Sustainable Finance: Three Questions in Search of an Answer

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Sustainable finance, broadly defined as the integration of environmental, social and governance (ESG) aspects into financial decision-making, has grown rapidly in recent years (ECB, 2020). From a niche market for specialized investors, it has become mainstream, driven not only by top-down initiatives by financial institutions and corporates, but also by a growing and genuine demand from investors (Panetta, 2020).

The pace of growth of this market is only matched by the proliferation of government policies in this area. The UN Agenda for Sustainable Development and Paris agreement contributed significantly to this process: in particular the international commitment to "making financial flows consistent with a pathway towards low greenhouse gas emissions and climate resilient development" has prompted policymakers to see sustainable finance as a key policy tool to mobilise and shift financial flows, to support, or even catalyse the transition to a low-carbon economy (Thimann, 2019). The European Union has notably been leading the way internationally in regulating sustainable finance (European Commission, 2018), but initiatives have rapidly expanded globally to promote the growth and integrity of this market and formally integrate sustainability into financial decision making (Panetta, 2021).

These trends point to a broad consensus over the *desirability*, or even the *necessity* of sustainable finance; yet the burgeoning new industry and the growing corpus of regulatory measures remain surrounded by a general

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ambiguity as regards the specific objectives they pursue, the mechanics of how they are supposed to achieve such goals, and the evidence over their concrete effectiveness.

This article argues that a clearer and more rigorous examination of this new area of finance is needed. A deeper understanding of sustainable finance is essential to design effective public policies, guide efficient private investment decisions, as well as to obtain a balanced assessment of the role of sustainable finance among the broader toolkit to achieve the transition to a sustainable economy. The discussion is structured along three key questions: (i) what is the aim of sustainable finance? (ii) How is sustainable finance supposed to work? (iii) Does sustainable finance actually work in practice?

What is the objective of sustainable finance?

A former investment banker and private equity professional once said “sustainable investing is a confusing area of finance that often means different things to different people” (Fancy, 2021). A closer look at the relevant literature, at the policy debate and the advertisements by investment professionals shows that they have not only been using different terminologies, but they also approach the field from different perspectives. The latter – although loosely associated – betray at close inspection a fundamental lack of consensus over the *purposes* of sustainable finance

This lack of consensus is arguably the key obstacle to the development of a coherent conceptual understanding and to deeper analysis of sustainable finance, which in turn generates confusion or even scepticism about the merits of sustainable finance, harming the credibility of the nascent market (Migliorelli, 2021).

To begin with, it is therefore essential to shed light on the motivations of sustainable finance, in other words, what are the objectives that sustainable finance is set to achieve? While numerous such typologies have been proposed (Busch et al., 2021), a minimal classification should distinguish between three main approaches, based on the main objectives each of them pursues.

1. The first approach’s main motivation is to align investments with ethical preferences: under this model, which has arguably been the first one to appear

historically (Busch et al., 2021), sustainable finance can be conceived as a tool to screen and adjust portfolios to better match the moral preferences of the investor, based on selective exclusions or penalisation of "undesirable", "unethical" or "unsustainable" activities. Investment decisions are guided by non-monetary motives: the investor's utility function is thus multidimensional, with utility derived not only by the risk-adjusted returns, but also by non-pecuniary rewards, such as consistency with the investor's value system. In this approach, what matters is the subjective motive of the investor: any real impact of these investment decisions, e.g. any effect on businesses' incentives and actions, is not the prime objective, but rather a (potential) by-product of investment decisions that maximise subjective utility.

2. A second approach sees sustainable finance as an enhancement of conventional financial decision-making: its stylised goal is to better capture financial risks associated to non-sustainable business activities which conventional finance is unable to detect. This model does not depart from the conventional financial motive of maximising returns: it carries instead the promise of combining ethical, social and environmental purposes with the traditional financial motive of maximising returns. Under this framework investors take into account ESG aspects in addition to conventional financial metrics, because this information is financially material and is considered to improve investment performance in the long-term (Amel-Zadeh & Serafeim, 2018). In this approach, individual self-interest and societal goals are not in contradiction, and no trade-off exists between the pursuit of financial returns and the achievement of desirable societal goals.

3. Finally, a third approach – which is arguably predominant among policy-makers – sees the primary purpose of sustainable finance as to produce real-world changes, e.g. solving social challenges and/or mitigating ecological degradation. Under this framework, sustainable finance is at the service of society at large. The underlying objective is not the monetary rewards of individuals, but the broader mitigation of sustainability risks for society. Individual investors do not only aim to maximise individual utility, but also social welfare. To this end, investors are willing to forego part of their returns or take greater financial risks in order to generate positive *impacts* on the society at large (Brest & Born, 2013).

