All you need is G(overnance): Sustainable Finance Following Ambrogio Lorenzetti's Frescoes

by

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Outline

- Vision: 7 centuries ago the Allegory of the Good and Bad Government
- From the Single Bottom Line to the Triple Bottom Line
- Towards Sustainable Investing: ESG Ratings
- The Three Dimensions of ESG Ratings
- Is G more important than either E or S?
- The test of ESG Controversies: Indeed, higher G causes higher ESG Resilience
- The support from selected business cases
- Higher G associates also with lower equity price volatility
- Perhaps Ambrogio Lorenzetti was right with his 14th century frescoes

The Effects of Good Government, Ambrogio Lorenzetti, Siena, 1338

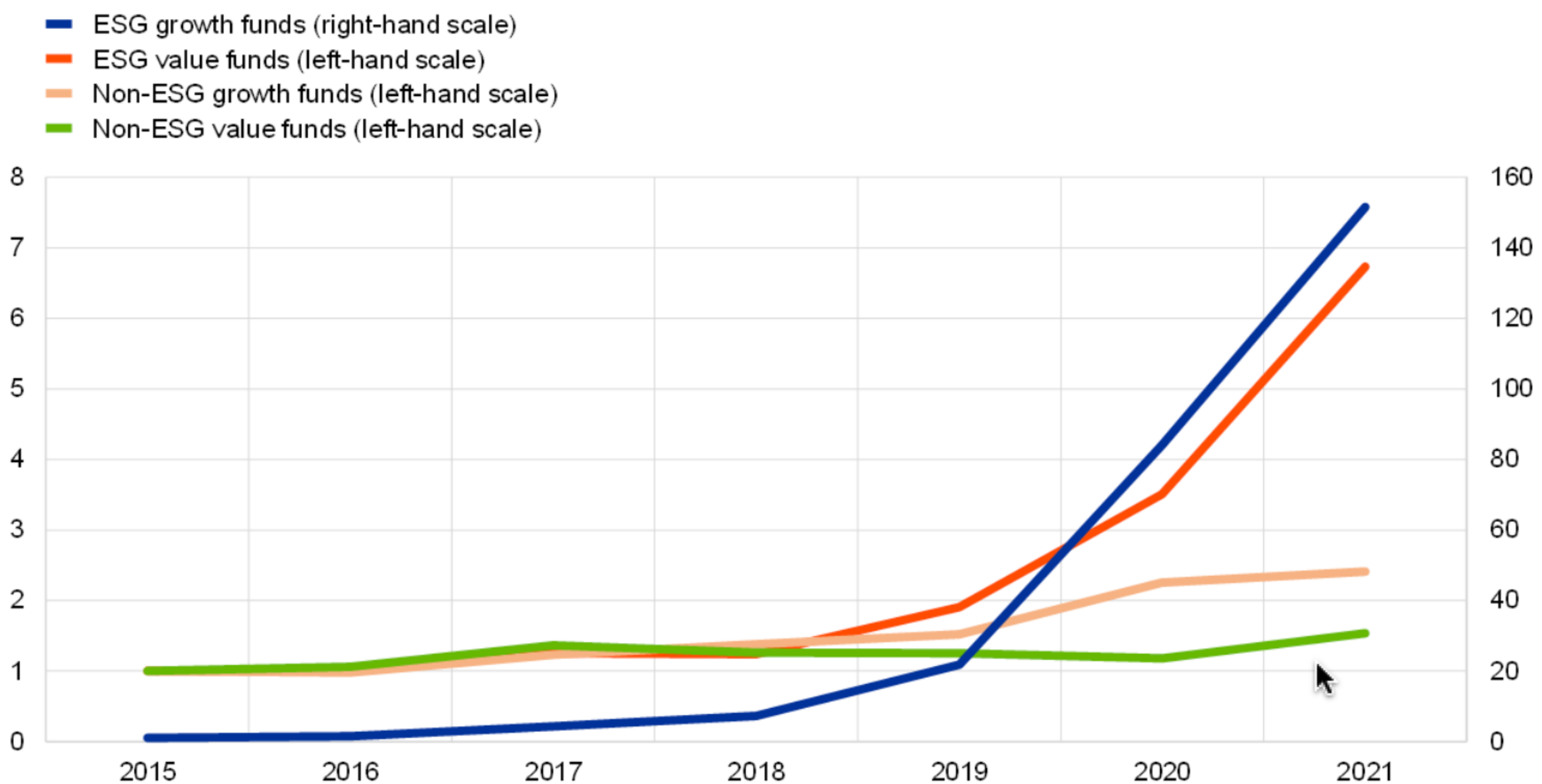
From the Single Bottom Line to the Triple Bottom Line

