From value to valuation: an economic case for sustainable finance

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"Who killed the ESG party?" the Financial Times asked last July. From a somewhat niche topic a decade ago, sustainable finance has become one of the top strategic agenda items at most financial services firms in Europe. Yet, the momentum seems now to be running out of steam.

Sustainability is not trendy

While the number of sustainable investment products skyrocketed between 2019 and 2021 (driven among others by the reclassification of pre-existing products), new launches have now plummeted globally since the 2021 peak. This year, existing products even witnessed net asset outflows in all regions of the world except in Europe – but even there, net new money has considerably slowed.

As governments worldwide continue developing regulatory frameworks, the complexity and cost of compliance have significantly increased. Some product manufacturers are considering stripping their investment funds from any sustainability-related terminology, repelled by the regulatory burden and risks linked to such classification. In the same period, the significant media coverage over greenwashing allegations at a small number of prominent financial services firms has unfortunately given a serious hit to the credibility of sustainable engagements overall.

Above all, the accumulating shakes to the global geopolitical order, exacerbated by the return of war on European soil, have shifted investors' priorities to what feels to be more immediate and pressing concerns. By comparison, ecological risk may appear as a deferred, obscure danger, distant in space and time. It is the subject of suspicion rather than certainty, thereby entertaining the illusion that change can wait and the hope that, with some luck, all of this may well have been just a terrible misunderstanding.

Aligning to values or generating value?

Still today, only a small fraction of investors would be willing to sacrifice performance and returns to align their investment to specific values. To expand in a world where financial services firms simply can't ignore returns, sustainable finance has to make economic sense.

It is the opinion of this paper that, even though international frameworks are still in their infancy (e.g. on how to embed climate and other risks in investment valuation principles), sustainability should already be a critical component of any investing or financing strategy in order to reduce the risk of financial losses.

Climate risk is a financial risk

Let's pick the example of climate risk. Increases in natural hazards, such as wildfires, floodings, storms, are creating more and more frequent disruptions in agricultural production, energy grids, or supply chains. This contributes to feeding price inflation, that many countries are already struggling to contain. Manufacturing plants, storage facilities and other properties turn out to be vulnerable to flooding or wildfire, what leads to production interruptions. This, in turn, obviously drives insurance premiums up, and at the same time pushes real estate valuation down.

In June 2024, sudden floodings in Switzerland submerged different cities and affected not only private households but also industrial production sites, among which the company Novelis, a supplier of aluminum alloy. Just a couple of weeks later, Porsche AG was releasing a public statement that it would have to cut its sales and profit outlook for 2024 by ca. 2 billion euro, due to a shortage of aluminum alloy caused by flooding at an unnamed European contractor – which commentators agree to identify as Novelis. This immediately led to a 4% drop in Porsche's shares.

The present or upcoming impact of such scenarios on the financial resilience of investee companies, and in turn on returns, margins and asset values, is of direct relevance to portfolio managers – across all asset classes. The potential adverse impact of these scenarios on the solvency of borrowers cant also not be ignored by banks and other lenders. It seems wise, already now, to assess this risk as part of initial and ongoing credit risk due diligence, and to reflect it in credit indentures.

A recent study by the European Central Bank ("Climate risk, bank lending and monetary policy", August 2024), indicates that some lenders are already taking into account the carbon intensity of their borrowers in adapting their lending conditions. Putting into perspective data from the ECB credit register and carbon emission statistics reported by companies, the study observes that banks already charge (in average) higher interest rates to companies with greater carbon emissions and lower rates to firms committed to lowering their emissions – indicating an expected link between them and the company's expected risk of default.

The study also explores the effect of monetary policy, and notes that while restrictive monetary policy increases the cost of credit and reduces lending opportunities to all firms, its effect appears to be milder for firms with low emissions and those that commit to decarbonization.

Modelling future impact on equity valuation

These are empiric, almost trivial, observations, but they are complemented by an increasing number of technical papers modelling the effect of climate risks (both physical and transition risk) on equity valuations. A recent EDHEC study ("How does climate risk affect global equity valuations?", July 2024) looks forward into the medium term and explores, under various scenarios, how climate change-related transition costs and physical damages may impact global equity valuations. The study establishes a negative impact from climate risk on equity valuation versus what its authors call "a no-climate damage world".

It concludes that strong abatement policies (i.e. the set of strategies and regulations aimed at reducing greenhouse gas emissions) aligned with the Paris Agreement's target to "limit the increase in the global average temperature to well below 2°C above pre-industrial levels" may keep global equity valuation losses between 5 and 10%. Without such policies, the authors expect a downward correction in equity valuations reaching as much as 40%. While this projected impact is more severe than typically reported in other studies, the authors interestingly note that it is actually based on conservative modelling assumptions – e.g. interest rates systematically fall during periods of low economic activity. Other studies and data sources, such as the ENCORE database, give us also interesting insights on the wider question of the dependency of many human industries and economic sectors to natural assets – water, soil, habitat, etc.

The right thing to do also makes economic sense

Of course, a couple of studies do not yet constitute scientific or market consensus, and climate risk is only a subset of all the dimensions that compose a sustainable finance framework. But let's not underestimate the extent of global wealth exposed to risk from the possibility of assets becoming stranded - whether from technologies becoming outdated or from capital and property becoming uninsurable. Enough data from sufficiently diverse sources is at our disposal indicating that we are on the verge of a significant change in business models that will affect the economic future of many investee companies: value of their assets and equity, creditworthiness, and resilience of their business model as a whole.

The massive market value destruction and social harm induced by the 2008 Financial Crisis taught us the inherent faultiness of focusing on short-term profit. Some prominent scandals in the past years, like Wirecard, showed us that good governance is not just a buzzword, but a primary condition to the reliability of invested assets' valuation.

Because it holds the reins to financing flows, the financial sector has the potential to significantly influence the transition of the economy. The financial sector is presented with this unique opportunity that the right thing to do is also what makes economic sense. Non-profit organizations like the Luxembourg Sustainable Finance Initiative[1] or Swiss Sustainable Finance[2] are dedicated to helping the financial sector on this journey. Now more than ever is the right time to promote and develop investing and financing practices that focus on the underlying forces that determine lasting value, facilitating the transition to sustainable and prosperous economies on the long term.

1) lsfi.lu
2) Sustainablefinance.ch