Sustainability risk and the capital markets

Socially responsible investments are slowly integrating with the broader financial markets. According to DAVID HUGHES a necessary next step is applying accepted accounting principles to this sector.

To date, the Socially Responsible Investments (SRI) sector has provided the capital markets with its viewing platform for coming to grips with “sustainability”, and from which the sector hopes that efficient market mechanisms may begin a rational process of capital allocation or re-allocation.

But what do the mainstream capital markets really understand about sustainability and those corporations that may be tagged as having “sustainability at risk”? Do the capital markets relate to the largely value based rating assessments? Are the capital markets ready to pick up on, and accept, emerging sustainability pricing signals? Are such pricing signals robust enough for mainstream analysts?

The answer to those questions at the moment is no, not yet. However interesting developments, particularly in the UK are putting a dollar price on sustainability and this is a language the markets will understand.

Sustainability

Sustainability is a collective environmental and social term and is widely described in the literature. (Refer Sustainability and Ethical Funds Management by Dr Sue Gosling, JASSA Issue 3, Spring 2001).

An important, but hidden, building block in measuring sustainability is the availability, access to and cost of embedded natural capital. Natural capital is used by all industry sectors in generating its productive output but, unlike financial capital, it is not priced. A firm that produces coal based electrical energy, or a manufacturer which consumes coal based electrical energy, is part of a value chain whose value is dependent, in part, upon the emission of carbon dioxide (CO2) into the atmosphere.

In agriculture, we have adopted farming systems that are inefficient in their use of water and which together with land clearing, have led to land degradation and dry-land salinity.

In a world that appears to have lost control of its natural carbon balance, and where the reversal of salinity is a major future cost, governments, the wider community and an increasing investor base are saying that the sustainability of our core economic system is now dependent on such capital being priced and paid for.

A firm’s alchemy of growth involves funding a pipeline of growth options over multiple time horizons. If a firm, in funding and resourcing each growth option, omits to provision for or hedge such future cost of natural capital in setting its targeted returns, it may risk unforeseen adjustments to its future value and dividend flow. In capital markets terms, this may give rise to sustainability at risk.

The market will develop in a way that holds a firm accountable in this regard. Are we able to empirically derive such costs in a way that is transparent and consistent and which adopts a standard that mainstream market analysts can
relate to? With the development in the UK of quantitative methods to generate sustainable after-tax profits by placing a transparent dollar value on environmental avoidance and replacement costs, there is a very exciting opportunity to start providing the markets with empirical data it so desperately needs.

Monetising the value of community or social capital and internalising this into mainstream accounts remains a more difficult task. This important area may default to social audits and their make-up of the SRI of corporate governance score.

**The sustainability option value**

Does an incremental investment by a firm in natural and social capital and tighter governance raise profits and share prices or do successful firms with higher profits and stock prices undertake such investments because they can afford to? This might be a circular argument.

If such investment outlay, and the embedding of a core sustainability culture in firms, can raise profits then two issues emerge:

1. Why is every firm not doing just that?
2. Any consistent “connect” between companies that make such investments, or have the potential to implement such investments, and their share price, would imply that the financial markets are efficient in their recognition of such signals. Such recognition is manifested in capital re-allocation towards these firms.

High variance SRI ratings appear not to be sufficiently robust at this stage to provide this market signal to mainstream analysts. Either that or the broader financial markets are not able to efficiently identify with and measure such signals.

The incremental investment can be viewed as an option value in converting or switching a less acceptable firm into an acceptable firm. The cost of this conversion or switching option will have different values according to industry sector and market recognition.

In a simpler form, and by way of
To monetise their environmental impacts and in so doing placing a value on the natural capital that they use. These externalities are internalised into the company’s mainstream accounts with the result that after tax profits and after tax sustainable profits are generated in the earnings statement.

In arriving at its after tax sustainable profits, Wessex Water has placed a market value on avoidance and restoration costs. The value is what Wessex Water would need to spend in order to avoid the collective range of environmental impacts. For example, the costs of avoiding 60% of the emissions associated with the company’s use of fossil fuel-derived electricity are based on the costs of developing on-site renewable energy supplies. (In Australia, this might not be a least cost abatement option given availability to the retailer of green-power credits, for example.) Carbon emissions from transport and gas consumption are based on the market price to sequester 90% of emissions.

Such assessments of sustainability cost allow the company to budget capital for a sustainability trajectory. More importantly, it provides an important market mechanism.

For its 31 March 2001 accounts, Wessex Water publicly discloses the following bottom line:

**WESESX WATER**

Profit after tax as per financial accounts: £72,000
Sustainability cost: £8,341
Environmentally sustainable profit: £63,659
Sustainability cost as a % of PAF: 11.6%

This sustainability cost of £8.3 million is effectively the firm’s conversion option value—Ks. The firm can elect to provision for this amount in the accounts or leave it and let the markets adjust its firm value and share price accordingly.

Funds may elect to screen out firms that have a sustainability cost/profit ratio of say 25% or higher. Such firms may not have access to the required capital and may be M&A targets to a firm with a low sustainability cost to profit ratio.

Because of data transparency, market analysts can adjust or input their own avoidance costs. The UK work by Forum for the Future is not only limited to utilities. This external cost accounting is being tried across all sectors.

