r3.0 Blueprints Series

Blueprint 6

Sustainable Finance Blueprint

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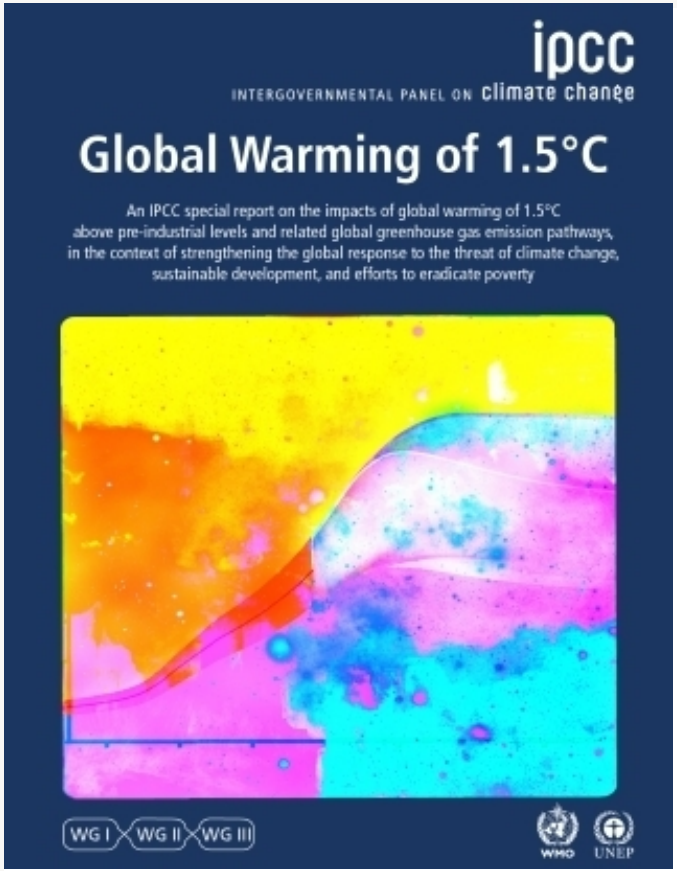
The Need: Transformation



"Limiting global warming to 1.5° Celsius would require rapid, far-reaching and unprecedented changes in all aspects of society."

"a 'whole systems' approach would be needed for the type of transformations that could limit warming to 1.5°C. This means that all relevant companies, industries and stakeholders would need to be involved..."

