Sustainability and Systemic Risk

Conference Report

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On 15 June 2020, Eva Micheler (LSE Law), Jon Danielsson (LSE Finance) and Jean-Pierre Zigrand (LSE Finance) organised a conference at the Systemic Risk Centre at the London School of Economics entitled 'Sustainability and Systemic Risk'.

The concept of sustainability discourages companies from focusing only on short-term gains and encourages them to integrate the long-term environmental, social and human impact into their decision making. The hope is that business can generate profit while also benefitting or, at the very least, not harming planet and people.

The conference explored how sustainability has been incorporated into corporate law and regulation.

In the area of corporate law, the concept of stewardship now integrates ecological and social factors. There is also a new focus on corporate purpose. Climate change and other environmental risks have become recognised as factors that can have implications for systemic risk. Sustainability has thus been added into macro- and micro-prudential regulation as well as monetary policy. With investors displaying a greater interest in sustainable financial products, the problem of green-washing has emerged. Financial regulators are currently attempting to address this issue.

Corporate law and regulation have come a long way from focusing entirely on financial return to now integrating wider aims into their remit. Sustainability has truly arrived. We cannot however say at this point how much this integration of sustainability into business decisions will achieve for the wider aims it is designed to serve. For example, measuring non-financial impact can cause substantial problems for the social enterprises and charities. Time will tell to what extent profit can be aligned with planet and people.

The sections below contain a summary of the contributions made at the conference.

1 Albert Desclée (Barclays): ESG Investing in credit

Albert Desclée presented an empirical analysis by Barclays Research on the relationship between ESG ratings and the performance of corporate bond portfolios.

The study used historical performance data from the period between 2009 and 2018 and ESG ratings provided by MSCI and Sustainalytics. It focused on three segments of the market: US Investment Grade, High Yield and EUR Investment Grade and found that a corporate bond portfolio with a high-ESG tilt outperformed a portfolio with a low-ESG tilt in all three markets considered, while keeping all other risk characteristics constant. They also found that the governance and environment factors were the two most significant for the impact on performance with the social factor being the weakest.

This performance advantage could not be explained by a systemic appreciation of high-ESG bonds due to an increase of demand relative to low ESG ones over the period of time considered. The higher performance could rather be explained by the fact that high-ESG issuers tended to be less exposed to downgrades by credit rating agencies than low-ESG issuers.

The presentation was based on the following report:

Barclays Research (2018), 'The case for sustainable bond investing strengthens', Impact Series 04. Available from: https://www.investmentbank.barclays.com/content/dam/barclaysmicrosites/ibpublic/documents/our-insights/ESG2/BarclaysIB-ImpactSeries4-ESG-in-credit-5MB.pdf

2 Dionysia Katelouzou (King's College London): Addressing environmental and social risks through stewardship?

Dionysia Katelouzou analysed the role of stewardship in addressing environmental and social risks.

She explained that the concept of stewardship has evolved from a governance and risk mitigation tool against excessive short-term risk taking.

In addition to governance, stewardship now also incorporates ecological and social factors. The 2020 UK Stewardship Code, for example, defines stewardship as ‹the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society›. In a content analysis of 25 stewardship codes she found that 80% of these contained a reference to ecological and social aspects in addition to governance factors.

The expectation of investors has thus been augmented from the enforcement of good corporate governance through their oversight of investee companies to the provision of ecologically and socially responsible investment. This new concept of stewardship can draw support from an emerging regulatory framework for sustainable finance as well as a broad range of national and international soft law initiatives such as the United Nations Principles of Responsible Investment.

The impact of this development has yet to appear. But the Covid-19 crisis has already triggered increasing inflows to ESG index funds and a stronger demand for social factors to be incorporated into financial decisions. We might also see the development of metrics on Covid-19 corporate responses (particularly at the level of labour practices) in future ESG ratings.

The presentation was based on the following paper:

- Dionysia Katelouzou and Alice Klettner, 'Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential' (17 April 2020), European Corporate Governance Institute – Law Working Paper No. 521/2020. Available at SSRN: https://ssrn.com/abstract=3578447.

