainability (Schoenmaker, 2018); the need to generate sustainable wealth for the present and future generations (Fatemi & Fooladi, 2013), the need to make a transition towards sustainable banking (Jeucken, 2010); the need for finance to contribute to the mitigation of climate change (Ryszawska, 2016), and on-going policy support for sustainability and sustainable development (Kuhn, 2020). In this paper, I discuss some issues associated with sustainable finance, and proffer solutions that can make sustainable finance become sustainable.

The discussion in this paper contributes to the emerging literature on sustainable finance. It also offers insight on specific improvements that can be made to make the sustainable finance agenda become successful.

The rest of the paper is structured as follows. Section 2 discusses the literature. Section 3 presents the issues that need to be addressed. Section 4 suggests some solutions to make sustainable finance sustainable. Section 5 summarizes the solutions. Section 6 concludes.

Literature review

Migliorelli (2021) argues that sustainable finance should be viewed as 'finance for sustainability' in policy and industry circles. Zioło et al., (2021) show that sustainable finance plays a fundamental role in implementing some sustainable development goals. Schoenmaker (2018) argues that the sustainable finance model brings about a shift from the narrow shareholder model to the broader stakeholder model. Ryszawska (2016) argues that a revolution in finance such as 'suitable finance' is needed to support the transition towards sustainable development, a green economy or a low carbon economy, and the adaptation and mitigation of climate change. Fatemi and Fooladi (2013) propose a sustainable value creation framework for sustainable finance. The proposed framework demonstrates how firms can internalize the social and environmental costs of their activities. Schoenmaker (2018) also developed a framework for sustainable finance. The framework shows that some financial institutions have started to avoid unsustainable companies, preferring to invest and lend to companies that balance financial, social and environmental goals towards the creation of long-term value for the wider community. Contreras et al., (2019) suggest that sustainable finance in the banking sector can be achieved through self-regulation. They show that banks are more likely to adopt sustainable finance principles due to peer pressure, and even without peer pressure, banks collaborating with adopters are more likely to become adopters themselves.

Some issues that need to be addressed

Not all aspects of finance can contribute to sustainability

The main idea behind sustainable finance is that finance should contribute to sustainability. This implies that all aspects of finance should contribute to sustainability. This is interesting because the term 'finance' encompasses all financial sector agents, financial instruments, settlement/payment systems, financial product and service offerings. This implies that all these aspects of finance should contribute to sustainability. This idea, although sound in principle, is impossible to achieve in practice. It is difficult to make all aspects of finance contribute individually to sustainability while still maintaining their individual usefulness as a tool for traditional financial intermediation. This is because the function of each aspect of finance needs to be redefined in a manner that makes it less useful for traditional financial intermediation purposes, and more useful for sustainable financing and development purposes.

Stringent regulation, particularly a stick and carrot regulatory approach, can increase the regulatory burden on financial institutions and make them exit the sustainable finance sector

Regulating the sustainable finance sector is a good idea. The important issue is the type of regulation. Many studies and reports have called for strict regulation of sustainable finance. They propose a carrot-and-stick regulatory approach where firms are rewarded for complying with ESG and other sustainability criteria and punished for failing to comply (see. Drummond & Marsden, 1995; Mendoza & Wielhouwer, 2015; Zhang, 2020; Szapiro & Pettit, 2020; Ramos Muñoz et al., 2020; Kahlenborn et al., 2017). The major issue with strict regulation of the sustainable finance sector is that the financial sector is already heavily regulated. New regulations may increase the burden on financial institutions, forcing them to choose between transferring the compliance cost to clients or choosing to exit the sustainable finance sector and to move to other areas of finance. Whichever option is chosen, it will not be in the best interest of clients in the sustainable finance industry. When financial institutions begin to exit the sustainable finance sector, the goals of the sustainable finance agenda will not be achieved.

The top-down approach to promoting sustainable finance might become its downfall

A top-down approach to promoting sustainable finance is one that requires multinational support to achieve local sustainable finance objectives. It involves creating mandatory disclosure rules, policies or standards by national governments which companies, financial institutions, investors and individuals engaged in a relevant sustainable financing activity must comply with. One merit of a top-down approach to promoting sustainable finance is that it provides oversight and policy support for activities in the sustainable finance sector.