http://report.ipcc.ch/sr15/pdf/sr15_faq.pdf

The Need: Existing Sustainable Finance Initiatives Fall Short

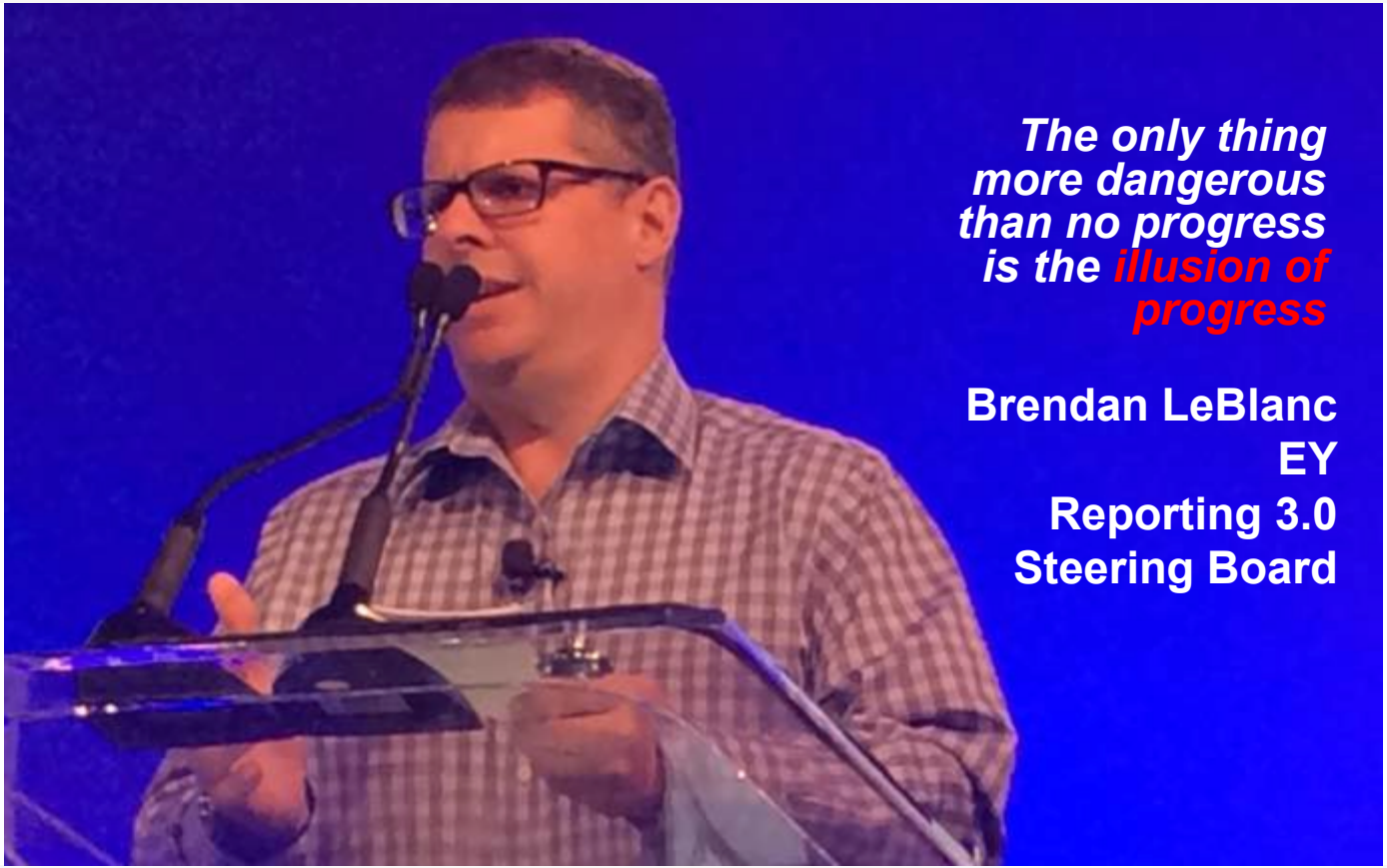
Against this background, the HLEG recommends that the Commission:

- **Foster natural capital assessment and disclosure.**
  - The Commission should encourage and support the development and use of standards, metrics and methods for quantifying, reporting and managing natural capital risks and opportunities in decisions by financial institutions. This should also consider accounting standards and draw on initiatives targeted at financial institutions, such as the Finance Sector Supplement to the Natural Capital Protocol and the EU Community of Practice on Finance and Biodiversity to standardise approaches, as well as on recent experiences with corporate environmental profit and loss accounting.[100] Action in this area is urgent, as the loss in diversity of flora and fauna is alarming.
  - The Commission should explore how to use frameworks for defining global science-based targets for natural capital management and restoration, building, for example, on the concept of planetary boundaries.
  - The Commission should improve natural capital disclosures in the next NFRD review and could examine how natural capital could better be accounted for in economic valuations.

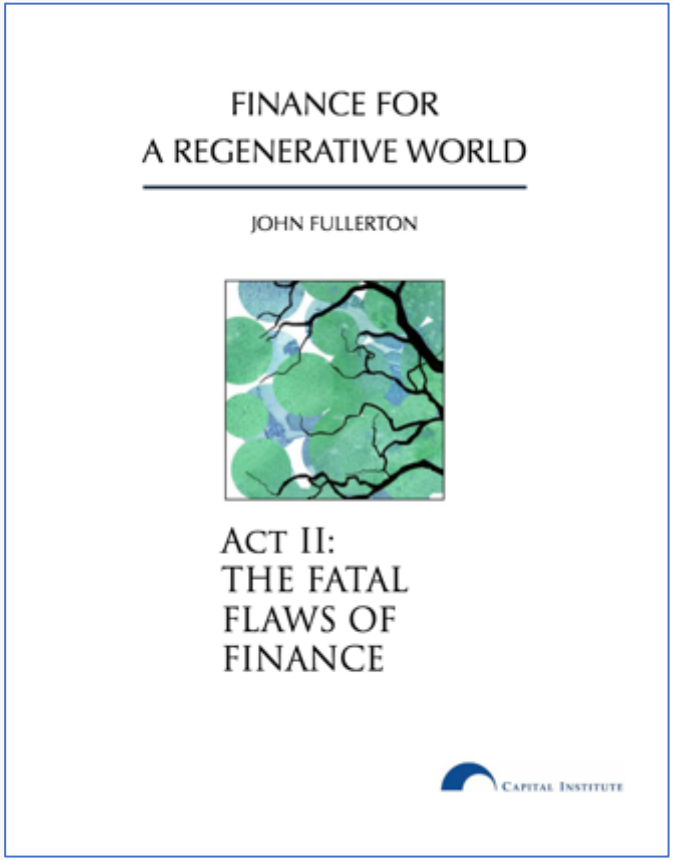
EU High Level Expert Group on Sustainable Finance calls for "exploring" how to integrate science-based targets linked to planetary boundaries, but falls short of calling for implementation, and is silent on social and economic sustainability thresholds…