3 Eva Micheler (LSE Law, SRC): Delivering sustainability through shareholder stewardship

Connecting to the previous two presentations, Eva Micheler spoke about the recent transformation of stewardship from a pure corporate governance tool to a mechanism aimed at also delivering sustainability.

Investors are now encouraged to both enhance the governance of investee companies and to cause them to observe high ecological and social standards.

This development needs to be analysed against the structure of the current market infrastructure in the UK. In the 1960s shareholders were mostly individuals. Now shareholders are nominee companies acting predominantly for pension funds.

While there are some investors who prioritise altruistic aims over financial return, most investors are motivated by financial return. Albert Desclée presented an example of an empirical study showing that financial return is enhanced by a focus on ESG factors. Overall the empirical evidence is, however, mixed. It is not possible to conclude generally that investors are financially better off with an ESG tilted investment strategy.

According to the UK Competition and Market Authority's 2018 market investigation report, 90% of the revenue of investment consultants and fiduciary managers derives from pensions. The Office of National Statistics has estimated the cost of pension tax relief in 2017-2018 at £37.8 billion. The UK government thus actively contributes money to financial markets. This financial contribution deprives pension investors from an incentive to actively engage with their investments. This in turn deprives the providers of pension investments of oversight. The government should however act as a steward in the same way as it expects other pension savers to act. It should accordingly align the availability of tax relief with stewardship aims including sustainability factors.

The presentation was based on the following paper:

- Eva Micheler and Dionysia Katelouzou, 'The Market for Stewardship and the Role of Government' (2020, forthcoming).

4 David Kershaw and Edmund Schuster (LSE Law): The purposeful transformation of corporate law

David Kershaw and Edmund Schuster presented a paper entitled 'The Purposive Transformation of Company Law'.

The paper takes as its starting point recent changes in the UK Corporate Governance Code 2018, which now requires boards to "establish the company's purpose".

The reference to corporate purpose in the UK Corporate Governance Code is best understood as an 'animated mission-purpose idea' about what the company does. Embracing and taking seriously the idea of such a corporate purpose has the potential of creating an environment in which companies can foster a more inclusive version of capitalism. Embracing corporate purpose would also enable companies to form more meaningful relationships with various stakeholders, including their employees and suppliers, by enabling companies to credibly commit to the mission and values elevated to its purpose. This bonding may also benefit shareholders, at least ex ante.

For the concept of corporate purpose to be meaningfully integrated into the UK's corporate landscape, however, the Companies Act (CA 2006) would need to be reformed. A string of rules which mandate the priority of shareholder interests in corporate decision-making currently stand in the way of a true integration of corporate purpose. This includes in particular s 172 CA 2006, which requires directors to act in what they believe is the interests of shareholders. Shareholders also have a statutory right to remove directors from office without cause – a right that is likely to ensure that shareholders' interests are prioritised even if the risk of liability under s172 CA 2006 remains low. Takeover rules are also designed almost exclusively to further target shareholder value in M&A transactions. Thus, UK company law does not currently allow companies to credibly commit to an overriding corporate purpose.

UK company law should be adapted to provide a more flexible framework, enabling a 'purposeful ecology' by allowing some companies to conclude that, for instance, insulating directors and managers from immediate market and shareholder pressures is beneficial – often also for shareholders – and to give effect to this view through their governance architecture. Only such changes will ensure that a company's stated purpose in fact influences, shapes and defines corporate actions, rather than developing into a statement that operates only as a vacuous marketing tool which most stakeholders will see through.

The presentation was based on the following paper:

- David Kershaw and Edmund-Philipp Schuster, 'The Purposive Transformation of Company Law' (forthcoming in the American Journal of Comparative Law). An earlier version of the article is available at SSRN: https://ssrn.com/abstract=3363267

5 Veerle Heyvaert (LSE Law): only connect. What COVID-19 can teach us about the governance of systemic environmental risks

Veerle Heyvaert reflected on what the Covid-19 crisis can teach us about the governance of systemic environmental risks.

