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Sustainable finance and governance: an overview

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ABSTRACT

We are currently facing great challenges around balancing environmental and social issues with economic development. This article provides an overview and insight into these challenges from a Finance perspective. It then introduces contemporary research that address specific points of interest.

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Society is becoming increasingly aware of the importance of sustainability and the need to effectively manage the finite resources it is endowed with. Naturally, this growing awareness has implications for financial markets and the way firms are managed. In turn, this opens up many avenues for interesting and potentially impactful research questions around the theme of sustainable finance and governance. How do companies manage their exposure to environmental risk? What are the characteristics of sustainable investments? How can one measure sustainability? These are some of the multitude of interesting research questions on these topics. This stimulated academics at several leading universities to organise an event to explore these and related issues.

Thus, the Sustainable Finance and Governance Workshop was launched and co-ordinated by the University of Bath, Loughborough University and the University of Liverpool. The first event took place on 17 May 2021 and was hosted by the University of Bath as an online event due to ongoing restrictions during the coronavirus pandemic. The workshop featured a keynote address from Alex Edmans. Alex is Professor of Finance at London Business School. His keynote address focused on the topic ‘Responsible Business in a Time of Crisis.’

The workshop attracted around 50 academics, practitioners and regulators participating from 25 universities around the world. A wide range of topics related to Sustainable Finance, Corporate Governance and the intersection of these two areas. In total about 20 research papers were presented. The papers included in this Special issue are selected from those presented at the 2021 Sustainable Finance and Governance Workshop. Following the standard double-blind review process of the European Journal of Finance, four papers have been accepted in this Special issue which covers diverse research questions in the field of Sustainable Finance and Governance.

The four papers in this special issue highlight the diversity of research being conducted. Themes covered include whether sustainability can ameliorate the effects as economic turbulence, the benefits and costs from non-financial reporting, whether there are investors who choose sustainable assets and to what extent Environmental, Social and Governance measures are substitutes. The special issue therefore helps to strengthen our knowledge and understanding of these crucial issues as well as providing policy recommendations where appropriate.

1. Can strong ESG help mitigate uncertainty?

Economic uncertainty is always a factor that needs to be considered when discussing economic outcomes and corporate decision-making. Given that Environmental, Social and Governance (ESG) considerations are always

at the centre of any corporate discussions, it is interesting to assess how firms that engage with ESG are affected by the increased economic uncertainty, compared to their counterparts. To that end, Asimakopoulos, Asimakopoulos, and Li (2023) assess how Economic Policy Uncertainty affects firm's leverage position and what is the role of ESG in that relationship.

Economic Policy Uncertainty (EPU) can have a negative effect on economic development through firms' financial decisions and activities. The main channels are via firms' investments, innovation, and access to capital markets (i.e. Cong and Howell 2021; Gulen and Ion 2016). As a result, under higher EPU firms are forced to adjust their leverage position (Li and Qiu 2021) and relevant speed of adjustment (Çolak, Gungoraydinoglu, and Öztekin 2018).

Even though a lot is known about the role of EPU on leverage, there is no study to assess the role of the Environmental, Social, and Governance (ESG) score on that relationship. Asimakopoulos, Asimakopoulos, and Li (2023) contribute to this discussion and show initially that the ESG score reduces information asymmetry and provide better access to financial markets. They further provide an intuitive discussion regarding the existing trade-off between EPU and ESG under the leverage decision-making of the firm. Their findings show that firms with an ESG rating can mitigate the negative effects of EPU on current leverage. This means that firms are able to sustain a given level of leverage without having the need to reduce their borrowing position due to the increasing EPU levels. This is crucial for firm's sustainability and further development.

Finally, Asimakopoulos, Asimakopoulos, and Li (2023) show that ESG rating enables firms to keep a smoother leverage pattern compared to their counterpart, when EPU levels are high. Therefore, when higher levels of EPU are forcing firms to reduce rapidly their leverage position due to liquidity shortages, the ESG rating can provide an alternative access to liquidity and financial markets to mitigate this negative effect.

These findings are relevant for investors analysts, and policymakers, as they demonstrate the importance of considering ESG factors in financial analysis. By assessing a company's ESG performance, investors and analysts can gain insight into its risk profile and identify firms that are better positioned to withstand economic volatility. Policymakers can also use this information to design policies that promote responsible corporate behaviour.