Although external accounting is still very much an evolving science, an interesting question emerges: To which earnings figure should the dividend payout ratio most logically apply?

**Rating the sustainability raters**

Sustainability as discussed in this paper is not rated as such. However, different specialist groups in the market rate its various environmental, social and corporate governance building blocks. Each group operates with its own rating architecture and objectives. They vary quite markedly.

**The SRI raters**

SRI ratings agencies benchmark listed corporations against each other on the basis of their commitment, management and performance on environmental and social issues.

A complicating issue for the markets is the high variance in company rating scores from the SRI ratings agencies. This results from the SRI ratings agencies varying markedly in their core rating architecture, the way they measure and score environmental, safety, social and management issues and the way they differentiate between parameters.

The FTSEGood family of equity indexes adopts selection criteria that are biased to reporting and management systems rather than performance. The Eiris team, which analyses companies on behalf of FTSE, believes that at present there is insufficient comparable data to rank SRI performance. SERM, the UK rating agency, assesses a firm’s capital at risk due to social, environmental, safety and reputational risk. DJSGI, in association with SAM, tries to identify industry leaders. Its indexes contain only those companies judged to be in the top 10% in each industry sector.

Although the SRI agencies have focused on independent verification and transparencies, and their market acceptance is growing, the high variance in results also troubles the
companies themselves. This makes them less sparing of the time they allocate to the agencies. A company at the top of a FTSE Good index can find itself at the bottom of a SERM index. Environmental Resource Management (“ERM”), as advisers to many of the top FTSE firms, has encountered first hand the negative attitude that this creates within the firm at both board and management level.

We see here a disconnect between the SRI and credit rating agencies. The credit ratings agencies, as custodians of the bondholders, have a more consistent rating architecture in rating issuer default risk, and one that, with the passage of time on their side, is more accepting to the market. Investors, even core SRI fund managers, are not at ease with the high variance in output by the SRI raters. However, active investors will successfully exploit such inefficiencies. The credit agencies do not apply SRI principles in rating default risk.

**Rating corporate governance**

Corporate governance and disclosure are an integral component of sustainability risk analysis. Events surrounding the recent collapse of world-class corporates will cause the markets to tighten up on this issue. Standard & Poor’s Corporate Governance ratings, although still early in their development stage, may represent an instrument that the markets may wish to promote further. The agency assigns a corporate governance score (CGS), which measures the extent to which a company’s governance practices serve the interests of financial stakeholders. The corporate governance rating architecture is the result of four component scores on a 1-10 scale. By way of illustration, Standard & Poor’s recently assigned a corporate governance rating of ‘CGS-8.3’ to Hong Kong Exchanges and Clearing Ltd. (HKEx). The score components were:

- Ownership structure and influence 8.0 (maximum 10)
- Financial stakeholders relations 8.0 (maximum 10)
- Financial transparency and information disclosure 9.3 (maximum 10)

- Board structure and process 8.0 (maximum 10)

**Disclosure**

Disclosure is driven by the rule of securities law and the embedded ethical machinery in the firm. As recent events have demonstrated, neither the SRI rating agencies, the credit ratings agencies nor agencies rating corporate governance can deliver where such ethical machinery elects not to disclose.

**Where to now?**

The UK has taken the strongest lead to date in issuing environmental and social reporting guidelines for Product Disclosure Statements (“PDS”) by the investment and funds management sector. In Australia, Section 1013D of the Financial Services Reform Act now provides for ASIC to develop appropriate PDS guidelines for socially responsible investing. While governments may act to set guidelines, they are actually reluctant to select standards by which sustainability related issues should be measured and valued (stated ASIC position). To a large extent, the standards adopted to measure and value the net sustainable bottom line remain a market consideration. In this regard, the capital markets, industry and bodies responsible for future financial sector reporting initiatives will hopefully progress this new, but important, discipline of sustainability costing accounting. The key focus areas are:

- Development of acceptable sustainability measurement standards;
- Valuation methods using acceptable restoration and avoidance costing;
- Integration into mainstream financial accounts;
- Understanding the impact of such accounting and need for consistency;
- Working to gain acceptance by mainstream analysts that sustainability is a financial term with environmental costings as an additional subset of core financial and governance risk assessment.

**Conclusion**

Efficiency in the capital markets would normally infer a certain order of governing behaviour. While an important element of such behaviour is governed by the need to preserve and grow capital, the markets are traditionally cautious in their acceptance and treatment of new pricing and risk signals. Assessing exposure to unfunded natural capital and the framework for measuring and valuing sustainability risk is not yet robust enough to influence mainstream market behaviour—but we are making a lot of progress.

It is only when firms or governments put a price on this natural capital and such costs are internalised in to mainstream financial accounts that the capital markets will efficiently identify with sustainability. In the meantime active managers will exploit some valuable inefficiencies in this field. With time, the adoption of workable sustainability cost accounting and a reporting framework that is acceptable to the market, it is possible that we will witness the merger of interests between the credit rating agencies and the SRI raters.

**REFERENCES**


Godling, S., 2001, Sustainability and ethical funds management, JASSA, 3.


Find out more at the Securities Institute seminars on this topic (Sydney 18 July and Melbourne 25 July) at: www.securities.edu.au/members/members_events.asp