- From Shareholder Value to Stakeholder Value
- John Elkington' Triple Bottom Line
- Business Roundtable's U-Turn in 2019

Rapid increase in growth ESG equity funds

Rebased total net assets (TNA) of euro area equity funds

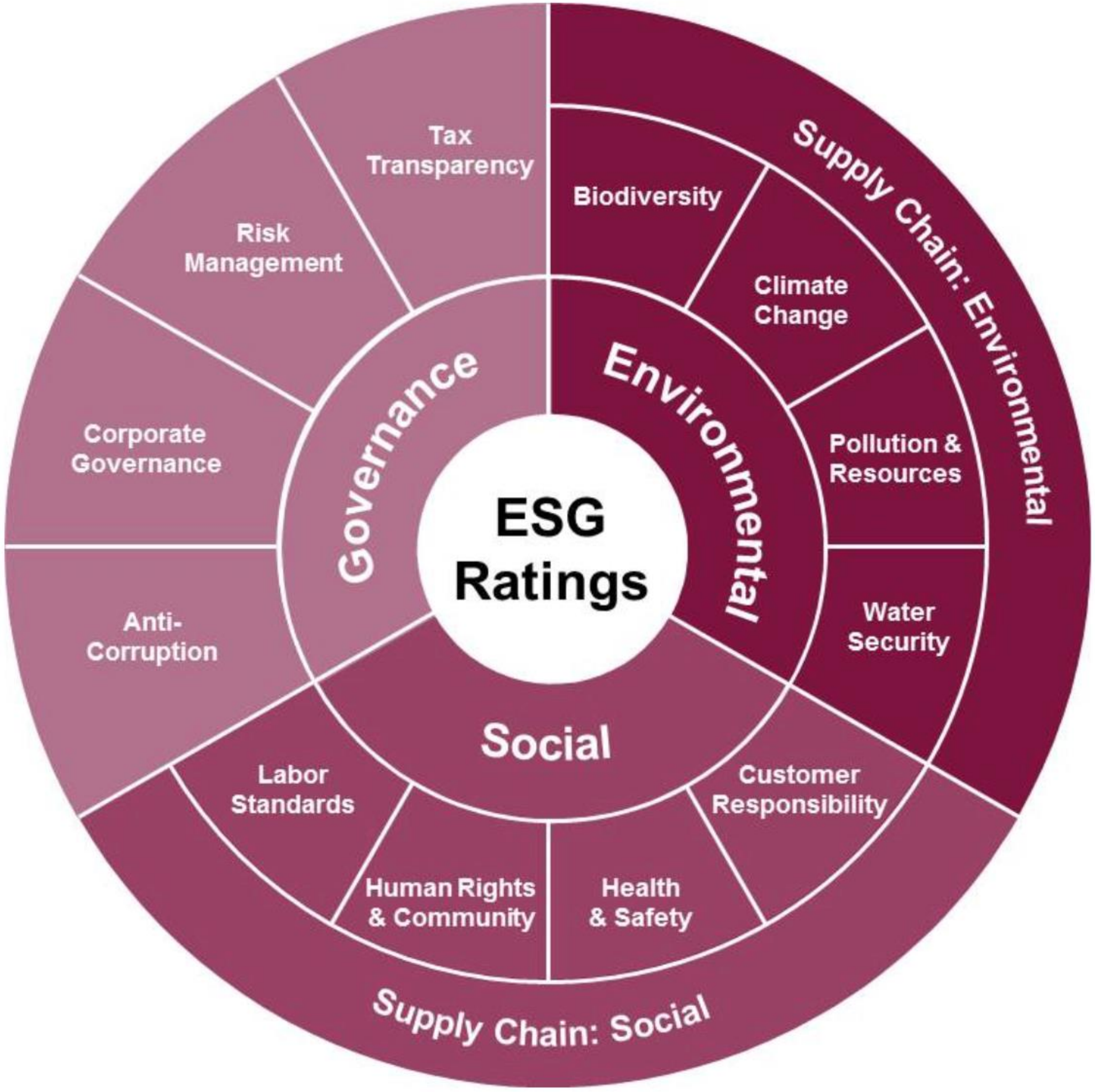
(TNA, rebased to 1 in 2015, December 2015 to June 2021)



Sources: EFPR and ECB calculations.

