



A Roadmap for Sustainable Capital Markets:

How can the UN Sustainable Development Goals harness the global capital markets?

An Aviva White Paper



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Foreword: Mark Wilson, CEO, Aviva



Aviva is a company that can trace its history back more than three hundred years to 1696. Such long-term success requires thoughtful strategic planning, a careful analysis of the risks and opportunities ahead, and diligent execution by the many outstanding employees who have worked for this firm.

As both insurers and investors we are well accustomed to thinking in the long term. And over the next few decades we see a new and growing category of strategic risk to global economic growth and the sustainability of economic development.

These risks originate from unsustainable economic activity that is motivated by mainstream economics' assumption of unlimited natural resources. This assumption helps simplify and model the complex economic reality we face but it creates a flawed pricing system. In a world in which we would need five planets worth of resources if all

countries consumed at the rates of the most developed, this simplifying assumption is increasingly dangerous to our future prosperity. This is why I am pleased that Aviva has published the first report to be associated with the United Nations Environment Programme Inquiry into the Design of a Sustainable Financial System, which was launched at the World Economic Forum earlier this year.

I am a strong believer in the power of the market to catalyse the innovation and entrepreneurialism required to meet the growing demand for goods and services from an ever-growing global population. I am also a strong believer in the role of governments to correct market failure. In my view, there are a number of important global capital market failures leading to unsustainable economic activity that are in need of correction by governments.

In view of the scale of our company, and the scale of the threats to economic growth from

unsustainable development, I challenged our investment arm - Aviva Investors - to work with others to develop some initial suggestions for how public policy makers could move the capital markets onto a more sustainable basis.

Aviva has an undeniable commercial interest in this work: the underlying issues are material to the long term success of many of the companies and economies in which we invest and so these reforms will benefit the long term investment returns of our investment clients and our shareholders, as Aviva itself is a significant asset owner. Left unchecked, climate change and other issues arising from unsustainable development would affect the actuarial assumptions underpinning the insurance products that our industry provides, potentially rendering significant proportions of the economy uninsurable and shrinking our addressable market.

I believe this report's key contribution is the series of proposals for capital market reforms. In formulating these proposals, I asked our investment arm to be ambitious and systemic, yet proportionate and practical. I believe they have delivered.

It should be clear by now that I personally consider sustainable development issues to present both strategic risks and opportunities to Aviva. My vision is that we will be regarded as good ancestors by future generations. Knowing what we do about sustainable development, we need to take action to protect the interests of future generations. I was

“My vision is that we will be regarded as good ancestors by future generations”

inspired by Gro Harlem Brundtland's seminal work on sustainable development a few decades ago. And this is why I want us to promote capital markets that finance development that, in her words, meet the need of the present, without compromising the ability of future generations to meet their own needs.

Aviva will focus on maximising our positive impact in transforming capital markets so that they are more sustainable. We will also continue to support and encourage the global companies that we invest in to integrate sustainability issues into their strategy and performance reporting. This will enable our analysts and fund managers to integrate these issues into their investment decisions and help protect the long-term value of our clients' investments.

In this way we will help to create integrated capital markets that properly consider long term sustainable development issues and help secure our common future - including the sustainability of Aviva's own success over the next three hundred years.



Foreword: Euan Munro, Chief Executive, Aviva Investors



As CEO of a major asset manager, I can see both risks and opportunities to us and our clients from issues such as climate change. The impacts of the worst case scenarios set out in the recent International Panel on Climate Change (IPCC) fifth assessment reports would be far-reaching for the environment, society and the economy.

This paper is clear that we believe the current structure of the global economy is unsustainable. We also believe that policy makers have an unprecedented opportunity to shape a better, more sustainable future for the planet and for our children. This would also enhance the long term financial value of companies, assets under management and entire economies. This is clearly critical for us as investors, and for our clients.

Policy makers have a duty to the wellbeing of current and future generations, as well as the environment upon which we all depend. As asset owners and asset

managers, I believe our industry has a fiduciary duty to do what we can to protect and enhance the value of client assets. I think this includes putting pressure on policy makers to address the key sustainability challenges within our capital markets and the broader economy. Government inaction in this area will reduce the wellbeing of current and future generations.

This paper proposes a three-fold framework for policy makers to harness the investment influence of capital markets. First, providing investment instruments for our capital. Second, changing the cost of capital for companies by altering their cash flows. And, third, harnessing the ownership mechanisms of equity investors.

I am extremely proud that Aviva Investors already does a great deal across all three areas. For example, we allocate capital to green bonds and renewable energy infrastructure. We go to considerable lengths to integrate environmental and social risks and opportunities into our investment analysis. And, as the case study on carbon action demonstrates, we have been engaging with the companies we invest in for over a decade. While this work is an important contribution, it is nowhere near the scale that is required to build a more sustainable economy. There are clear market failures which require strong action by global governments.

I share Mark's vision that we seek to be regarded as good ancestors by future generations. If our industry fails to engage with policy makers to ensure that they correct the climate

“Our proposals are for significant but incremental changes, not radical reform.”

change market failure, then those future generations will look back at those of us who were able to do something and see our legacy as their liability.

I am committed to using our influence as investors to work towards more sustainable capital markets. I would encourage those in similar positions of influence today to work together to urge government policy makers to correct these market failures as a matter of priority.



Executive Summary

For generations policy makers have sought to align the interests of the financial markets and society. Nowhere is this tension more keenly and persistently felt than in the relentlessness of the capital markets to allocate capital to short term, unsustainable uses and policy-makers' need to plan for the long-term and tackle a range of environmental and social issues, such as poverty, climate change and human rights.

The purpose of this report is to provide people involved in policy making with specific suggestions as to how they can move the capital markets onto a more sustainable basis. Adopting the conventional definition of sustainable development, we are seeking to promote: *capital markets that finance development that meets the need of the present, without compromising the ability of future generations to meet their own needs.*

The particular audience that we have in mind is people involved in policy making in governmental, intergovernmental, think tanks and non-governmental organisations who share our desire to move the markets onto a more sustainable foundation. Our immediate focus is those involved in the United Nations Post 2015 Development Framework, which will eventually replace the Millennium Development Goals once they come to an end in 2015. In particular, we seek to address the Intergovernmental Committee of Experts on Sustainable Development Financing. In addition, we also wish to address those policy makers involved

in the finance discussions surrounding the UN Framework Convention on Climate Change, as well as The UN Financing for Development (FfD) Conference (Monterrey 2) in Addis Ababa in July 2015.

Public policy makers have traditionally tended to focus on the flow of aid when considering traditional sustainable development issues. However, we believe that considering how the tens of trillions of private capital are allocated matters far more than how the tens of billions of dollars of official assistance get dispensed.

We see the primary failure of the capital markets in relation to sustainable development as one of misallocation of capital. This, in turn, is a result of global governments' failure to properly internalise environmental and social costs into companies' profit and loss statements. As a consequence, the capital markets do not incorporate companies' full social and environmental costs. Indeed, until these market failures are corrected through government intervention of some kind, it would be irrational for investors to incorporate such costs since they do not affect financial figures and appear on the balance sheet or – therefore - affect companies' profitability. This means that corporate cost of capital does not reflect the sustainability of the firm. The consequences of this are that unsustainable companies have a lower cost of capital than they should and so are more likely to be financed than sustainable companies.

We believe that the capital markets are of relevance to sustainable development policy makers for three distinct but related reasons:

1. As a way of *raising capital* to enhance government spending on sustainable development projects;
2. As a target for systemic change to integrate sustainability at each stage as the *financial influence* of the capital market via corporate access to capital can enhance or undermine long-term sustainable development goals; and,
3. As an *ownership mechanism* for influencing corporate practices that policy makers can seek to harness to improve the sustainability practices of existing listed companies.

We believe that policy makers need to *both change the pricing signals within the market and improve the readiness of the supply chain of capital to integrate sustainability issues*. This involves moving all participants towards a longer-term perspective when investing and exerting their influence as company owners. This requires an understanding of the role of institutions at each stage of the capital supply chain (see Section 3.1 and Appendix 1) and a clear vision of how this stage should *integrate* sustainability issues within its operations. Put simply, policy makers need to improve the profitability of sustainable businesses relative to unsustainable ones. They also need to improve the ability of all key market participants to integrate these signals. This report provides a few suggestions as to how this can be achieved.