https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

Current “Sustainable Finance” = Illusion of Progress?



The Need: Five Fatal Flaws of Finance



I. Finance Ideology: A Confusion of Means and Ends
II. Confusion of Investment with Speculation
III. The Limits of Markets
IV. The Agency Problem of Misaligned Incentives
V. Limits to Investment

https://issuu.com/capitalinstitute/docs/act_ii_final?e=33301005/67791969

Defining Sustainability: Sustainability Context in GRI G2 (2002)

- [S]ustainability reporting draw significant meaning from the larger context of how performance at the organisational level affects economic, environmental, and social capital formation and depletion at a local, regional, or global level.
- [S]imply reporting on the trend in individual performance (or the efficiency of the organisation) leaves open the question of an organisation's contribution to the total amount of these different types of capital.
- [P]lacing performance information in the broader biophysical, social, and economic context lies at the heart of sustainability reporting.
- [R]eporting organisations should consider their individual performance in the contexts of economic, environmental, and social sustainability.
- This will involve discussing the performance of the organisation in the context of the limits and demands placed on economic, environmental, or social resources at a macro-level.

https://www.epeat.net/documents/EPEATreferences/GRIguidelines.pdf

Defining Sustainability: The Sustainability Quotient

Sustainability Quotient: $S = \frac{A}{N}$

Sustainability = $\frac{\text{Actual Impacts*}}{\text{Normative Impacts*}}$ $\left(\frac{\text{Numeration}}{\text{Denomination}}\right)$

**On the Carrying Capacities of Vital Capital Resources*

@Reporting 3.0 2018

Source: Mark McElroy, Social Footprints, 2008

99.7% of Sustainability Reporters Ignore Sustainability

Journal of Cleaner Production

Volume 163, 1 October 2017, Pages 106–117

Is Earth recognized as a finite system in corporate responsibility reporting?

Anders Bjørn[a], Niki Bey[a], Susse Georg[b], Inge Røpke[b], Michael Zwicky Hauschild[a]

Show more

https://doi.org/10.1016/j.jclepro.2015.12.095

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0.3%

A MERE 31 of 9,000

Highlights

- We systematically reviewed references to ecological limits in 40.000 CR reports.
- In 2000–2013 ≈ 5% of companies referred to ecological limits in any year.
- Of these 5%, only 31 companies planned to align performance or products to limits.