Pandemics are systemic risks to animal or human health, which in turn can threaten the health of other systems such as the financial system. They are inter-systemic systemic risks. The ongoing of a pandemic is caused by a zoonotic disease. These have become significantly more prevalent. They are no longer rare or 'black swan' events. The emergence of zoonotic diseases and subsequent transmission of pathogens from wildlife to domesticated animals and human beings is fostered by a range of factors, including encroachment and degradation of habitats, intensive farming as well as illegal hunting and trading. These same factors also contribute to climate change and threaten climate change resilience.

There is a broad landscape of regulation that contributes to the prevention and control of pandemics, ranging from measures affecting land use and planning to human disease control requirements. The framework for measures preventing diseases is currently less developed than the body of measures that aim to stop the spread of diseases. A better regulatory response would involve a stronger focus on prevention. Stephen

Shavell's classic model for determining the optimal point of intervention supports the argument that more preventative measures are needed to address pandemic risks as well as other systemic environmental risks such as climate change.

A stronger emphasis on preventative regulation is warranted because 1) the likelihood of such risks materialising has increased; 2) the harm caused by such risks, conversely, has become less predictable; 3) individuals have limited information about how their actions relate to global outcomes; 4) with a greater likelihood of risks materialising, the benefits of preventative measures increasingly outweigh the costs; and 5) the effectiveness of intervention at a later stage (for example, through culling) is waning.

While still very instructive, the Shavell model does however not account for the inter-systemic nature of contemporary systemic risks. The inter-systemic qualities of risks such as pandemics and climate change further strengthen the rationale to adopt an integrated analysis across different fields (eg conservation of habitats and safeguarding of ecosystem services; climate change resilience; disease control) and across the different stages of intervention in order to avoid a compartmentalised vision of regulation which generates sub-optimal strategic responses.

6 Nick Robins (LSE Grantham Institute): Building a sustainable financial system - the state of practice and future priorities

Nick Robins spoke about the role of central banks in building a sustainable financial system.

There has been an important shift since 2015 from an initial inaction with respect to environmental risks to an acknowledgement and adjustment of central bank policies to take into account climate change and sustainability in their assessment of systemic risks. Central banks now recognise that sustainability is part of their core mandate as prudential regulators and that the macroeconomic implications of climate change and the regulatory responses should be tackled both through prudential regulation and monetary policies.

There are five main areas of activity. First, central banks have raised awareness by alerting financial institutions and the market to climate change risk. Second, they have integrated climate change risk into micro-prudential regulation by insisting on enhanced market disclosure and by suggesting the adaptation of capital ratios depending on the nature of an investment as an either low-carbon ("green") or a high-exposure ("brown") asset. Third, from a macro-prudential perspective, centrals banks have recognized the potential systemic risk relating to climate and sustainability risks and have reviewed regulatory instruments such as capital buffers and large exposure restrictions on high carbon risks assets to address those risks. Fourth, from a monetary policy perspective, central banks have recognized that climate change can materially affect price stability and monetary operations within the economy. Finally, centrals banks have started to promote green finance and the reallocation of assets to sustainable finance by not only adjusting central bank portfolios, but also by supporting green financial markets and green credit allocation.

Despite the recent initiatives responding to climate change risks, Nick Robins argued that there remains significant challenges in building a sustainable financial system. We need to clarify and standardise the taxonomy used in sustainable finance and the characterisation of assets considered as sustainable. In addition, it is necessary to reflect on the strategic assumptions for the development of sustainable finance and ensure market neutrality. In doing so, policy-makers should broaden the scope of the issues considered from green finance to wider sustainable development and social goals such as the reduction of poverty and inequality and universal access to financial services. Finally, these challenges will best be overcome through a supportive international regime for central banks to ensure consistent actions across the different branches of the financial system.

More specifically, within the context of the Covid-19 crisis, Nick Robins argued that there is an imperative to undertake a sustainable recovery. His analysis in this regard can be found in its recently published research paper entitled 'A Toolbox for Sustainable Crisis Response Measures for Central Banks and Supervisors' (2020).