For example, to put this in the context of climate change, the International Energy Agency estimates that incremental investment in the energy sector alone will need to reach around **\$1 trillion a year** from 2012 to 2050 in order to keep global average warming below 2 degrees Celsius.

The above three mechanisms of (i) *raising capital*; (ii) *securing financial influence* via changes to the cost of capital; and, (iii) *harnessing the ownership mechanisms* of equity investors should be explicitly integrated into the discussions within the UN Framework Convention on Climate Change and the forthcoming replacement for the Kyoto Protocol in 2015. It is hoped that this will be agreed at the 21st session of the Conference of the Parties to the UNFCCC, which is expected to take place in December 2015, in Paris, France.

We also believe that the above three mechanisms should be integrated into the UN's forthcoming Sustainable Development Goals. Such mutual reinforcement of objectives will multiply the joint impact of both the UNFCCC and the SDG processes. For example, the climate change Capital Raising Plans should be integrated within broader Capital Raising Plans for the SDGs.

As Jeffrey Sachs has argued, the SDGs should matter to investors as they could unleash a wave of growth-creating investments (Sachs, 2013). As a consequence, we have given some thought to how they could promote capital markets where participants systematically integrate sustainable development issues into their work.

Our specific SDG proposals are structured according the relevant thematic areas used by the Sustainable Development Goals (SDGs) Open Working Group and are as follows:

“Goal: A resilient, sustainable economy that optimises quality of life for all”
Targets: Economic Growth

- Develop SDG Capital Raising Plans: for all Governments to develop national capital raising plans covering how they intend to finance the delivery of a zero-carbon economy and the Sustainable Development Goals; and for these national plans to be coordinated at the international level by the UN and World Bank. These will include

a view on the money that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment, equity investment and sovereign and Multilateral Development Banks debt (see Box A on page 22);

- Establish Integrated Incentives: Governments to promote financial incentives along the investment chain that are fully aligned with long-term sustainable performance. This could involve reshaping the structure of individual remuneration along the capital supply chain;
- **Promote Integrated Financial Regulation: Governments to promote capital markets regulation that integrates sustainable development factors in the mandates of the supervision agencies of stewardship codes, listing rules and financial stability (*= key, see below);**

“Sustainable Consumption and Production (of financial services)”

- Improve Integrated Financial Literacy of the consumers and producers of financial services: Governments to have integrated sustainable finance into their national curricula by 2020; for the top fund manager and analyst courses such as the Chartered Financial Analyst Institute and for all the top MBA programmes to cover sustainable finance;
- Ensure Integrated Asset Ownership: Governments to ensure all asset owners¹ with more than \$1 billion under management publish a report to the beneficial owners and society on how they have integrated sustainability considerations into their investment management

agreements, or to explain why they have not done so;

- Ensure Integrated Investment Consulting: Governments to require all investment consultants advising on more than \$10 billion in assets under management (AUM) to include a report to their clients and society on how well they think their fund managers are integrating sustainability, or to explain why they have not done so;
- Develop Integrated Asset Management: Governments to require on a comply or explain basis all fund managers with more than \$10 billion under management to be publishing an integrated report to their asset owning clients and society by 2030, including details of how they have integrated sustainable development into all AGM voting, or to explain why they have not done so;
- Ensure Integrated Corporate Brokerage: Governments to require all investment banks to have considered corporate performance on sustainability into all their recommendations to investors and advice to companies, or to explain why they have not done so;

“Good Governance and Capable Institutions”

- Improve Integrated Corporate Governance: Governments to ensure all national corporate governance codes promote integrated corporate governance – i.e. corporate governance that integrates sustainable development;
- **Improve Integrated Reporting by companies, investment banks, stock exchanges, asset managers, investment**

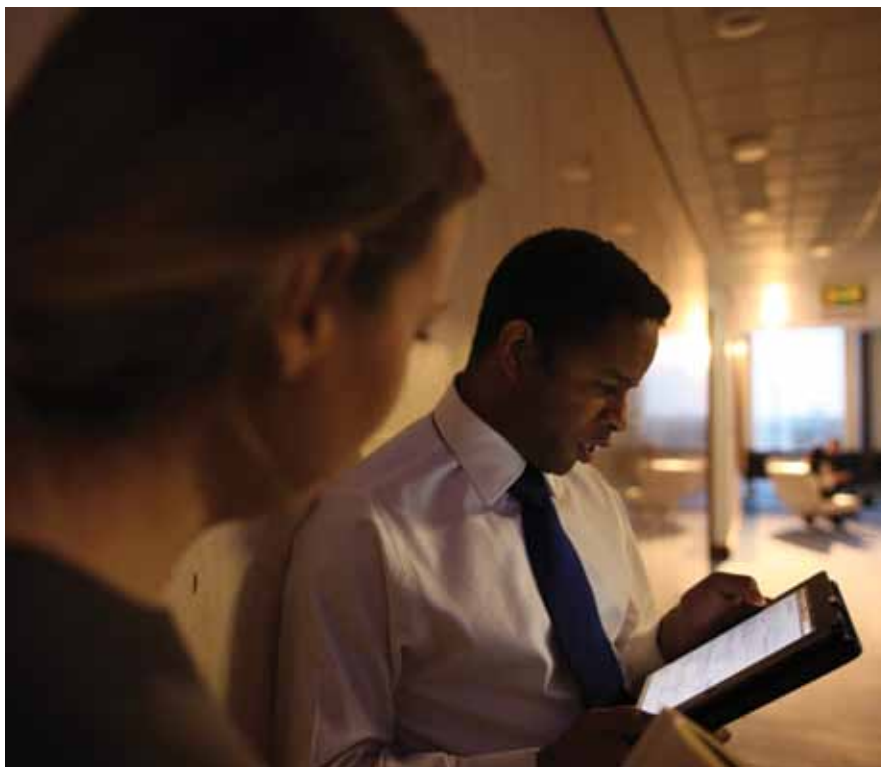
1. Such as pensions, insurance companies, foundations and sovereign wealth funds. This is partly for legal reasons in that a trustee has the responsibility to represent pension fund beneficiaries, and partly for practical reasons in that many trustees do not have the professional skills to assess the investment processes of fund managers.

consultants, asset owners and proxy voting agencies: Governments to establish a national legislative framework requiring participants in the capital market supply chain to be producing an integrated sustainability report to society – on a mandatory comply or explain basis; (* = key, see below)

- Improve Integrated Proxy Voting: Governments to call for proxy advisers covering at least 80% of the market to be integrating corporate sustainability performance into their advice to asset managers and asset owners on director (re)election, directors' remuneration, and the quality of corporate integrated reports, or to explain why they have not done so;
- Establish Integrated Investment Legal Duties: for long-term sustainable development to be incorporated into the legal duties of market participants including, in particular, their fiduciary duty and duty of care of asset managers and investment consultants;

(* = Following a round table discussion with a group of sustainable finance experts, the above two proposals marked in bold and with an asterisk were regarded to be the two key next steps for policy makers that are seeking to integrate sustainability into sustainable capital markets.)

For the health of the economy, society and the environment, policy makers feeding into the Post 2015 process, the UNFCCC and the FfD processes should integrate sustainable development issues into capital market policymaking. We need policy makers to work on the price signals and internalise corporate externalities onto company accounts via, for example, increased use of fiscal measures, standards



and market mechanisms. We also need to ensure that the culture within the City is one where each agent works to promote the interests of their clients rather than their own. Some of this will require greater government intervention, particularly around the regulation of investor delivery of responsible ownership and elsewhere a more light-touch approach will be required to help shift culture towards the long-term. In this way, capital markets can become the primary facilitator of a global green and just economy.

1.0 Introduction

The period 2014 to 2015 represents a vital opportunity for global decision makers in the financial and regulatory community to engage seriously with the task of creating sustainable capital markets.

The purpose of this report is to provide people involved in policy making with specific suggestions as to how they can move the capital markets onto a more sustainable basis: by raising capital for sustainable uses, moving capital from unsustainable practices and harnessing the stewardship capabilities of investors. In formulating these proposals, we focus on sustainable development issues that are relevant to business performance and aim to be ambitious and systemic, yet proportionate and practical.

