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Sustainable finance: A new paradigm ☆

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ABSTRACT

We argue that our current approach to shareholder wealth maximization is no longer a valid guide to creation of sustainable wealth: An emphasis on short-term results has had the unintended consequence of forcing many firms to externalize their social and environmental costs. An unwavering faith in markets' ability to efficiently uncover long-term value implications of short-term results has created many unacceptable outcomes. Given the social and environmental challenges ahead, such practices and their unacceptable outcomes cannot be sustained. Therefore, a shift in paradigm is called for. We propose a *sustainable value creation* framework, within which all social and environmental costs and benefits are to be explicitly accounted for.

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1. Introduction

This paper was first delivered at the 2011 meetings of Global Finance Conference, April 5–7 in Bangkok, Thailand. The April 2, 2011 edition of *Bangkok Post*, like other local papers, was filled with reports of the flooding that had brought death and devastation to many areas of Thailand, and the Krabi area in particular. Its front page prominently displayed a quote from Samran Thetkit, a Krabi resident: "we have harmed nature, so nature has taken revenge." The emphatic tone of this Krabi resident was, perhaps, one of the most remarkable features of the article reporting on the devastating floods hitting the region. Two days later, the same paper laid out the cause and effect relationship that Mr. Thetkit had in mind. In that issue, Thawil Suwanwong, a former Thai agricultural official, blamed illegal logging for Thailand's 2011 flooding. Mr. Suwanwong was further quoted as laying the blame squarely at the doors of the Thai government, criticizing its policies in "promoting the planting of rubber and palm trees by boosting their prices". In essence, government's actions were held responsible for the deforestation that ultimately led to the flooding disasters of Thailand in 2011.

Half a dozen years earlier, on a different continent and in the aftermath of Hurricane Katrina, government inaction was blamed for the extent of damage caused by that storm. Long before Katrina hit the Gulf Coast of

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the United States, the American Society of Engineers had warned of the inadequacies of the Gulf Coast's defenses against a major storm. The warnings were not heeded, and the country ended up picking the storm's tab estimated at more than $110 billion. Moving forward in time, the same society's warnings, issued in 2009, regarding the precarious situation of New York were also treated with indifference.[1] Summarizing the results of simulations of storm surge threats, the group had recommended the installation of surge barriers in New York harbor to protect New York City. The report was shelved and two years later hurricane Sandy hit the Northeastern seaboard and the initial estimates of damage ran well in excess of $100 billion. The common characteristic of these types of governmental actions (or inaction, as the case may be) is an apparent failure to consider the issue of sustainability in the decision making process. In our first example, to mollify the income aspirations of an electorate, a government chooses to adopt policies that have short-term payoffs but are detrimental to the long-term interest of the population and are, therefore, not sustainable. In the second case, in an effort to minimize the immediate pain of imposing taxes (or otherwise finding a source of financing), a government ignores the longer-term needs of the society, thus exposing it to much greater risks and to much higher costs over the long run.[2]

Similar examples of sacrificing the long-term viability of the firm in exchange for the shorter-term payoffs are plentiful and can be easily documented across the world. One of the issues that the field of financial economic needs to address is the question of how to minimize the occurrence of such clearly inferior outcomes. In this paper, we argue that the solution, or at least part thereof, can be found in academia. Indeed, it can be argued that some of the blame for the occurrence of these inferior outcomes lay squarely at the doors of academia. Given our unquestioned faith in the efficiency of the markets, we have turned managers, and other decision makers, one generation after another into believers of the gospel that today's share price is the best indicator of long-term true value and that end-of the-quarter earnings numbers are the best indicators of a firm's true economic performance. Emulating the corporate world, other sectors have followed suit by putting undue emphasis on the “immediate” and the “short-term” at the expense of longer-term benefits, thus creating inferior outcomes. However, given the current paper's focus, and without loss of generality, our analysis will deal with the corporate decision making process.

1.1. Inferior decision outcomes

Perhaps, one of the best ways of demonstrating the detrimental effect of putting too much faith in short-term earnings numbers and on the share price would be to examine (albeit selectively) the careers of some who came to be known as the masters of such craft in producing explosive earnings numbers and skyrocketing share prices. *The CFO Magazine* annually recognizes such people as having reached the pinnacle of their careers and bestows upon them the CFO Excellence Award. Let us review the longer-term accomplishments of the three of their honorees beginning with the winner of the 1998 award, Scott Sullivan of Worldcom. Less than four years after having received this award, Worldcom filed for Chapter 11 bankruptcy on July 21, 2002, the largest such filing up to that point. In between the recognition and the bankruptcy, auditors unearthed a $3.8 billion fraud and an avalanche of bogus accounting entries orchestrated by Mr. Sullivan and his colleagues in Worldcom's executive suite.

The recipient of the 1999 CFO Excellence Award was Andrew Fastow, Enron's CFO. An award that recognized the spectacular growth of Enron's EPS and its share price which reached a record high of $90 per share by mid-2000. Not more than a year later a huge scandal unfolded and Enron's shareholders lost nearly $11 billion when the stock price plummeted to less than $1 per share by the end of November 2001. When

[1] See *New York Times*, “Engineers' Warnings in 2009 Detailed Storm Surge Threat to the Region,” November 4, 2012.

[2] Shortsightedness of this type is not limited to national governments or large cities. Examples can be found in many smaller-sized communities, where decision makers are much more likely to be affected by the consequences of their actions; either directly at a personal level or indirectly through their effects on their relatives and friends. One such example, reported in the August 30, 2009 edition of the *New York Times*, from Uniontown, Alabama is worth considering. In exchange for $30 million and the prospect of 30 new jobs, county officials there decided to bury three million cubic yards of coal ash into a landfill. One can easily rule out the possibility that such a deal could be in the long-term interest of the community, if one considers (1) that coal ash, because of its high concentrations of toxins (such as mercury, arsenic and other substances), is considered a hazardous waste by the EPA, (2) that the main source of livelihood for the area residents is catfish farming which will be confronted by a significant risk of contamination once the coal ash is buried in the landfill, and (3) that the area is susceptible to flooding and tornadoes, exposing the buried material to a high risk of uncontrolled dispersal. Indeed, the negative elements of the deal appear to overwhelm the short-term benefits.

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