2. Do investors prefer green assets?

Recent theoretical work by Pastor et al. (2021) and Pedersen et al. (2021) formally shows how attitudes towards ESG affect the pricing of financial assets. These theoretical models motivate Blomqvist and Stradi (2022) to empirically investigate the relationship between ESG preferences and stock returns. The authors empirically proxy for ESG attitudes and examine the link with stock returns.

Their empirical strategy is based on two observations. First, the National Consumer League survey finds that 96% of Democrats support the idea that companies should pay attention to and address social issues. The comparable figure for Republicans is much lower at 65%. Second, previous research, such as Di Giuli and Kostovesky (2014), documents that firms headquartered in predominantly Democratic states invest more in addressing CSR issues than firms headquartered in Republican states. Motivated by these findings, the authors use information on the political party that won the majority in each state during the presidential election as a proxy for ESG preferences.

Blomqvist and Stradi (2022) document a significantly negative average abnormal stock return for firms headquartered in Democratic states. In contrast, the average abnormal return for firms headquartered in Republican states is statistically indistinguishable from 0. Economically, their results are consistent with the notion that green investors overpay for the stock of firms headquartered in Republican states. This result is consistent with the Pedersen et al. (2021) model in which ESG-motivated investors derive utility from holding green assets.

3. Do firms benefit from CSR reporting?

There has been a growing interest in ESG-related information disclosure and the associated greenwashing effects. For example, recent literature has investigated the importance of non-financial disclosure regulations on corporate outcomes (Grewal, Riedl, and Serafeim 2019; Jackson et al. 2020; Mittelbach-Hörmanseder, Hummel, and

Rammerstorfer 2020). Cuomo et al. (2023) contribute to this literature by assessing how the EU Non-Financial Reporting Directive (NFRD) impacts on corporations.

The EU Non-Financial Reporting Directive (NFRD) aims to increase transparency and accountability of publicly listed companies in relation to their environmental, social, and governance (ESG) performance. Even though NFRD is non-binding, it is mainly adopted using the ‘comply or explain’ approach, according to which companies can choose to not disclose the regulated information, but rather explain the reasons for their non-compliance.

Cuomo et al. (2023) find that the NFRD has led to an increase in the amount of ESG information disclosed by companies. Specifically, European companies have started to disclose more information on their policies, processes, and performance related to ESG issues. This has enabled stakeholders, such as investors, civil society organisations, and customers, to be more engaged with company’s ESG issues and have a better understanding of its ESG performance and impact on society and the environment. In addition, Cuomo et al. (2023) found that firms that adopted CSR reporting experienced lower systematic risk and cost of equity after the enactment of the EU NFRD. However, Cuomo et al. (2023) also identify several challenges associated with the NFRD, including a lack of enforcement mechanisms, inconsistencies in reporting standards, and limited engagement from investors in using ESG information.

Overall, Cuomo et al. (2023) suggest that the NFRD has had a positive impact on CSR in Europe by increasing transparency and awareness around ESG issues. However, further improvements are needed to ensure the quality and comparability of ESG information and to encourage greater investor engagement.

4. Are the components of ESG substitutes or complements?

Most existing studies in the vastly growing ESG literature focus on overall ESG performance and its impact. Duygun et al. (2023) take a different perspective. They recognise that ESG captures different aspects and dimensions. Specifically, they examine whether Environmental, Social and Governance are complementary or substitutes.

The methodological approach they take draws on economics and estimates elasticities. It implements the innovative methods developed in Glass, Kenjegaliev, and Kenjegalieva (2020) to estimate elasticities from the input distance function (IDF). Complementarity in quantity (q) is estimated as the marginal value of an input to a change in the quantity of another input. Complementarity in price (p) is given by the response of an input quantity to a change in input price. Environment, Social and Governance rankings are q -substitutes as measured by cross-elasticities. This suggests that firms are facing trade-offs and have to choose which ESG element to prioritise given finite resources available. However, the study also finds that E, S and G are p -complements; this indicates that when the price of any falls then there is an increase in the expected quantity of all 3 chosen.

The results therefore appear to align with the view that ESG is an investment of resources by a firm with the aim to score as highly as possible. At the margin, there is a trade-off between the different dimensions of ESG. This is an interesting and important insight. However, this is not inconsistent with there being projects or situations with benefit all dimensions of ESG; these would not however be marginal projects.

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