https://www.sciencedirect.com/science/article/pii/S0959652615019204

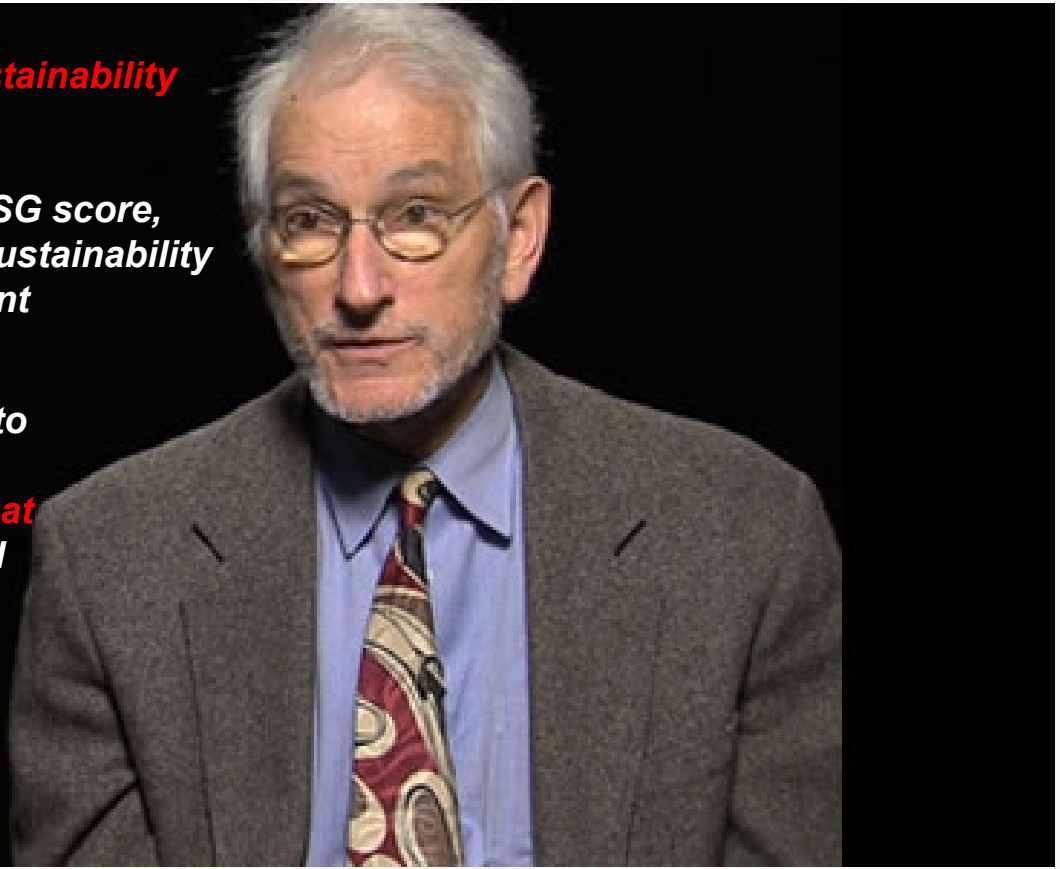
ESG = Incrementalism; ESG ≠ Sustainability

ESG does not, by nature, carry a true sustainability gene.

A company may rate very highly on an ESG score, but to say this company is an excellent sustainability performer is a very fundamentally different statement.

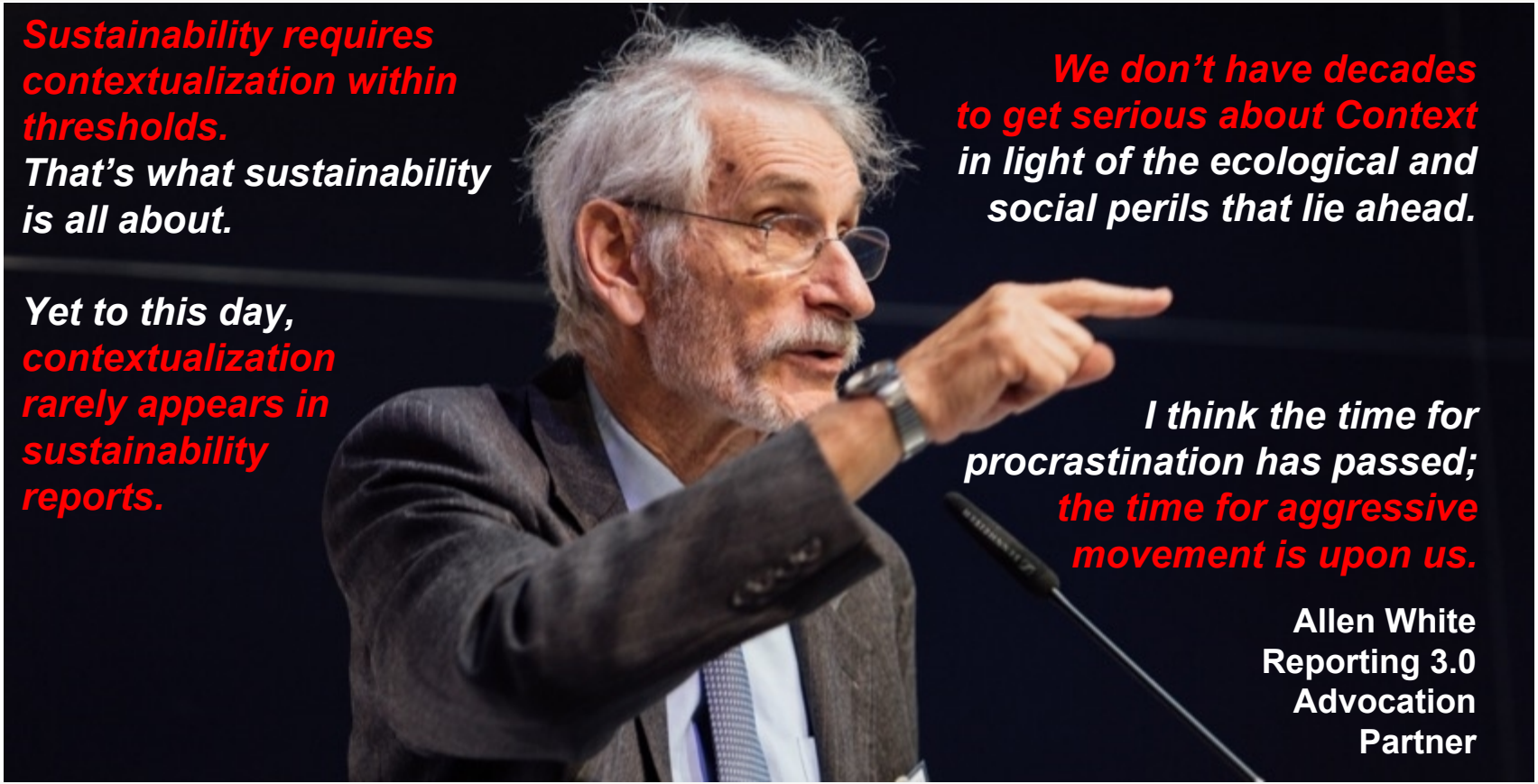
It means that the company is positioned to prosper for the long-term in a way that respects limits, thresholds, and norms that are externally defined, not simply defined by peer group comparison or internal targets and goals.