The audience we have in mind is people involved in policy making in governmental, intergovernmental, think tanks and non-governmental organisations who share our desire to move the markets onto a more sustainable foundation. Our particular focus is those involved in the United Nations Post 2015 process, who are focussing on the Sustainable Development Goals that will replace the Millennium Development Goals once they come to an end in 2015. In addition, we also wish to address those policy makers involved in the finance discussions surrounding the UN Framework Convention on Climate Change, as well as The UN Financing for Development (FfD) Conference (Monterrey 2) in Addis Ababa in July 2015.

We believe that capital market policy makers have a central role to play in providing the kind of enabling environment necessary for companies, investors and others to act. As the President of the World Bank highlighted at the World Economic Forum in January 2014: *“Financial regulators need to lead, as well. Sooner rather than later, they must address the systemic risk associated with carbon-intensive activities in their economies, made clear, of course, by price signals. Start now by enforcing disclosure of climate risk and requiring companies and financial institutions to assess their exposure to climate-related impacts.”*²

Similarly, in October 2013, the OECD Secretary-General highlighted that: *“Governments need to stand back and look across the entire range of signals they are sending to consumers, to producers and investors. If they are serious about climate change they can leave no stone unturned – all avenues to price carbon in a cost-effective way need to be explored and all conflicting policy signals eliminated. A critical element in this is financing the transition. There is no shortage of capital in this world. The question is whether non-fossil energy investments can currently compete in terms of their risk-return profile. In addition to pricing carbon, that means ensuring the right regulatory arrangements are in place and where appropriate, sufficient incentives for investors to redirect investment from fossil fuels to more climate-*



friendly alternatives.”³

As many of the negotiators and policy makers are by definition not financial market professionals, we felt that we may be able to make a useful contribution to this debate by helping this community better understand how the capital markets work. We have therefore included an introductory section on how the equity markets are structured, and how they relate to sustainable development in Appendix 1.

Capital markets are large and complex, so it is important to be clear about the limitations within our proposals from the outset. The first and most important limitation is that our proposals do not replace the need for government actions that internalise the many externalities surrounding sustainable development. We have not, for example, developed specific proposals on such externalities for companies in a range of sectors, and there are limits to the extent to which reform

of the capital markets will be sufficient. Ensuring that the price mechanism works properly and, for example, properly values environmental and social goods and services is primarily the role of governments, not investors. If the economy is to be moved onto a truly sustainable basis, then we would expect to see governments taking action to correct the many distortions in the pricing systems on fisheries, freshwater, climate change and natural resource depletion. This is how sustainability issues become relevant to our corporate valuation work, and this is how our capital is put to work in the right places. This requires, for example, setting standards, creating fiscal measures such as carbon taxes, or setting up market mechanisms such as carbon trading schemes that price the externalities and ensure that the negative externalities are corrected.

In terms of the scope of our recommendations, while Aviva is one of the

**3. The Climate Challenge:
Achieving zero emissions,
Lecture by the OECD
Secretary-General, Mr. Angel
Gurría, London, 9 October
2013.**



world's largest insurance companies, the focus of this paper is how to promote more sustainable and responsible capital markets. We have chosen to focus in this way as we recognise that the capital collectively raised by the insurance industry can be deployed by asset management companies in ways that will exacerbate some of the hazards that we insure – climate change is an important contemporary example of this. As members of UN Principles for Sustainable Insurance, we play an active role in that debate.

We have chosen to focus on listed companies and the equity markets because companies are such significant users of the capital markets. As recent research by Harvard Business School shows (Eccles & Serafeim, 2013), the top 1000 listed companies are responsible for sales that are equivalent to 72.90% of OECD⁴ GDP. This is up from 30.9% in 1980. These companies also employ an equivalent of 8.1% of the

OECD working population (up from 3.33% in 1980).

The equity markets have the ownership influence and arguably, therefore, the ultimate responsibility. The Harvard presentation also shows that the top 25 asset managers control 58% of global assets under management. This clearly has important implications for policy makers regarding the balance of power, ownership and control.

Companies are also the principal source of Foreign Direct Investment. They use the equity and the debt markets to finance this FDI alongside their retained earnings. Being able to influence corporate practices via their equity owners can help to shape the sustainability credentials of the market for FDI as well (for example, portfolio investors can encourage companies to adhere to, for example, the Guiding Principles on Business and Human Rights when conducting their FDI).

4. It should be noted that the OECD figures are merely indicative. The increasing economic importance of Global Emerging Markets and countries outside of the OECD are clearly an important consideration.

Similar market failures and market inefficiencies also exist in the market for corporate debt and will be alluded to throughout the report. We recognise that the capital markets help finance a range of crucial public goods as they are mechanisms for governments to raise money via the issuance of sovereign debt, and bonds from multilateral development agencies.

To give a sense of how this capital was harnessed post the financial crisis, amounts outstanding on the global bond market increased by 2% in the twelve months to March 2012 to nearly \$100 trillion. Domestic bonds accounted for 70% of the total and international bonds for the remainder. The US was the largest market with 33% of the total followed by Japan (14%). As a proportion of global GDP, the bond market increased to over 140% in 2011 from 119% in 2008 and 80% a decade earlier. The considerable growth means that in March 2012 it was much larger than the global equity market, which had a market capitalisation of around \$53 trillion. This significant growth of the bond market since the start of the economic slowdown has been largely a result of an increase in issuance by governments associated with dealing with the implications of the financial crisis.

It is also possible to access the markets to fund projects via bank-led project finance, via infrastructure as an asset class, or to fund the establishment of commercial and residential property. While all of these asset classes can have positive or negative consequences for sustainable development, they are very different in nature and not covered in depth in order to focus this report on the asset class where ownership influence is greatest (it is hoped that these will become topics of other reports produced in conjunction with the UNEP Inquiry into the Design of a Sustainable Financial System: Policy Innovations for a Green Economy).

State owned enterprises and privately owned enterprises are also out of scope, as they do not make such significant

use of the capital markets. However, we recognise that the state can fund them through sovereign debt, and that privately owned enterprises can access the private equity and debt markets through private placements.

This report starts by examining the relationship between capital markets in their current form and the rest of society in their current form (as mentioned, a more thorough description of how the capital markets work and recommended reading can be found in Appendix 1). Section two then considers the relevance of the capital markets to sustainable development policy-makers with particular reference to their ability to raise capital, move capital and harness the ownership influence of investors. Section three looks specifically at misaligned incentives, imperfect knowledge and a lack of education amongst market participants. It offers policy recommendations to correct these market failures. The next section presents recommendations to the Post-2015 Development Framework, which we believe represents an excellent opportunity to address the failures of the capital markets in relation to sustainable development. And finally, section six provides a summary of recommendations made throughout the report.

2.0 Background

Capital markets are phenomenally important to society. The invisible hand of the market guides the production and distribution of the goods and services. Markets in general have enabled specialisation and trade, which has supported an economic rise from subsistence. Markets can help to provide for our education, our food, our energy, our healthcare and our housing. Allocating capital to innovative research and development projects helps to ensure that our economy continually improves the efficiency and effectiveness with which it meets our current and future needs and desires. From this perspective, markets provide the foundation upon which we build our culture, values and ambitions.

However, we have become increasingly concerned that the capital markets are built on unsustainable foundations. In 2001 we were the first asset manager in the world to integrate sustainability issues into our formal voting policy by voting against companies at their annual general meetings if they did not produce substantive performance data on material sustainable development issues. Since this time we have engaged with hundreds of companies to promote more sustainable and responsible business practices. In 2010 this work became a case study on the Harvard Business School MBA. We have also joined the Investment Leaders

Group of the University of Cambridge Programme for Sustainability Leadership, as well as the UN supported Principles for Responsible Investment.

The phrase sustainable development was defined by Gro Harlem Brundtland in *Our Common Future* as *development that meets the needs of the present without compromising the ability of future generations to meet their own needs* (Brundtland, 1987, p43). This is an important concept for investors as development that provides short term benefits but creates significant costs over the long term can reduce the absolute value of long term investment portfolios.