One major issue with the top-down approach is that it introduces friction among two or more consenting economic agents engaged in sustainable financial transactions. It can increase transaction costs, thereby affecting the pricing of green financial products and services. It can also limit the extent of creativity and innovation in the sector. Also, under a top-down approach to promoting sustainable finance, a policy-induced boom in the sector is more likely to occur than a private sector-led boom. This is because private investors and financial institutions generally tend to stay away from heavily regulated financing and investment activities (particularly, risk-loving investors) as they prefer to participate in financing and investing activities that have less regulatory scrutiny or oversight. An example of this is the credit derivatives boom of 2006 in the United states. The credit derivative market was not tightly regulated, and some argued that it was loosely regulated. Many financial institutions freely participated in the market and traded in derivative instruments which led to a boom up until 2007. The credit derivatives market was subsequently regulated after the 2008 global financial crisis.

Mandatory corporate ESG reporting may become counter-sustainable

Environmental, social and governance (ESG) reporting is an important aspect of sustainable finance. Making ESG reporting a mandatory requirement for companies through regulation has the merit of ensuring that companies take responsibility for the consequence of their business decisions on the environment and society. However, one unintended consequence of mandatory ESG is that it makes companies reduce the

ESG reporting process to a mere paperwork activity especially when firm executives do not believe it contributes anything significant to corporate financing and investment activities. In this context, mandatory ESG reporting will have no value to firm executives and will not transform corporate behavior even though regulators and standard setters take ESG reporting seriously.

Long-term sustainable finance will replace short-term liquidity with illiquid exposures, thereby making liquidity crises and government intervention more frequent

A major feature of sustainable finance is its long-term orientation (see Fatemi & Fooladi, 2013; Schoenmaker, 2018). A long-term orientation to sustainable financing can reduce or eliminate short-term liquidity in some segments of financial markets, and lead to increase in illiquid exposures. The danger of eliminating short term liquidity in any segment of financial markets is that liquidity freeze will become more frequent, and government intervention through liquidity provision to affected segments of the market will become too frequent. There are strong concerns that the sustainable finance agenda, when fully implemented, can give rise to many illiquid exposures which may lead to a liquidity crisis at some point in financial markets, and the government has to intervene through liquidity provision to restore confidence in financial markets. The constant loop of government intervening in financial markets due to liquidity shocks suggest that sustainable financing – which emphasizes long-term orientation– is not sustainable.

Solutions: some ways to make sustainable finance sustainable

Only some aspects of finance should contribute to sustainability

One idea to address this issue is to focus only on some aspect of finance for sustainability purposes. Some aspect of finance should contribute to sustainable finance, not all aspects of finance. This is important because it creates an opportunity to focus only on some segment of the finance industry and identify ways to ensure that funds flow from those segments to sustainability activities and projects. However, if proponents of sustainable finance insist that all aspects of finance should contribute to finance, the social consequence of such an idea is that it will make the sustainable finance agenda have the resemblance of a campaign against traditional finance, or a takeover of mainstream finance, by a new group of environmental globalists. This can lead to resistance, and can negatively affect the global sustainable development agenda.

Light-touch regulation can reduce the regulatory burden on financial institutions and encourage them to participate actively in the sustainable finance sector

Light-touch regulation can reduce the regulatory burden of financial institutions in the sustainable finance sector, and encourage unprecedented innovation in sustainable financing. Currently, the sustainable finance sector is relatively small yet growing compared to other areas of finance. Light-touch regulation can help to grow the sustainable finance industry.