Allen White
Co-Founder
Global Reporting Initiative



https://www.sustainablebrands.com/news_and_views/new_metrics/bill-baue/sustygoals-2-dialogue-allen-white-gisr-godfather-sustainabili-0

The Time for Movement is Upon Us



https://www.sustainablebrands.com/news_and_views/new_metrics/bill-baue/sustygoals-2-dialogue-allen-white-gisr-godfather-sustainabili-0

UNEP Proposes Body on Thresholds & Allocations

The report contains two key recommendations pertaining to *Sustainability Context*:

- All companies should apply a context-based approach to sustainability reporting, allocating their fair share impacts on common capital resources within the thresholds of their carrying capacities;

- Multilateral organizations should collaborate to create a global governance body of scientists, academics, business practitioners, NGOs and other stakeholders to provide guidance on methodologies for determining ecological (and social) thresholds, as well as guidance on approaches to allocations, all of which are broadly applicable to the business level.

https://wedocs.unep.org/bitstream/handle/20.500.11822/9807/-Raising_the_Bar_-_Advancing_Environmental_Disclosure_in_Sustainability_Reporting-2015UNEP_Raising_the_Bar_2015.pdf.pdf

Global Thresholds & Allocations Council

Mission

● Identify thresholds & norms for sustaining the carrying capacities of systems-level capital resources in the commons that are vital to stakeholder wellbeing, based on a comprehensive review of research in physical and social sciences and practice in the field.

● Design and validate allocation methodologies that apportion fair share responsibility for jointly preserving and enriching capital resources vital to stakeholder wellbeing.

● Disseminate consensus-based thresholds/norms/allocations with “off-the-shelf” ease-of-use in mind to facilitate global mainstreaming of such practices.

Sustainable Finance Transformation Needs

- From ESG Integration To Threshold Investing
- From Fiduciary Duty to Strategic Duty
- From Monocapitalism to Multicapitalism
- From Inside-Out Enterprise & Portfolio Risk to Inside-Out Systemic & Existential Risk
- From Tea & Biscuits Engagement To Forceful Stewardship
- From Alpha Generation to & Beta Activism
- From Scenario Analysis to Transformation Planning
- From Dirty Lobbying To Positive Lobbying

From ‘ESG Integration’ to ‘Threshold Investing’

Current best practice of ESG Integration represents an incremental step toward the ultimate goal of a sustainable finance system that operates within economic, social, and ecological thresholds – or “threshold investing. In short: sustainable finance requires thresholds & allocations embedded in investment decisions

Guardian sustainable business

Investing 2.0: assessing companies' true sustainability performance

Development of real-world ecological budgets mean investors must consider companies' environmental and social impact

Bill Baue, *Cary Krosinsky, and Mark W. McElroy*

Thu 4 Apr 2013 09.37 EDT

https://www.theguardian.com/sustainable-business/sustainable-investing-assessing-companies

From ‘Fiduciary Duty’ to ‘Strategic Duty’

Current interpretations of fiduciary duty obsess on short-term shareholder value creation (profit maximization); a proper interpretation (enforceable through redefined case law) calls for a “strategic duty” to ensure long-term system value creation.