In order to help inform our views in this area, in 2011 we commissioned Forum for the Future to produce "*Vision 2040 – A Framework for a Sustainable Economy*". Forum for the Future's work has had an important influence on our views. They confirmed that the capital markets were allocating capital in a way that undermines sustainable development. Their research found that we are approaching the limits to which the amount of land surface can be converted to cropland, and that human processes convert more nitrogen than the combined effects of the Earth's natural processes. It also confirmed that the marine fisheries, and global forests are being exploited at unsustainable rates of consumption.

Individually, these problems are



deeply concerning indicators about the status and stability of our economic development. Collectively, they are profoundly worrying signs that our economy and capital markets are on an unsustainable footing.

In describing what humanity needs from our shared economy, Forum for the Future suggested: *"A resilient, sustainable economy that maximizes quality of life for all, so that people can develop their full potential and lead productive, creative lives within environmental limits"*.

This is a commendable and inspiring aim, and we at Aviva would certainly prefer to be able to deploy our capital in support of it. However, as investors and insurers, we should be clear that our commercial concern is the contemporary threat to financial stability and long term economic growth that originates from the unsustainable use of natural and

social capital.

2.1 Key concepts

In addition to the concept of sustainable development defined above, there are a number of other key concepts used throughout this paper, including: *corporate sustainability, short termism, responsible investment, and integrated reporting*. The rest of this background section will outline these concepts and how they relate to each other.

Corporate sustainability requires the board of a company to define a business strategy that is sustainable. This is defined by UNEP as follows: *"A sustainable strategy is one that enables a company to create value for its shareholders, while contributing to a sustainable society. A sustainable society is one that meets the needs of the current generation without sacrificing*

the needs of future generations. Thus a sustainable strategy is one that minimizes its negative externalities and integrates the material sustainability issues for its sector and strategy into the core of its operations". (UNEP, 2014).

The inter-generational aspects in the above definition of corporate sustainability hints at how it links to short termism. Short termism itself refers to the maximisation of short-term profitability. This can be a long-term problem for the economy as a whole: if the capital market does not sufficiently factor in long-term capital investment returns, then it undermines long-term investment decision-making by company directors and leads them to allocate insufficient capital to investing in the long term health of companies overall. In other words, short termism by companies stems from short term investors exerting pressure on company executives. While a lack of focus on the long-term financial health of a company is a general problem, short-termism is also a particular problem for sustainable development as it systematically erodes incentives for company directors to invest in a sustainable strategy that considers how a range of environmental, social and governance issues impact the future success of the business.

The Aspen Institute has published a set of guiding principles for "Long-Term Value Creation" that aimed to invigorate *"the ability of business to serve as the driver of long-term economic growth on a national scale, and to more fully serve the public good"*. It considers the role of investors in exacerbating short termism and suggested that company boards should *"De-emphasize short-term financial metrics such as quarterly [earnings per share] and emphasize specific forward-looking metrics that the board of directors determines are appropriate to the long-term, strategic goals of the firm and that are consistent with the core principles of long-term sustainable growth, and long-term value*

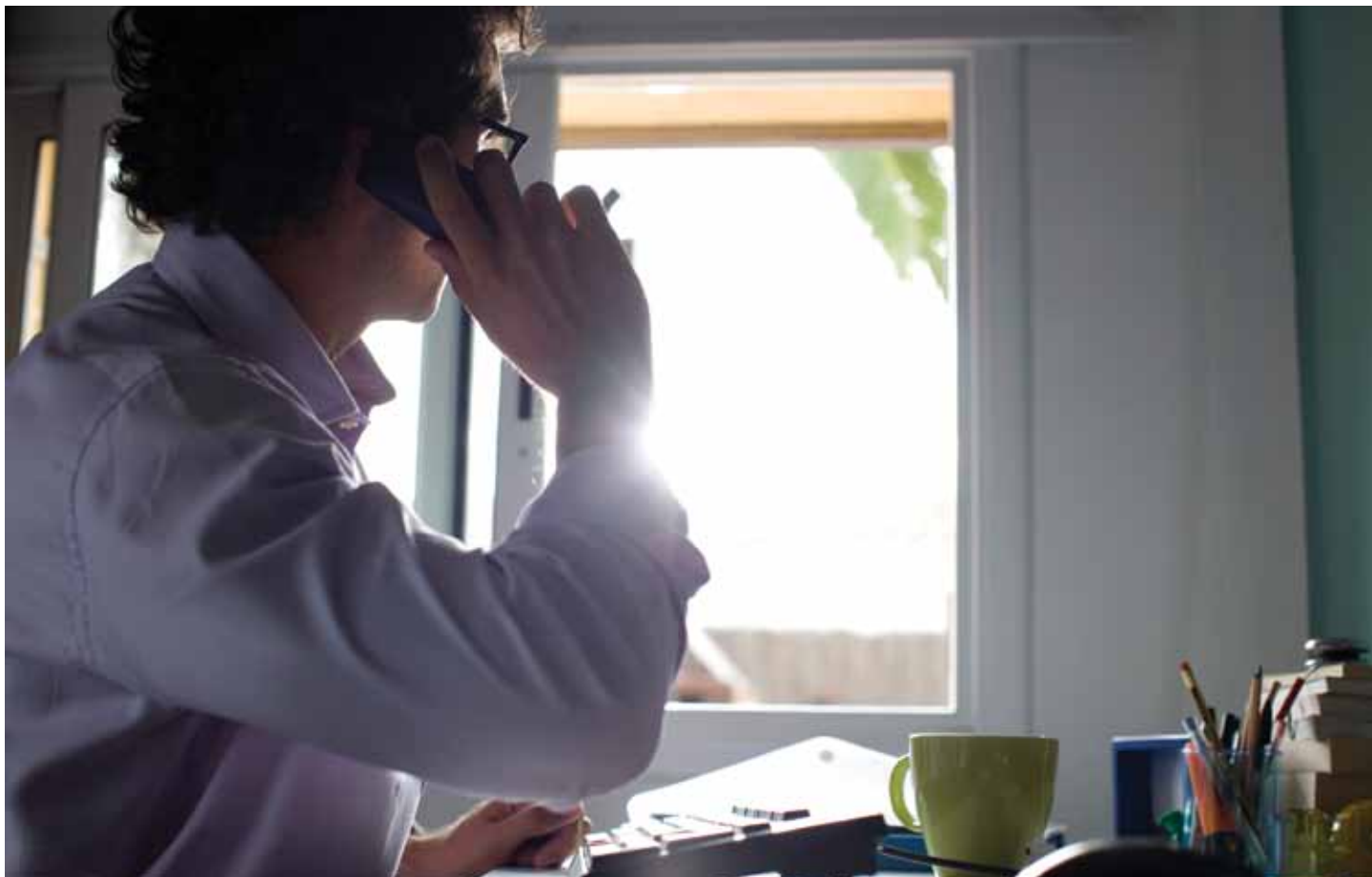
creation for investors" (Aspen Institute, 2007, p2).

The United Nations backed Principles for Responsible Investment (PRI) highlights the importance of the long term in its definition of responsible investment: *"an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems."* The PRI encourages asset managers and asset owners to integrate ESG issues into their investment decision making, as well as into the messages that they send to corporate boards as company owners. Responsible investment, therefore, helps deal with short termism by encouraging boards to focus on long term profit maximisation (see Section 5)⁵.

Integrated reporting by companies is fundamental to the ability to execute responsible investment strategies. Integrated reporting itself is defined by the International Integrated Reporting Council as: *"a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term"*. Measures of environmental and social capital are disclosed alongside to the more commonplace measures of financial stocks and flows published in a conventional report and accounts (see Section 5.2 for more details on Integrated Reporting).

Without Integrated Reporting, investors are unable to integrate the ESG performance measures of corporate sustainability into their valuation work. As a result, a company's cost of capital does not reflect its sustainability. This is critically important here – the aggregate

5. We would also like to highlight the excellent work of Generation Investment Management. They have published an important manifesto that has played a significant role in helping to catalyse this debate on how public policy can promote responsible investment and sustainable development. Appendix 3 includes this manifesto.



investment decisions of analysts and fund managers are powerful because they influence the terms on which companies raise capital. These terms can be central to achieving a competitive advantage and influence the ease with which companies go about their businesses. If the market does not integrate sustainability issues into their investment decisions, then it will not motivate improved corporate sustainable development (see Section 3 and Appendix 1 for a further explanation of how corporate cost of capital relates to sustainable development).