A bottom-up approach to promoting sustainable finance is better

If we want to witness a boom in the sustainable finance sector, we need to begin to think about a bottom-up approach to growing the sustainable finance sector. A bottom-up approach is one that allows financial sector agents to freely choose how they wish to transact business in the sustainable finance sector, how to draw up contractual agreements on a case by case basis, determine the time horizon on each transaction whether short-term or long term, learn from the outcomes of each transaction, and determine their expected return or profit margin aligned with sustainability. This will attract other firms to the sustainable finance sector, and may lead to a boom in the sustainable finance sector. Then the government, through light-touch regulation, can supervise compliance with minimum rules, and ensure there is fairness in dealings with investors, financial institutions and borrowers.

Corporate ESG reporting should be voluntary

ESG disclosures and related sustainability reporting should be voluntary. When ESG disclosures are voluntary, companies can decide to learn about the value of ESG factors, learn about how it leads to a change in corporate behavior, understand how it can improve their profitability prospects, integrate them into their corporate strategy, and make disclosures that are more meaningful to investors and shareholders. Making sustainability disclosures voluntary is supported in the literature (see, for example, Healy & Palepu, 2001; Barman, 2018; Jiang & Fu, 2019). Healy and Palepu (2001) find that voluntary disclosures are more value-relevant to investors than mandatory disclosures especially when voluntary disclosures are credible and accurate. In sum, ESG disclosures should be a voluntary, not mandatory, requirement .

A short-term orientation can complement a long-term orientation in sustainable financing

The sustainable finance agenda should not discourage short-term orientation among players in the sustainable finance industry. A short-term orientation in financial markets exists because the future is uncertain due to information asymmetry, changing policies, inconsistent policies, changing environmental conditions, unexpected borrower defaults, etc. These are some of the reasons why most investors and financial instruments have a short term orientation. The goals of sustainable finance can be achieved with both short-term and long term financial instruments. Short-term debt can be issued to finance environmental-damage mitigation activities designed to be completed within a few months or a year. Investors with a short-term focus may wish to invest in short-term green projects in exchange for a fair return. Also, banks may be more willing to support green firms by issuing short-term financing instruments such as commercial paper or overdrafts to fund environment-friendly activities and projects rather than issuing long-term debt instruments. Therefore, a short-term orientation should not be seen as anti-sustainability. Rather, a short-term orientation can complement a long-term orientation in sustainable financing.

Summary of the suggested solutions

In this section, I summarise the suggested solutions to make sustainable finance sustainable:

1) Policy makers and non-governmental organizations should focus on the contribution of some aspect of finance to sustainability. Some aspect of finance should contribute to sustainable finance, not all aspects of finance.

2) Light-touch regulation can help to grow the relatively small sustainable finance sector. Strict regulations can be introduced in the future when the sector has witnessed massive growth. But strict regulations are not needed in the early stages of the development of the sustainable finance sector.

3) Adopting a bottom-up approach will grow the sustainable finance sector.

4) ESG disclosures and related sustainability reporting should be voluntary. When ESG disclosures are voluntary, such disclosures will be meaningful to firms, investors and shareholders.

5) The sustainable finance movement should accommodate the short-term orientation of investors and financial instruments. Short-term orientation can complement long-term orientation in sustainable financing.

Conclusion

In the paper, I highlighted some issues that need to be addressed and proffered solutions that can make sustainable finance become sustainable.

The suggested solutions are the following. One, there should be greater focus on how some aspect of finance can contribute to sustainability. Two, light-touch regulation may be needed to grow the relatively small sustainable finance sector. Three, there is need to adopt a bottom-up approach to grow the sustainable finance sector. Four, voluntary ESG disclosures and related sustainability reporting should be encouraged. Five, short-term financial instruments can complement long term instruments in sustainable financing.

There is currently no one right path towards sustainable finance as long as the principles of doing less

harm to the environment and striving to do more good to the environment are respected and incorporated. Of course, some issues will be difficult to address immediately. There will be some debate and contention about the horizon of sustainable financing and investment instruments and its appeal to short-term investors, debates about the extent and limit of government intervention, and contention about the limit of private involvement in sustainable financing by citizens, foreign investors and institutions. This will give rise to a need to have serious conversations and discussions about the current underlying principles of the sustainable finance agenda. These discussions should identify where adjustments can be made to ensure that the sustainable finance agenda will not become another failed development agenda just like the microfinance movement.

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