Michigan Business & Entrepreneurial Law Review

Volume 8 | Issue 1

2018

The Elephant in the Room: Helping Delaware Courts Develop Law to End Systemic Short-Term Bias in Corporate Decision-Making

Kenneth McNeil
Susman Godfrey L.L.P.

Keith Johnson
Reinhart Boerner Van Deuren, s.c.

https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1077&context=mbelr

From ‘Monocapitalism’ to ‘Multicapitalism’

Current decision-making in finance predominates on a single capital – financial. Sustainable finance bases its decisions on the multiple capitals – particularly respecting their carrying capacities.

https://blogs.thomsonreuters.com/sustainability/2018/06/07/executive-perspective-from-monocapitalism-to-multicapitalism-21st-century-system-value-creation/

From ‘Monocapitalism’ to ‘Multicapitalism’

In addition to company-level integrated reporting on the multiple capitals, asset owners are encouraged to practice integrated reporting to assess portfolio impacts on the carrying capacities of the capitals.

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Blogs

On Governance: How the Shift from Monocapitalism to Multicapitalism Creates Integral Value

« On Governance: Using Sustainability Metrics in Incentive Compensation Plans

On Governance: The Biggest and Most Dangerous Risk CAEs and CROs Don't Want to Report to Boards »

20 Feb. 2019 | Comments (0)

On Governance is a series of guest blog posts from corporate governance thought leaders. The series, which is curated by the Governance Center research team, is meant to serve as a way to spark discussion on some of the most important corporate governance issues.

This is the second of a two-part series on making the case for asset owner integrated reporting. The first part was about integrated reporting's involvement in defining and measuring value.

Keith Ambachtsheer

Bill Baue

Integrated Reporting (IR) is based on a simple premise: that value is created by using up to six types of capital (financial, manufactured, human, social, intellectual, and natural) to produce desirable goods and services. In other words, it is the integrative use of these capital resources that drives value creation – and destruction too. IR thus expands traditional thinking, with its predominant focus on financial capital (i.e., monocapitalist), by casting a wider net to assess how value is created across multiple capitals (i.e., multicapitalist).

In addition to expanding the scope horizontally along multicapitalist lines, IR also sets up a vertical connection bridging from micro (i.e., enterprise) to macro (i.e., systems) contexts. Asset owners experience this link as their investments in multiple micro-level investments increasingly span the globe, collectively aggregating up to the macro systems level.

https://www.conference-board.org/blog/postdetail.cfm?post=6984

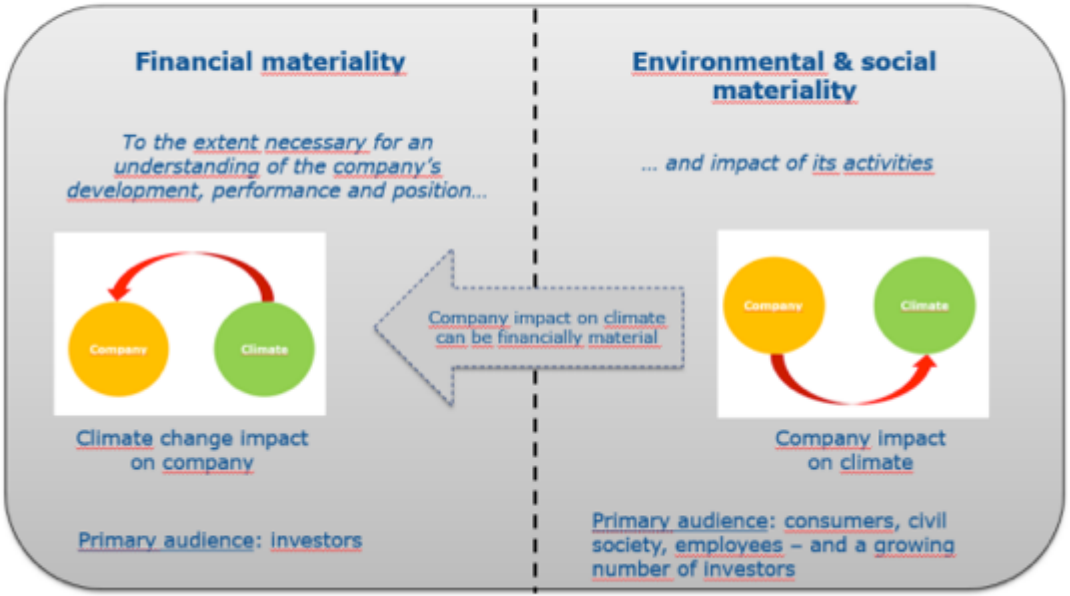
From ‘Portfolio Risk’ to ‘Systemic & Existential Risk’