The presentation was based on the following papers:

- Simon Dikau, Nick Robins and Matthias Täger: 'Building a Sustainable Financial System: The State of Practice and Future Priorities. Financial Stability Review' (2019), Madrid – Banco de España, Financial Stability Review, Issue 37. Available at: **http://www.lse.ac.uk/GranthamInstitute/publication/building-a-sustainable-financial-system-the-state-of-practice-and-future-priorities/**
- INSPIRE, 'Building the analytical foundations for greening the financial system – The first report of the International Network for Sustainable Financial Policy Insights, Research and Exchange' (2020). Available at: **http://www.lse.ac.uk/GranthamInstitute/publication/building-the-analytical-foundations-for-greening-the-financial-system-the-first-report-of-the-international-network-for-sustainable-financial-policy-insights-research-and-exchange-inspire/**
- Simon Dikau, Nick Robins and Ulrich Volz: 'A Toolbox for Sustainable Crisis Response Measures for Central Banks and Supervisors' (2020). INSPIRE Briefing Paper. London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science and SOAS Centre for Sustainable Finance. **Available at: http://www.lse.ac.uk/granthaminstitute/publication/a-toolbox-for-sustainable-crisis-response-measures-for-central-banks-and-supervisors/**

7 Kevin James (LSE, SRC): Climate change and asteroids: the precautionary principle when there is a lot to be cautious about

Kevin R. James observed that while climate change does pose an extinction risk, it is not the only source of extinction risk (other sources include, for example, asteroids, ice ages, and nuclear war).

It follows from this perspective that a narrowly focused climate change policy is inferior to a more general extinction risk policy that also incorporates climate change risk.

Climate change creates an extinction risk because humans inhabit one planet. This and other single point of failure extinction risks could be eliminated by developing a space-faring civilization. Recent development in space technologies suggest that doing so would be possible over the next century (and for less money than dealing with climate change risk will demand).

Of course, it won't be possible to develop a space-faring civilization if humanity does not survive long enough to do so. Consequently, the optimal extinction risk policy must strike a balance between dealing with climate change risk, other extinction risks, and developing space capabilities. A key implication of this approach (relative to one that focuses upon climate change risk alone) is that economic growth is crucial as it produces the resources required to deal with other extinction risks and to develop space capabilities.

The US approach to extinction risk is superior to that of the EU as the US has reduced carbon emissions at almost the same rate as the EU while doing much more to support the space industry and the exploitation of space.

The presentation was based on the following contribution:

- Kevin R. James: 'How to address sustainability risk in a dangerous universe' (2020), LSE Blogs. Available at: **https://blogs.lse.ac.uk/businessreview/2020/07/15/how-to-address-sustainability-risk-in-a-dangerous-universe/**

8 Kern Alexander (University of Zurich): Integrating sustainability into prudential regulation

Kern Alexander has long argued that climate change should be integrated into prudential regulation.

In his presentation he explained that since the 2008 financial crisis, prudential regulators have increasingly focused their attention on the links between systemic environmental risks and financial stability.

The Bank of England has classified environmental risks as falling into three categories: 1) physical risks and environmental phenomena which might disable the financial system; 2) policy-driven risks if the transition is sudden, unexpected and non-linear in its effects; and 3) risks linked to the enforcement of a breach of environmental regulation.

The European Insurance and Occupational Pensions Authority recommended to insurance companies in June 2019 to conduct scenario analysis and stress testing to assess the exposure of insurance companies to climate change.

The European Systemic Risk Board is currently assessing climate change risks in terms of the magnitude of potential shocks, their pricing and the exposure for banks and insurers. In particular, it is also asking financial regulators, banks and insurers to adopt a forward-looking scenario analysis as to the evolution of the market in light of climate risks.

The Capital Requirement Directive V (in effect since June 2019) has given a mandate to the European Banking Authority (EBA) to assess the impact of environmental and social risks on banking sector stability and credit institutions.

On an international level, the Network for Greening the Financial System (NGFS) has recently published a guide for supervisors for the integration of environmental risks into prudential supervision with recommendations for bank supervisors, securities supervisors and insurance companies supervisors.