We earlier outlined that our key commercial concern as investors and insurers is the contemporary threat to financial stability and long term economic growth that originates from the unsustainable use of natural and social capital. It is clear to us that one of the underlying causes of the financial crisis in 2008 was the incentive structure

throughout the markets. This focused too many market participants on short-term profits. They looked only so far as the next quarterly earnings, at the expense of paying attention to the longer-term fault lines that were emerging. A compounding problem was that much of the information available to investors – particularly on the environmental and social impact of a company, on financial structuring and business practices - was itself short-term and inadequate. This lack of information eventually negatively affected the entire market.

A stable macro-economic environment is also important for the maintenance of financial stability. Prudent monetary and fiscal policy is important in avoiding speculative bubbles. So are economic reforms that facilitate the creation of an economic environment where real interest rates can be low and stable, and growth can be achieved, is key in

maintaining long term stability in the sector.

We agree with the report by International Institute for Sustainable Development and UNEP that a *“fundamental test for long-term financial market stability and resilience is the ability of the financial system to deliver a low-carbon, resource-efficient economy that also acts to reduce both poverty and financial exclusion”* (IISD & UNEP, 2009, P12). We also share the view that governance of both markets and individual institutions is central to many of the discussions around the stability of the financial system, as well as to the oversight of financial institutions and markets. The events around what has become one of the most infamous episodes in financial history bear testimony to a failure of governance at many different macro and micro levels and it is clear that significant governance failures at the system-wide and corporate levels of our financial markets were major contributors to the most severe economic downturn in three generations.

We believe that it is well within the collective ability of our governments to ensure that capital markets enhance corporate sustainability and promote long-term business behaviour. They will need to deliver integrated reporting and require responsible investment. This will help resolve the underlying problems associated with unsustainable development that have been set out within the SDG process. It will also promote financial stability and long term economic growth.

Global capital markets should be among the primary facilitators of a sustainable global economy. Indeed, the creativity, entrepreneurship and innovation funded by capital markets should be the driving force behind a globally green and just economy. Fortunately, sustainable development issues do not arise from a lack of financial capital, as the markets have the financial firepower to deal with them now. They

arise from the mispricing of sustainability issues and the ensuing misallocation of capital.

It is of course the role of government to shape and correct the market, and the role of investors to capitalize projects that they believe will be profitable within that market environment. In this way, the analytical, financial and long-term perspective of the capital markets should be harnessed to help develop more sustainable capital markets. Or, integrating this into the Brundtland definition, with this report we are promoting: *capital markets that finance development that meets the need of the present, without compromising the ability of future generations to meet their own needs*. In other words, development that maximizes the long-term value of investment portfolios rather than short term profit maximization that exploits future generations.

3.0 The relevance of the capital markets to sustainable development policy makers

It is perhaps obvious to say that electronic flows of money around the capital markets have no tangible impact on our physical environment, nor on our society. However, tangible impacts certainly do arise when the capital is spent on the production or consumption of goods and services. For example, the environmental costs and social benefits that arise from the development of infrastructure projects by companies. Importantly, impacts also arise when capital is required for a development project but is not forthcoming.

Policy makers have traditionally tended to focus on the flow of aid, or official development assistance. This is important and the c.\$130bn of official assistance matters. However, how the tens of trillions of assets under management within the global capital markets are allocated matters far more.

We believe that the capital markets are of relevance to policy makers for three distinct but related reasons:

1. As a way of raising capital to enhance government spending on sustainable development projects;
2. As a target for systemic change to integrate sustainability at each stage as the financial influence of the capital market via corporate access to capital can enhance or undermine long-term sustainable development goals; and,
3. As an ownership mechanism for influencing corporate practices

that policy makers can seek to harness to improve the sustainability practices of existing listed companies.

We believe that policy makers need to *both* change the pricing signals within the market and improve the readiness of the supply chain of capital to integrate sustainability issues. This involves moving all participants towards a longer-term perspective when investing and exerting their influence as company owners. This requires an overview of the role of institutions at each stage of the capital supply chain, which we touch on next in 3.1. It also requires a clear vision of how these market participants should *integrate* sustainability issues within their operations. We also need policy makers to improve the profitability of sustainable businesses relative to unsustainable ones which 3.2 briefly covers.

Section 4 will then consider each of the above three reasons why the capital market is primarily of relevance to policy makers in make some suggestions to policy makers for how this potential can be harnessed.

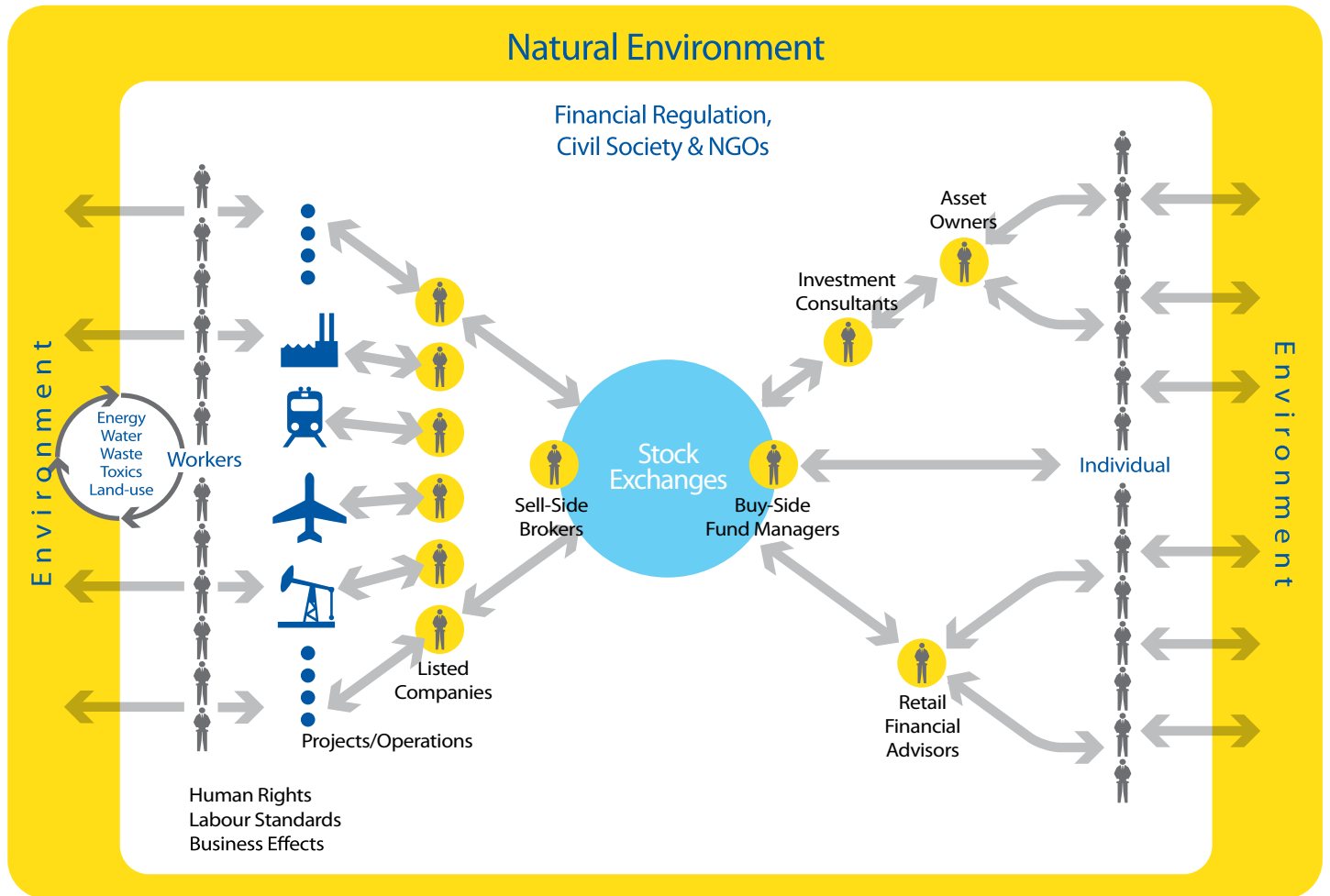


Figure 1: The structure of the capital market

3.1 A brief introduction to the equity capital markets

To help those involved in policy making picture the system, we have produced Figure 1 above. This depicts the relationship between the financial institutions that operate the market between the demand for and supply of capital. The different roles of the financial institutions are important as each role reflects the nature of the influence. We will also use this systems map as a mechanism for analysing the equity markets and making recommendations as to how sustainability can be integrated into the system.

