Climate Change And Finance: Is There Any Relationship?

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The Debate: What Is The Goal Of An Organisation?

In his seminal article "The Social Responsibility of the Business is to Increase its Profits", Milton Friedman argued that:

"There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception fraud."

Milton Friedman's views received many criticisms. In 1973, Peter Drucker argued in his classic book, *Management*, and suggested that "There is only one valid definition of business purpose: to create a customer…It is a customer who determines what a business is.

In recent years, as the debate around climate change has accelerated, the discussion around the goals of corporations and the topic of Corporate Social Responsibility (CSR) has received lots of momentum in Australia and the rest of the world. There are many theoretical arguments such as legitimacy theory, which proposes that organisations may continue to exist only if the society in which they operate perceives those organisations to be operating according to a value system consistent with the society's own. The view embodied within the legitimacy theory is that organisations will be penalized if they breach their *social contract*. Very similar to what Peter Drucker debated in the '70s, there is a trend of Shareholder Activism which is growing and points to events such as:

- The emergence of "green" financial instruments like the Swedish Green Bonds
- Institutional investors like BlackRock urging CEOs of major companies that climate risk is an investment risk
- Top Super Funds divesting from so-called "unethical investments"

Climate Change: Is it all about "Feel Good"

Whilst there is a "feel-good factor" associated with CSR, climate change, ESG, however you may wish to call it, the author presented one of the first published academic research demonstrating the quantitative evidence of the association between Australian firms' sustainability reporting practices and firm value, as measured by the ex-ante cost of equity capital and expected future performance. Cost of capital has a very important place in the world of finance and there is plenty of evidence to suggest that businesses which are perceived to be unethical will find it more and more difficult to access funding. A local example in Australia was Westpac and Commonwealth Bank ruling out lending to Adani coal.

When funding becomes expensive, this will increase the cost of capital. A firm's ex-ante cost of equity capital represents the discount rate used by investors when converting the expected future cash flows from an investment in the firm's stock to present-day value. Factors that affect the rate at which investors discount each dollar of future profits include the risk-free rate of interest; the perceived risk attaching to the firm's expected profits; and investors' risk tolerance.

More than a decade ago, the author argued through regression analysis for a strong association between sustainability practices and firm value. As we continue to see a change in what customers want, this association will continue to get stronger and it may provide some important debate in many company boardrooms around the strategic directions companies take.

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Kaveen is a qualified MBA academic with a progressive finance career spanning over 15 years. His experience is based on a variety of roles across geographies as well as several years of formal qualifications and trainings. In his current role, Kaveen is the Head of the Finance function for Glencore's zinc business in Australia.