Traditional finance assesses portfolio risk; sustainable finance assesses systemic risk and even existential risk.

https://www.breakthroughonline.org.au/whatliesbeneath

From ‘Outside-In’ to ‘Inside-Out’ Risk

Figure 1
The double materiality perspective of the Non-Financial Reporting Directive in the context of reporting climate-related information



Financial materiality is used here in the broad sense of affecting the value of the company, not just in the sense of affecting financial measures recognised in the financial statements.

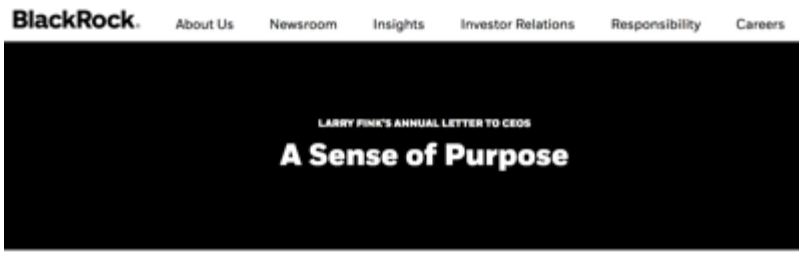
https://docs.wbcsd.org/2018/10/COSO_WBCSD_ESGERM_Guidance.pdf

https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-non-financial-reporting-guidelines-consultation-document_en.pdf

From ‘Tea & Biscuits Engagement’ to ‘Forceful Stewardship’

Transforming finance to achieve sustainability requires fiduciaries to shift from what’s called “tea & biscuits” or “tummy tickling” engagement to “Forceful Stewardship” pressing for transformative change of the business models of portfolio holdings.

We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.



Dear CEO,

As BlackRock approaches its 30th anniversary this year, I have had the opportunity to reflect on the most pressing issues facing investors today and how BlackRock must adapt to serve our clients more effectively. It is a great privilege and responsibility to manage the assets clients have entrusted to us, most of which are invested for long-term goals such as retirement. As a fiduciary, BlackRock engages with companies to drive the sustainable, long-term growth that our clients need to meet their goals.

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2551478
https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

From ‘Tea & Biscuits Engagement’ to ‘Forceful Stewardship’

How does Blackrock walk its talk?

The Power Players in the Power Industry

	Voting score	Ownership average	Score
Vanguard	-9	8.94	-80.46
BlackRock	-9	7.97	-71.73
BNY Mellon	-9	1.29	-11.61
Invesco	-3	1.45	-4.35
Geode	0	1.01	0
FranklinTempleton	2	1.88	3.76
GoldmanSachs	5	1.28	6.40
Fidelity	6	1.33	7.98
Northern Trust	9	1.36	12.24
StateStreet	3	5.04	15.12

BlackRock	# of funds voting				Ownership % of outstanding
	Yes	No	Abstain	Score	
AES		11		-1	10.36
Ameren		6		-1	6.65
Dominion		9		-1	6.87
DTE		8		-1	8.12
Duke		12		-1	6.17
FirstEnergy		18		-1	9.92
PNM		5		-1	10.46
PPL		10		-1	7.08
Southern		8		-1	6.11
				Sum: -9	Avg: 7.97
				Score: -71.73	

https://preventablesurprises.com/wp-content/uploads/2017/11/Missing-55-V7-1.pdf

From ‘Tea & Biscuits Engagement’ to ‘Forceful Stewardship’