While there has been a significant progress, regulators are still at the stage of the assessment of risks and data collection. A substantial amount of work thus remains to be done to effectively integrate sustainability in prudential regulation.

The presentation was based on the following contributions:

- Kern Alexander and Paul Fisher: 'Banking Regulation and Sustainability' (5 November 2018). Available at SSRN: https://ssrn.com/abstract=3299351;
- Kern Alexander, Principles of Banking Regulation (Cambridge University Press 2019), Chapter 3 pp 81-83, and Chapter 13 pp 347-372.

9 Iris Chiu (UCL): Building a single market for sustainable finance in the EU-mixed messages

Iris Chiu discussed recent EU reforms for sustainable finance in the field of capital markets regulation.

She focused on the recently adopted EU Regulation on Sustainability-related Disclosures in the Financial Services Sector 2019 (the "Regulation") which requires disclosures on the integration of sustainability risks in investment decisions and sets standards for the labelling and marketing of sustainable products. The Regulation will be supported by the forthcoming Taxonomy Regulation which will provide for further disclosure.

The Regulation attempts to address the problem of greenwashing by requiring the disclosure of specific information. It applies to both actively and passively managed products. The Regulation increases the compliance costs associated with actively-managed sustainable products. This might have the unintended effect to strengthen the passively-managed market.

The Regulation aims to connect market-building with public interest goals encouraging the allocation of assets to provide sustainable finance. Iris Chiu questioned the adequacy of the two tier compliance system. She argued that the Regulation could have the effect of creating a competitive advantage for larger firms which will find it easier to comply with the mandatory disclosure requirements. This could lead to a domination of the sustainable market by certain larger firms. She also noted that the UK had not yet decided on whether to implement the Regulation post Brexit.

The presentation was based on the following paper:

- Iris H-Y Chiu, 'Building a Single Market for Sustainable Finance in the EU- Idealism, Policy and Mixed Messages' (20 June 2020). Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3631946

10 Julia Morley (LSE Accounting): The impact of social impact reporting

Julia Morley focused on the effects of social impact reporting on social enterprises and charities.

Impact reporting is increasingly prevalent in the social sector, financializing the effectiveness of particular social interventions, such as those delivered by charities or social enterprises. Impact reporting is often demanded by funders seeking social returns, particularly in the case of social impact bonds where private investors engage in payment-by-results contracts with local authorities to deliver social care. By providing information about a project's effectiveness, impact reporting is intended to improve funding decisions and optimise resource allocation in the social sector.

The measurement and the reporting of social impact can, however, have adverse practical and ethical consequences. It can incentivise delivery organisations to game results by focusing on only the easiest targets and may even lead to the provision of misleading information by delivery organisations intending to signal effectiveness to investors. It can also lead to a denial of service to needy individuals if the assessment of the impact is determined using a randomized control trial which requires a non-treatment control group. In some cases, unfair contractual terms regarding impact measures may result from the greater bargaining power of private investors, thereby transferring excessive resources from local communities to the private sector. Furthermore, impact reporting can demotivate staff who deliver front line social care if they find the financialization of moral activities associated with impact reporting to be dissonant with their intrinsic motivation for doing such work. The significant form-filling necessary for establishing impact can also lead to dissatisfaction and burn-out.

A more significant problem is that impact reporting makes possible the commoditisation of individuals, turning youth offenders, rough sleepers and toddlers with learning disabilities into sources of profit for private investors. This raises broader moral issues regarding issues intended to promote sustainability and social value creation.

The presentation was based on the following paper:

- Julia Morley, 'The Ethical Status of Social Impact Bonds' (2019), Journal of Economic Policy Reform.

EVA MICHELER

Eva Micheler studied law at the University of Vienna and at the University of Oxford before joining the LSE Law Department in 2001. She is an Associate Professor in Law at the London School of Economics. She too Habilitation at the University of Economics in Vienna, where she took Habilitation. Professor Micheler is also on the management committee of the Systemic Risk Centre at LSE. She was a TMR fellow at the Faculty of Law of the University of Oxford.

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