Figure 1: The structure of the capital market

Figure 1 above is a simplifying model of the equity capital market and is intended to demonstrate how the various capital

market institutions relate to each other. Put simply, money flows from the individuals on the right hand side into companies on the left hand side, which put the capital to work in different ways to generate a return on investment for their shareholders. These individuals may invest alongside others as institutional investors - such as pension schemes, insurance companies, or sovereign wealth funds – or – as individual investors through retail financial advisors.

In many developed markets, institutional asset owners take the advice of investment consultants who, in turn, recommend which asset manager to choose. Such asset managers are also referred to as buy-side fund managers, and they buy shares from brokers on stock exchanges. Sell-side brokers are typically part of an investment bank. Such brokers provide investment analysis and recommendations to fund managers. They also act as market intermediaries, helping those fund managers that want to buy and

sell securities. Some brokers will also be the prime broker for a company. Where this is the case, they will also advise the company on their capital structure and underwrite the issuance of new equities to the market.

Corporate debt is also traded in a similar way, although it tends to be conducted between fund managers and brokers, without the use of stock exchanges. Of course, while company workers are highlighted as working for companies, they are also in many cases the providers of capital. So, in this sense the flow of capital can be thought of as circular.

3.2 Introducing Capital Market Failure

As mentioned previously, we see the primary failure of the capital markets in relation to sustainable development as one of misallocation of capital. This, in turn, is a result of global governments' failure to properly internalise environmental and social costs into companies' profit and loss statements (through, for example, fiscal measures, standards, regulation, market mechanisms, and so forth). As a consequence, the capital markets do not incorporate companies' full social and environmental costs. Indeed, until these market failures are corrected through government intervention of some kind, it would be irrational for investors to incorporate such costs since they do not affect financial figures and appear on the balance sheet or – therefore - affect companies' profitability or earnings per share. This means that corporate cost of capital does not reflect the sustainability of the firm. The consequences of this are that unsustainable companies have a lower cost of capital than they should, and vice versa.

This is a critical point to understand as it is central to how the power of the market can be harnessed by policy makers to promote sustainable development. Put simply, if it costs Company A more than Company B to invest in its own growth, then all other things equal, Company B will prosper. As mentioned before, this is why the aggregate investment

decisions of analysts and fund managers are so powerful: the pricing signals we send to corporate managers influence the terms on which they raise capital. These terms can be central to achieving a competitive advantage and influence the ease with which companies go about their businesses. It is in this sense that the market can be seen as failing to motivate corporate practices that promote sustainable development.

As the World Business Council for Sustainable Development has noted : *“Financial markets are key in the pursuit of sustainable development because they hold the scorecard, allocate and price capital, and provide risk coverage and price risks”* (2003, p6). If financial markets do not understand and reward sustainable behaviour, progress in developing more sustainable business practices will be slow. This requires the kind of system interventions by governments that change a company's cost of capital and harness the influence of company owners.

One of the reasons for emphasising this market failure point is that government representatives can often direct market participants to embed sustainability issues into their valuation work. However, until the policy makers themselves correct the market failures, this directive would amount to little more than a rhetorical flourish.

Some may wonder why we have not deliberately focussed on the discounting of future returns, which is commonplace in the investment community when valuing companies. This is because investor use of discounting is central to valuation due to both the time value of money and the uncertainty of cash flow projections. We therefore believe it is both wrong and unrealistic to expect market participants to move towards a discount rate that takes account of the very long-term costs of unsustainable development independently of robust policy measures. However, it is important to emphasise that we do believe that it is entirely realistic to hope that policy makers do not discount the interests of future generations in the same way. Indeed, we believe that it is wrong for regulatory impact assessments to use market discount rates.

4.0 Raising capital to fund government spending on sustainable development projects

Capital markets provide funding for public goods via a range of mechanisms, for example: sovereign debt, which is issued by countries; the multilateral development bonds, which are issued by development banks; and, municipal bonds, which are issued by local authorities.

Sovereign debt is one of the asset classes best predisposed to provide the capital to finance global sustainable development needs. The speed and scale of the growth in sovereign debt that was issued to underpin the global financial system during the financial crisis demonstrates that it is possible to secure financing at the speed and scale implied here. The key question is the existence of political will to direct that

finance towards sustainable development.

The issuance of new sovereign debt during the financial crisis has tested the credit ratings of a significant number of countries, stretching them to the point where it is unlikely that they will have the economic capability let alone political will to make new issuances at the scale required here. Of course, the multilateral development banks (MDBs) would also have a role to play in issuing new debt that could finance these sustainable development plans. Indeed, there has already been some work in this area from the World Bank.⁶

In view of the scale of financing required - and the need for governments to also underwrite the MDBs - it is possible that there will come a point where the MDBs will also be unable to issue new debt on this scale without affecting their credit rating, and those of the countries supporting the MDBs. This will make debt more expensive as well as politically far less palatable. Therefore, post the financial crisis the two important mechanisms for raising this capital may be constrained in their ability to do so.

Intergovernmental organisations have traditionally been good at sourcing public financing but not yet as successful in leveraging private finance.

6. This work has not reached the scale required and many green bond issuances have been at a premium to the main MDB debt which renders the products suitable largely only for the niche green investment community not the mainstream investment industry, severely limiting the scale of capital that can be raised.



Box A: Raising Capital for Sustainable Development

The International Energy Agency estimates that incremental investment in the energy sector alone will need to reach around **\$1 trillion a year** from 2012 to 2050 in order to keep global average warming below 2 degrees Celsius. More capital will also be required to finance the Millennium Development Goals and the Sustainable Development Goals that look likely to succeed them. The MDGs were the most broadly supported, comprehensive, and specific poverty reduction targets the world has ever established but no mechanism was agreed for how they could be financed. A vitally important part of the process to design new goals will be an associated agreement on the Means of Implementation (MOI) outlining how the goals will be achieved. A key part of MOI (and quite often the most contentious element) is about who and how to finance any such international agreements.

While the precise amount is open to question, it is clear that significant sums of money will be required. Raising this money will need considerable planning, effort and international coordination.

Failure to tackle this will have serious economic consequences in the relatively short term. The Stern Review on the Economics of Climate Change conducted for the UK treasury in 2006 found that without action, the overall costs of climate change will be equivalent to losing at least 5% of global GDP each year, now and in perpetuity. Including a wider range of risks and impacts could increase this to 20% of GDP or more, also indefinitely. Stern believes that 5-6 degrees of temperature increase is "a real possibility." However, the costs of taking mitigating action were estimated to be around 1% of global GDP.

As an insurer, we are accustomed to dealing with financial arguments that

point towards the benefits of taking preventative and mitigating action before a much more expensive disaster unfolds. The economic losses from natural catastrophes and man-made disasters totaled \$56 billion in the first half of 2013 according to Swiss Re, with \$17 billion covered by the global insurance industry and caused by natural catastrophes, mainly flooding. History has shown that political will often depends on the presence of a crisis. We believe that the implied changes to the global economic system associated with a 5-6 degree change and unsustainable economic development present such a crisis. Fortunately, with over \$50 trillion invested in the global stock markets, and a further \$100 trillion of sovereign and intergovernmental debt, on the face of it, there should be no shortage of capital available.

The short fall we perceive is a broad enough understanding of how to harness capital markets to raise new capital, move existing stock of capital and harness the influence of asset owners in a concerted, integrated and focused way.

Intergovernmental organisations have traditionally been good at sourcing public financing but not yet as successful in leveraging private finance. If we are to raise this money in an efficient, effective and sustainable manner, **we collectively need to challenge the international community to develop a well considered international capital raising plan** that coordinates national plans and includes a view on the money that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment, equity investment as well as sovereign and MDB debt.

Raising and or diverting capital on this scale is likely to provide a significant number of practical challenges that policy

Box A: Raising Capital for Sustainable Development *Continued*

makers developing such a plan will need to consider.

