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Issues in Sustainable Finance – a research agenda

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- Disclaimer: the following comments are not the outcome of rigorous research. They represent my opinion, are subjective and not comprehensive. They are meant to stimulate a discussion.
  - I do think that sustainable finance needs exactly that: discussions about the research agenda; focused programs and initiatives rather than vague and unspecific programs with catchy titles.
  - Please note that my examples will be highly stylized and meant to only illustrate potential challenges in research.
  - My claims will be on a general level rather than prioritizing and emphasizing individual research questions.

- Four key themes:
  - Fact-based versus agenda-driven research.
  - Theory.
  - Data.
  - Interdisciplinary approaches.

- Challenge in the context of sustainability because the agenda is clear --- but that must not drive our research results.

- Agenda-driven results might appear to be successful in the short-run but will be very counter-productive and costly for the process of transforming our economy into a more sustainable economy in the long-run.

- Example 1: the debate in asset management.
  - “Doing well by doing good“:
    - Not surprisingly, a popular result.
    - Sounds a bit too good to be true.
  - However, in the long run, investors might need to realize that in order to save the planet we might have to give up returns even if that is a less popular message.

- Example 2: the debate about the goals of the firm – shareholder value maximization versus stakeholder value maximization.
  - Interestingly, it is almost precisely 50 years after Friedman's famous NYT article in which he claims, "the only social responsibility of business is to increase its profits".
  - Interesting sequence of posts about the Friedman article including contributions by Zingales, Rajan, Fama, Edmans, Kaplan, etc.: https://promarket.org/tag/friedman-50-years-later/
  - A common theme of those blog posts is that one needs to read Friedman's NYT article carefully, put it in perspective to economic theory and discuss it fact-based rather than agenda-driven.
  - Alex Edmans suggests that the Friedman perspective serves as a benchmark (like Modigliani-Miller's irrelevance theorems) and that one needs to identify deviations from the underlying assumptions to justify deviations from shareholder value maximization.
    - More on this later…

- The fact-based versus agenda-driven discussion has the following implications for research:
  - There is need to develop theory to better understand the mechanisms under which ES-dimensions start to matter in the financial context. Also, empirical research needs to impose a consistent conceptual framework when interpreting results.
  - It is important not to abandon the "finance" in "sustainable finance“.
  - One should also not bluntly discard the literature but build on it (or have good arguments to follow new paths).

- Back to example 1: what are conditions under which "doing well by doing good" could appear to hold in the data?
  - Market does not fully price in the positive effects of ESG on future cash flows (see Pedersen et al., 2020).
  - The market does not correctly anticipate future preference shifts towards SRI, i.e. more investors will become socially responsible. Unanticipated preference shifts lead to price increases of clean firms and price drops of polluting firms (Heinkel, Kraus and Zechner, 2001).

- Back to example 2: the conditions under which Friedman's shareholder wealth maximization deviates fundamentally from stakeholder value maximization.
  - Based on Edmans' blog post "What Stakeholder Capitalism Can Learn From Milton Friedman".
  - One key assumption Friedman makes is that a company has no comparative advantage in socially responsible actions → as a consequence, any choice to support a good cause becomes arbitrary and could have been done by any individual or any other firm → however, if there is a comparative advantage along the socially responsible dimension, then a given firm should pursue that specific investment → and it will do so if it follows stakeholder value maximization principles.
    - Coca-Cola, for example, has developed expertise in logistics to distribute its drinks all over the world → they leverage this expertise to distribute medicines throughout several African countries; medicines rather than books, as the former must be kept cool—and, as a drinks company, Coca-Cola has a particular comparative advantage in refrigerated transportation.

- This is an obvious point. Still, a very important one.
- We need better quality data.
  - Verified, standardized and not self-reported.
    - Basically, we need ESG to become part of "financial reporting".
    - ESG-data needs to be validated like financial data is validated by auditors.
  - Measures that measure what matters: a key issue for the research agenda is to study the right output variables (e.g., detailed data on emissions) and not necessarily the available output variables (e.g., financial returns).
    - A main challenge for research is to find evidence that any of the current developments in financial markets (e.g., the large increase in SRI) will have any measurable impact on the environment or other dimensions of ESG.
    - Currently, we study the impact of ESG on bond spreads, equity returns, fund flows, etc.. This is interesting in a traditional finance context but does not teach us much about the progress we are making in the transition to more sustainable markets.
    - Research in sustainable finance needs to go one step further and also establish that any of the patterns documented in financial markets will cause (are likely to cause) a change in the behavior of firms, consumers, market participants that ultimately leads to a reduction in emissions or better safety standards for workers, etc.
      - Side note: this, however, is difficult and challenging to achieve beyond the data availability issue.

- Sustainability is an area that asks for interdisciplinary research but that is very tricky for several reasons:
  - More challenging in terms of production because different disciplines write very different papers (even the overall process of research varies substantially across disciplines).
  - Few journals that are top quality publish interdisciplinary research.
  - Thus, hard to evaluate and assess such research in tenure and promotion situations (leading to incentive problems for junior faculty).
  - Interdisciplinary research must not compromise in terms of quality within each field involved.
- Academia, broadly speaking, and finance as a field, in particular, need to find a better framework to foster, evaluate and reward interdisciplinary research.

- Sustainable finance is a special topic at the intersection of multiple disciplines that is growing very quickly.
- I think it is important to think carefully about the research agenda to ensure that academic research will contribute to the transition to more sustainable markets.
- Important aspects of that research agenda:
  - Favor fact-based and avoid agenda-driven research.
  - Focus on theory and do not discard established principles in finance without good arguments.
  - Improve the quality of ESG data and measure variables relevant for sustainability.
  - Stimulate and enable interdisciplinary approaches.