Note: The chart is based on a representative sample of equity funds in EPFR.

The Three Dimensions of ESG Ratings



Is G more important than either E or S?

H2: *Good performance in the Governance dimension contributes to controversies management more than good performance in either the Environmental or the Social dimensions.*

Table 12. ESG Controversies on ESG. This regression analyses the effect of the ESG controversy (t) on the ESG score (t + 1) if the company (i) had a Good Governance at (t-1) – Model (1-2); a Good Environment at (t-1) – (Model 3-4); a Good Social at (t-1) – Model 5-6. These models include firm and time fixed effects. Heteroskedasticity-consistent standard errors are reported in parentheses. ***, ** and * indicate that the parameters estimate is significantly different from zero at the 1% , 5% and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable	ESG(t+1) GG(t-1)= 0	ESG(t+1) GG(t-1)= 1	ESG(t+1) GE(t-1)= 0	ESG(t+1) GE(t-1)= 1	ESG(t+1) GS(t-1)= 0	ESG(t+1) GS(t-1)= 1
ESG Controversies	.0028	.02612***	.01189	.01585**	.00192	.01702
	(.00927)	(.00805)	(.00968)	(.00753)	(.00983)	(.0077
E	.20997***	.12358***			.33342***	.15766*
	(.01527)	(.01718)			(.01327)	(.0169
S	.30037***	.22566***	.38795***	.20789***		
	(.01504)	(.01724)	(.0128)	(.01672)		
G			.13944***	.08767***	.15459***	.10346*
			(.01146)	(.01315)	(.01177)	(.0134
TA	2.25421***	-.62153	2.6543***	-.05485	4.05241***	.7280
	(.49983)	(.65806)	(.51736)	(.6435)	(.51999)	(.6361
LEV	-.8991*	-.34658	-.8436	-.18253	-.45421	-.2307
	(.53722)	(.34228)	(.64524)	(.31167)	(.47796)	(.3425
PTB	.0436	-.1379	.0248	-.12184	.05735	-.1729
	(.06195)	(.09449)	(.06753)	(.08593)	(.06929)	(.0849
ROA	.03161	-.00239	-.03117	.05398*	-.0358	.05997
	(.02412)	(.03061)	(.02342)	(.03048)	(.02387)	(.0312
CASH	.02716	.26047	.19575	.16947	.66333**	.1100
	(.25416)	(.31917)	(.26638)	(.29128)	(.26687)	(.2987
_cons	-13.46329*	45.94456***	-24.94451***	44.33788***	-47.35263***	35.1744
	(6.97277)	(9.32879)	(7.06629)	(9.24201)	(7.22672)	(9.1233
Obs.,	4568	4613	4568	4610	4560	4618
R-squared	.29047	.09899	.30284	.06433	.27713	.0498

Standard errors are in parentheses
**** p<.01, ** p<.05, * p<.1*

The support from selected business cases – 1

- **Positive cases** (in both non-financial firms and financial firms):

- Petra Diamonds Ltd managed an ESG controversy in the Social pillar with high ESG resilience via good governance. Its ESG Controversies Score in 2018 was 15.69 (i.e. a serious level), an S score of 65.8 and a G score of 94.95. In 2019, following changes in the Governance, a major improvement: ESG Controversies = 100 (i.e. no controversy), ESG = 78.93, S = 68.21, and G = 95.65.

- SAP, a Software's AG competitor (see below) also involved in the #GuptaLeaks. As a consequence of good G changes, its ESG score increased from 93.43 in 2017 to 93.51 in 2018 notwithstanding the allegations, and SAP's G moved from 94.08 in 2017 to 96.26 in 2018.

- Unicredit managed an ESG controversy linked in the Social pillar with high ESG resilience via good governance. Its ESG Controversies Score in 2017 (the year the problems emerged) was 50, an S = 79.03 and G = 73.48 (well above the median sector). In 2018, following changes in the Governance, a major improvement: ESG Controversies = 100, ESG = 87.4 (vs an ESG score in 2017 of 77.55), S = 88.96, and G = 86.5.