In order to catalyse policy makers into developing a set of capital raising plans this, we propose the following actions:

1. The establishment of a focused group of finance sector chief executives that are willing to take on a high-level advocacy role at a small number of the key meetings with Finance Ministers, and UN negotiators;
2. The publication of a range of research notes tackling some of key questions that the policy makers setting the national and international capital raising frameworks will need to consider. This will also include broker notes setting out why the current performance of the policy makers falls a long way short of moving the markets over a time frame that is supported by the science. These finance sector papers

would be provided to the Expert Committee on a Sustainable Development Financing Strategy;

3. The development of a capacity building course that uses the research notes to train policy makers, NGOs and negotiators in governmental and non-governmental organisations on how the capital markets work and how they can be better harnessed to influence sustainable development.

These aims are consistent with the United Nations Environment Programme Inquiry into the Design of a Sustainable Financial System, which we are pleased to be working with.

In terms of specific sustainable finance policy recommendations on *raising capital*, if policy makers are to raise this money in an efficient, effective and sustainable manner, we believe that the international community should develop a series of well-considered national capital raising plans

that are internationally coordinated at the UN and World Bank level and that include a view on the money that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment, equity investment as well as sovereign and MDB debt.

5.0 The capital markets' financial influence over corporate sustainable development

The capital market's financial influence over corporate sustainable development originates from the buying and selling of equity shares and debt on the capital market. As noted earlier, this trading activity influences the cost of capital for listed companies, which is the price the company has to pay to raise capital to finance its business. This is generally referred to as a Weighted Average Cost of Capital⁷. Put simply, the more a company has to pay for capital, the less it can raise. This limits the extent of its activity. In addition, the financial value of the shares influences a director's remuneration and the degree to which the company is perceived as a candidate for takeover.

There is mounting evidence that companies with strong sustainability performance deliver improved long-term returns. For example, a July 2013 Harvard Business School study found that "High Sustainability" companies significantly outperform their peers over the long-term, in both stock market and accounting terms (Eccles, Ioannou and Serafeim, 2013). This finding is consistent with a Deutsche Bank study providing a meta-analysis of over 100 academic studies (Fulton, Kahn and Sharples, 2012).

So if sustainability performance matters to companies and their shareholders, what is the problem with the capital market?

The key sustainable development problem with the existing capital markets is that the cost of capital for companies is not *sufficiently* influenced by how

sustainable the company is. In other words, sustainability issues do not matter enough to ensure that the performance is sustainable. We believe that this is for two related reasons: market inefficiency and market failure.

Market inefficiency is used here to refer to the situation where it pays companies to do the right thing and be sustainable, but markets neither recognize nor reward this behaviour until the company delivers the results within their accounts. In other words, while companies plan to be sustainable, investors do not proactively see the business case and their ensuing investment decisions do not contribute towards lowering a company's short term cost of capital, until the benefits are obvious to all. This time lag can punish more sustainable companies via a higher cost of capital until the benefits of their behaviour appear in their accounts.

Market failure on the other hand refers to the situation where it pays companies in the long term to do the wrong thing and be unsustainable. In other words, a market failure is where the externalities associated with unsustainable business practices do not hit the company's profit and loss statement (P&L) at all. As mentioned earlier, this is largely because global governments have not taken corrective action to internalise the costs onto corporate balance sheets.

The difference between capital market inefficiency and capital market failure is that the former is a failure of the predictive power of investors, whereas in the latter case, it is a failure of the governments

7. The WACC equation is the cost of each capital component multiplied by its proportional weight and then summing. Broadly speaking, a company's assets are financed by either debt or equity. WACC is the average of the costs of these sources of financing, each of which is weighted by its respective use in the given situation. By taking a weighted average, we can see how much interest the company has to pay for every dollar it finances.

to create a market price mechanism that ensures that companies have to pay the cost of their externalities.

5.1 A Cause of Market Inefficiencies: Misaligned Incentives

One of the main sources of market inefficiency is an excessively short-term view among the market participants who are more concerned about short term costs or benefits of an initiative than the long term costs or benefits arising from it. The short termism argument rests on the capital market being too near-sighted in the way it evaluates companies.

One root cause is that fund management organisations are evaluated by their clients – for example pension funds – based on criteria that are themselves too short term. Such evaluation motivates short-term investment behaviour on the part of fund managers that is more akin to speculation than to genuine ownership. Fund managers are subject to a legal fiduciary duty to obtain the best risk adjusted financial returns for their clients, and this is often evaluated on the basis of very short-term, even daily results. In an ideal world, their interest would be in the long term, but the structure of the market pushes them into maximising short-term returns.

As previously outlined, this maximisation of short-term results is a long-term problem for the economy as a whole: if the capital market does not sufficiently factor in long-term capital investment returns, then it undermines long-term investment decision-making by company directors and leads them to allocate insufficient capital to investing in the long term health of companies overall. While a lack of focus on the long-term financial health of a company is a general problem, short-termism is also a particular problem for sustainable development: it systematically erodes incentives for company directors to invest in a sustainable business.

A Tomorrow's Company report commissioned by Aviva Investors confirmed this thinking and found that potential conflicts in the capital market supply chain exhibited in Figure 1 of interest include (see Appendix 1 for an explanation of the roles and responsibilities of the institutions mentioned below):

- Pension fund trustees: the close and frequent monitoring of fund management performance by trustees can result in fund managers feeling pressured to maintain high levels of short-term performance relative to the benchmark to retain funds; 66% of pension funds formally review fund manager performance every quarter (92% annually or less), despite 62% of them claiming that the key investment period for trustees appearing is longer than a rolling or calendar year (Source: "NAPF/IMA Short-Termism Study Report", MORI, 2004). This can create incentives that affect fund managers' approach to risk taking.
- Investment consultants: The degree to which investment consultants take into account factors relating to the long-term sustainability of companies is dependent on: (i) the degree to which pension fund trustees wish to take them into account; (ii) the cost of maintaining dedicated research teams and (iii) the availability of good long-term comparable data. Investment consultants also tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use. There is an opportunity to generate substantial income through the fund manager selection process, so consultants may be incentivised to encourage fund manager turnover.



- Brokers: the remuneration of brokers is directly linked to trading volumes. As a result they have a powerful incentive to encourage market activity. Even when sell-side analysts are aware of corporate governance or sustainability concerns, these analysts do not report this in their reports to buy-side analysts for fear of losing access to those boards.
- Stock exchanges: Nearly half of all exchanges are companies listed on their own exchange and are therefore subject to shareholder pressure to maximise returns. The largest sources of revenue for demutualised, for-profit stock exchanges are reliant on market activity. This results in an incentive for exchanges to create inducements for trading activity.

In order to change this, simple measures could be implemented to align these incentives. For example, to expand on the specific example regarding investment consultants: the United Nations Environment Programme Finance Initiative's Asset Management Working Group (UNEP FI AMWG) has called for actions that they believe will magnify the extent to which responsible investment is demanded by the capital markets. They proposed that *"Global capital market policymakers should make it clear that advisors to institutional investors have a duty to proactively raise ESG [environmental, social and corporate governance] issues within the advice that they provide, and that a responsible investment option should be the default position. Furthermore, policymakers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues*

into their investment process, as well as from companies on their performance on ESG issues.” (UNEP, 2009)

The report also proposes clauses on responsible investment that should be written into fund management contracts and that fund managers’ performance should be based on an evaluation of their long-term ability to beat benchmarks. Moreover, as a result of the potential for unsustainable development to harm the absolute value of long-term investment portfolios, the report also proposed that investment consultant and fund manager clients should be able to sue for negligence if these issues are not properly considered.

More generally, we believe that various market participants should be incentivised to change their behaviour in order to achieve a culture shift in financial institutions. We support, for example, the abolition of quarterly reporting and similarly believe that fund manager performance should be reviewed over longer time horizons than the typical quarterly cycle. Such evaluation based on short-term returns undermines long term sustainable development; for the same reason excessive reliance on measuring performance relative to a market index should be reduced.