How is sustainable finance supposed to work?

These various conceptual frameworks are not mutually exclusive and often coexist to some degree in investors' motivations or in the products offered by the industry. Their different focus affects the specific investment strategy adopted. Numerous typologies of such strategies exist. Seven main strategies can be broadly defined (GSIA, 2017): (a) negative/exclusionary screening; (b) positive/best-in-class screening; (c) norms-based screening; (d) integration of ESG factors; (e) sustainability themed investing; (f) impact investing; (g) corporate engagement and shareholder action.

Linking these strategies to the motivations discussed in the previous section, it emerges that exclusionary approaches (*a* to *c*) are particularly common among *ethically* motivated investors. ESG integration (d) or best-in-class approaches (b) is the dominant approach for those investors that see sustainability as enhancing investment performance. Impact investment and corporate engagement (*f* and *g*) put an emphasis on real world impact.

Yet, a rigorous analysis needs to go beyond acknowledging the coexistence of different motivations and investment strategies. These different approaches imply entirely different *theories of change* of corporate behaviour that are underpinned by contradictory assumptions over how sustainable finance is supposed to achieve its goals.

Perhaps the most striking contradiction involves the role of returns.

If the purpose of sustainable finance as to produce real-world changes, then portfolio adjustments or divestments of unsustainable activities should lead to a higher cost of capital for unsustainable companies, either via change stock prices (and the cost of external capital more broadly), or through the reputational impact that divestment announcements can make (Heinkel et al., 2001). The higher cost of capital should, in turn, incentivise corporates to move away from unsustainable activities (Pastor et al., 2021). As such, sustainable investors should be willing to *forego part of their finacial returns* for societal goods.

This theory of change is inconsistent with the alternative view that ESG investing *improves financial performance*, by providing investors with material information over the long-term financial performance of a company and thus leading to outperformance of ESG investments over conventional ones. In this

model, sustainable firms perform better financially regardless of the action of sustainable investors, and sustainable investing simply reflects this intrinsic outperformance (Friede at al., 2015). In this framework, being sustainable *in itself* delivers financial rewards for the company, without the need for the investor to step in to provide the extra incentive. ESG investors simply reap the benefits of companies' self-interested sustainable behaviour. This is in contradiction with impact-oriented approaches, where sustainable behaviour *emerges* as a result of sustainable investors' willingness to forego part of their returns, thus reducing the cost of capital for sustainable activities.

These two approaches are in antithesis: if the former approach is correct, and ESG investment improves financial returns, then the latter is wrong, and sustainable finance cannot affect companies' financial incentives and produce meaningful real-world impact. While different actors may well adopt one or the other, and the two may coexist in the industry as a reflection of different understandings and assumptions by users, logically they are mutually exclusive approaches that cannot be held as valid at the same time.

What is the evidence of sustainable finance?

Whether the different approaches outlined above work in practice, and which one best delivers on its intended goals, could be ultimately set by empirical investigations. Yet, the confusion existing over the various conceptual frameworks of sustainable finance, has also affected the empirical analysis conducted so far. While a large and growing literature has looked at the relative financial performance of sustainable investments over conventional or unsustainable ones, little is known about the impact of sustainable finance on companies' decisions, its channels, and their magnitudes. To date the vast majority of studies uses ESG metrics as an explanatory variable and only very few have analyzed ESG metrics as a dependent variable, leaving the following two fundamental questions unanswered (Kölbel et al., 2020). First, if there is no agreement on the size of the effect sustainable investors have on asset prices, how can we sure about the material effect of sustainable finance? Second, even in the presence of evidence that the capital allocation of sustainable investors has affected asset prices, is there evidence that such

changes in asset prices have translated into changes in ESG practices by the companies?

This literature gap is striking and worrying, calling for further research. In the absence of the latter, the question whether sustainable finance is capable of delivering on the high public expectations which the industry and the public sector have put on it remains still unanswered. The absence of such research negatively impacts on the ability to design effective public policies to promote sustainable finance able to address societal challenges.

Conclusions

Coherently answering what sustainable finance is, how it works and whether it concretely delivers, is of the essence for a clearer debate on the government policy and regulatory initiatives needed to make it work. The current confusion and lack of a clear conceptual understanding of sustainable finance, on the contrary, risks limiting its development, triggering public scepticism over sustainable finance and ultimately hindering its transformative potential. It could, in fact, lead to the opposite, giving a false sense of hope that the dramatic growth of sustainable finance will be able – alone – to make the necessary adjustments in our economy to meet the major challenges of climate change and sustainable development. If we fail, there is a real risk that sustainable finance is merely a placebo that ultimately harms public interest (Fancy, 2021).

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