The support from selected business cases – 2

- **Negative cases** (one in non-financial firm and one in financial firm):

- The misbehaviour of Software AG in the #GuptaLeaks and also its inaptitude to disclose any results or changes in the conduct, damaged its ESG Score. When the controversy occurred in 2017, the firm had already a G Score (32.23 in 2016) well below the median's sector. Lack of adequate repairing action resulted in a further decrease of the ESG score, from 53.52 to 47.67.

- National Westminster Bank suffered an ESG controversy linked to money laundering. However, the issues of money laundering were not even mentioned in the Annual Reports NatWest. The ESG scores decreased from 77.05 in 2012 to 74.58 in 2015 with an ESG controversies ranging from 6.82 to 15.22 signaling the magnitude of these events. The S score – that comprehends also anti-money laundering policies – decreased from 83.39 to 74.74 and the G score from 77.63 to 72.97.

Higher G associates also with lower equity price volatility

- H3: *When ESG controversies occur, good performance in the Governance dimension curbs equity volatility more than good performance in either the Environmental or the Social dimensions.*

Table 14. Equity volatility and ESG score instrumented by ESG Controversy and GRI compliance. This table shows the relationship between equity volatility and ESG score instrumented if a firm has a Good Governance (Model 2); a Good Environment (Model 4); a Good Social (Model 6). Heteroskedasticity-consistent standard errors are presented in parentheses. ***, ** and * indicate that the parameter estimate is significantly different from zero at the 1%, 5% and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	Volatility GG(t-1)= 0	Volatility GG(t-1)= 1	Volatility GE(t-1)= 0	Volatility GE(t-1)= 1	Volatility GS(t-1)= 0	Volatility GS(t-1)= 1
ESG	-.00534***	-.0069**	-.00627***	-.00465*	-.00435***	-.00583
	(.00144)	(.00316)	(.00143)	(.00275)	(.00155)	(.0024
TA	-.0026	-.00319	.01403	-.02492	.01131	-.0218
	(.0181)	(.0219)	(.02189)	(.02026)	(.02644)	(.0164
Debt ratio	.011	.01407***	.08755***	.00907**	-.00421	.01368*
	(.01007)	(.00408)	(.02144)	(.00384)	(.00725)	(.0040
PTB	-.00466***	-.00964***	-.00528**	-.00595***	-.00497***	-.00694
	(.00151)	(.00129)	(.00231)	(.0011)	(.0017)	(.0011
ROA	-.00176***	-.00279***	-.00217***	-.00267***	-.00245***	-.00278
	(.00062)	(.00047)	(.00062)	(.00046)	(.00064)	(.0004
CASH	-.00301	-.00907*	.00968	-.01042***	-.00256	-.01003
	(.00541)	(.00473)	(.00703)	(.004)	(.00671)	(.0040
_cons	.73252***	1.02448***	.29453	1.23604***	.44191	1.26579
	(.22478)	(.1877)	(.28333)	(.17847)	(.33894)	(.1473
Obs.,	1922	3081	1284	3719	1346	3657
Instrumented	ESG	ESG	ESG	ESG	ESG	ESG
Instruments	GRI ESGControv.	GRI ESGControv.	GRI ESGControv.	GRI ESGControv.	GRI ESGControv.	GRI ESGContro
R-squared	.0823	.0312	.0065	.0622	.0323	.0766

Standard errors are in parentheses
**** p<.01, ** p<.05, * p<.1*

Higher G associates also with lower equity price volatility

- If we hortogonalise and take the Good Governance residuals.

Table 15. Equity volatility and Good Governance residuals. This table shows the relationship between equity volatility and Good Governance residuals. Heteroskedasticity-consistent standard errors are presented in parentheses. ***, ** and * indicate that the parameter estimate is significantly different from zero at the 1%, 5% and 10% level, respectively.

	(1) Volatility
Good Governance Residuals	-.678***
	(.046)
TA	-.022***
	(.006)
Debt ratio	.006
	(.005)
PTB	-.007***
	(.001)
ROA	-.004***
	(0)
CASH	-.003
	(.003)
_cons	1.111***
	(.078)
Observations	10466
R-squared	.101

Robust standard errors are in parentheses
*** p<.01, ** p<.05, * p<.1

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