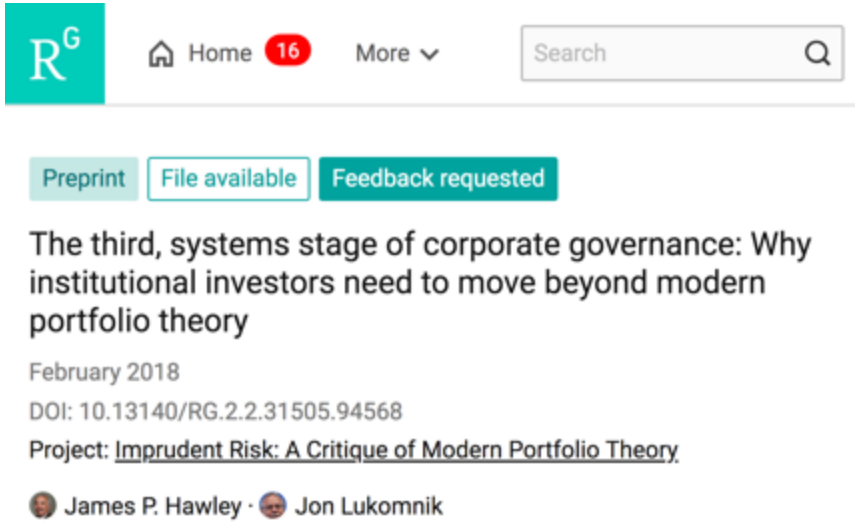
“In the United States, we can’t put environmental things in front. That’s against the fiduciary standard rule of the United States… We don’t want to vote *against* management. We want to vote *with* management and helping management move forward. We vote against management when we believe they are not listening to our views.”

Larry Fink, CEO, BlackRock

https://event.webcasts.com/viewer/event.jsp?ei=1201212&tp_key=17f64510d8 Min. 27:00-29:00 & 32:00-40:00

From ‘Generating Alpha’ to & ‘Beta Activism’

Investors traditionally seek to generate alpha, or outperformance, through individual stock-picking. Yet systemic risks apply across the board to all companies, so “smart” investors are starting to protect the value of their portfolios through “beta activism.”



This paper focuses on underlying causes for the emerging systemic emphasis among major corporate governance institutional owners. It does this by building incorporating three stages of corporate governance: structure and process as governance (stage I), broadening to include E and S factors (stage II), and stage III, a system focus. By looking at system focus this paper breaks ground by arguing one must examine the role modern portfolio theory (MPT) in the investment processes and explore how MPT impacts corporate structure, behavior and governance. We focus on the dynamics of a portfolio, and of multiple portfolios (the market) becoming part of governance analysis and actions, challenging the idea that portfolio investment risk is limited to diversifying idiosyncratic risk through security selection assuming that will have no impact on beta. There are strong feedback loops between portfolio risk management, beta and systemic risk: they are conjoined.

https://www.researchgate.net/publication/323323162_The_third_systems_stage_of_corporate_governance_Why_institutional_investors_need_to_move_beyond_modern_portfolio_theory

From ‘Scenario Analysis’ to ‘Transformation Planning’

Investors should use their influence to encourage portfolio companies to produce transformation plans to new business models that create future value in the context of the SDGs and the Paris Climate Accord. As You Sow issued a report similarly calling for such Transition Plans.

https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

https://preventablesurprises.com/wp-content/uploads/2017/05/Flip-the-Switch-web.pdf

https://www.asyousow.org/reports/2020-a-clear-vision-for-paris-compliant-shareholder-engagement

From ‘Dirty Lobbying’ to ‘Positive Lobbying’

Current lobbying seeks to entrench and deepen unsustainable practices. In order to advance sustainable finance, investors and other financiers need to focus lobbying efforts on positive pursuits that support the transition to a green, open & inclusive economy?

Forbes Billionaires Innovation Leadership Money Consumer Industry

9,213 views | Jun 7, 2016, 06:30am

Why Isn't Anyone Lobbying For Climate Change?

Capital Flows Contributor

Guest commentary curated by Forbes Opinion. Avik Roy, Opinion Editor.

GUEST POST WRITTEN BY

Sen. Sheldon Whitehouse

Mr. Whitehouse is a Democratic U.S. senator for Rhode Island.

Coca-Cola and PepsiCo are terrific climate companies, but they lobby through the American Beverage Association, which is moribund on climate. (Photographer: Carla

Washington's dirty secret is that even the American companies that are really good on sustainability put net zero effort into lobbying Congress on climate change.

Here's one example of how that transpires: Coca-Cola and PepsiCo PEP -0.65% are terrific climate companies in virtually every way, but they lobby through the American Beverage Association, which is moribund on climate. When something important to the soda industry comes up, like killing a soda tax to pay for healthcare, the Association will lobby like crazy. But on climate—nothing.

https://www.forbes.com/sites/realspin/2016/06/07/lobby-climate-change-failure/#6c7ee3c250c6

Thank You!

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