In order to align incentives for the long-term (as highlighted by Tomorrow’s Company) pension funds should be required to integrate voting and engagement policies into the investment process; shareowner activism should be given more weight in the selection and retention of fund managers and other matters; all advisors to institutional investors should have a duty to proactively raise ESG issues and encourage adherence to the Stewardship Code; fund management contracts and fund managers’ performance should include an evaluation of long-term ability to beat benchmarks; investment consultants’ fee structures should not reward them for moving clients between fund managers; and within companies the implementation of strong cultural norms should be supported by independent whistle-blowing mechanisms, overseen by professional bodies who offer

the whistleblower appropriate protection.

5.2 A Cause of Market Inefficiencies: a lack of information from companies to the providers of capital

The ability to assess a company’s overall governance and performance in the context of these non-financial factors is of central importance to institutional investors and the ultimate beneficiaries for whom they act, as well as employees, governments and society as a whole. Information is the life blood of capital markets. If the information that the market participants have to rely upon is short term and thin, then these are the characteristics that will define our market.

Unfortunately, the current reporting model, framed by International Financial Reporting Standards, national standards and stock exchange rules, does not provide the necessary framework to enable non-financial factors to be taken into account systematically in reporting and decision-making. Bloomberg data shows us that of 25,000 companies surveyed, 75% do not report on even one data point of sustainability information (Corporate Knights Capital Study, 2013).

As a result, undue focus and reliance is placed on short-term financial performance, with the risk that capital is not being directed efficiently towards those companies that have robust business models, that make a meaningful contribution towards the achievement of a sustainable society and which outperform in environmental, social and governance terms.

In order to promote change in this area, in 2008 Aviva Investors called for a debate with stock market listing authorities regarding how they could integrate sustainability issues into the listing rules of stock exchanges. We wanted to explore how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and

ultimately performance, on environmental, social and corporate governance issues and encourage responsible long-term approaches to investment.

This initiative has evolved to become the UN Sustainable Stock Exchange initiative and is led by the UN Conference on Trade and Development (UNCTAD), The UN Global Compact (UNGC), The UN Environment Programme (UNEP) and the UN supported Principles for Responsible Investment (PRI). It was named by Forbes magazine as one of the “World’s Best Sustainability Ideas” in 2010.

While a number of important debates on stock exchanges and sustainability have taken place since this time, these debates have largely focused on encouraging voluntary action by national stock exchanges. A number of exchanges have taken some action – particularly in emerging markets – and this should be welcomed. However, none of the debates so far have managed to reach out beyond the stock exchanges themselves and successfully engage their regulators. This is a key strategic problem as many of the largest exchanges have said they are concerned that they will lose corporate listing business to other exchanges if they move ahead of national regulators and the international community by embedding sustainability disclosure requirements on their exchanges. Conversely, one of the key constraints referenced by capital market participants is the lack of corporate disclosure in the area of environmental, social and corporate governance performance. Consequently, there is a case for internationally coordinated action.

Recognising this problem, the UN Sustainable Stock Exchanges Initiative produced “A Report on Progress” for their 2012 Global Dialogue. This report included a survey of stock exchanges and found that a minimum level of comparability across markets is needed. At the time, more than three quarters of stock exchange respondents to the survey welcomed a global approach to consistent and material corporate sustainability reporting. Further,



75 per cent of stock exchange respondents favoured internationally coordinated action via a convention on corporate sustainability reporting. The report’s recommendations included that: “Regulators should work with policymakers in developing an international policy framework requiring, on a comply or explain basis, listed companies to provide material and consistent ESG disclosures.” And that policymakers should “set a roadmap for the development of an international policy framework that supports improved and consistent ESG disclosure by listed companies across markets”.

BOX B: AVIVA'S CSRC

Can Investor Advocacy be Effective? A case study on The Corporate Sustainability Reporting Coalition

There is emerging evidence that financial institutions and NGOs can collaborate to engage with governments directly on public policy issues. For example, in 2011 Aviva founded the Corporate Sustainability Reporting Coalition (CSRC) with the aim of transforming how open companies are about how they manage improving corporate reporting on material environmental and social issues and so improve the ability of investors to accurately value companies. We launched the Coalition at the private sector forum of the UN General Assembly, which was hosted by the UN Global Compact.

We argued that in addition to this being good for sustainable development, such disclosure is in all companies' interests since reporting is one of the most important catalysts for changes that contribute to the long-term health of a business. It would also provide the data investors need to integrate sustainability issues within their valuation work.

Our Coalition succeeded in bringing together a unique combination of pension funds, asset managers, church organizations, charities, and professional bodies. Its members manage over \$2 trillion in assets and it also included industry bodies that, in turn, represented well over \$50 trillion. The NGO members included Christian Aid, Forum for the Future, Save the Children, Stakeholder Forum, Peace Child International, and WWF-UK, as well as multi-stakeholder coalitions such as the Global Reporting Initiative. The financial institutions included Aon Hewitt, Thomson Reuters, Jupiter Asset Management, Generation Investment Management (Al Gore's fund

management firm) Schroders, and FTSE, as well as Aviva Investors.

The Corporate Sustainability Reporting Coalition asked participants at the United Nations Rio+20 Earth Summit to come to a new global agreement on corporate sustainability reporting in the form of a treaty. We enjoyed significant support from the UK Government both before and during the Rio+20 Summit, particularly from The Department for Environment, Food and Rural Affairs (Defra - the government department responsible for environmental protection, food production) and the then Secretary of State, Caroline Spelman, and were invited to be part of the formal government delegation to Rio. Important interventions supporting our aims were also made by a number of other countries, particularly Brazil, Denmark, France, Norway, Mexico, and Columbia. However, there were a number of countries that sought to reduce the strength of commitments in the preliminary drafts particularly, notably, Australia, the U.S., Canada, and Kazakhstan.

Despite considerable opposition, a Resolution was ultimately adopted by the General Assembly that endorsed the outcome document of the United Nations Conference on Sustainable Development, which was entitled "The Future We Want." This outcome document included the following text as paragraph 47:

We acknowledge the importance of corporate sustainability reporting and encourage companies, where appropriate, especially publicly listed and large companies, to

consider integrating sustainability information into their reporting cycle. We encourage industry, interested governments as well as relevant stakeholders with the support of the UN system, as appropriate, to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account the experiences of already existing frameworks, and paying particular attention to the needs of developing countries, including for capacity building.

While this commitment fell short of the CSRC's proposal of a treaty requiring corporate sustainability reporting on a "comply-or-explain" basis, it does build on the UN's previous commitments to the Global Compact and the Global Reporting Initiative. It is also the first time that the UN Conference on Sustainable Development has explicitly encouraged listed companies to integrate sustainability information into their reporting cycle.

There were also other practical positive outcomes. For example, Brazil's main stock exchange now promotes integrated sustainability reporting on a comply-or-explain basis—a policy they implemented in the run up to hosting the event as a direct consequence of the sustainable stock exchange initiative and the CSRC. This policy has also generated significant growth in the sustainability data (Corporate Knights, 2012). The UK government also announced in Rio that they would include mandatory carbon reporting from 2013 for all companies listed in the UK stock exchange.

We also saw a number of stock exchanges publicly commit to do more to integrate sustainability issues within their own listing environment, including Nasdaq, Istanbul, South Africa, and Brazil. Since the conference, exchanges

in India, Hong Kong, and Thailand have also made positive statements in this area, with NYSE Euronext also endorsing the sustainable stock exchange initiative in July 2013. It is important to note, however, that the effectiveness of these commitments by stock exchanges has yet to be assessed, and this should be the key measure of change.

The experience of the CSRC at Rio+20 demonstrates the importance of participating in the World Summit debates. It also suggests that the global forums best placed to increase the effectiveness of NGO-financial institution advocacy partnerships include UNCTAD's International Standards in Accounting and Reporting, the UNCTAD World Investment Forum projects, the UN-backed Principles for Responsible Investment, the UN Global Compact (particularly their Private Sector Forum within the General Assembly), and the United Nations Environment Programme Finance Initiative.



More generally, Aviva Investors and Standard and Poor's commissioned CK Capital's 2013 report on corporate sustainability disclosure practices shows that growth in the number of companies disclosing a core set of seven basic sustainability indicators is slowing. While the absolute number of listed companies that disclose these seven indicators has increased markedly since the early 2000s, the disclosure rate is slowing. Most of the indicators remain undisclosed by over half of the world's large listed companies. By analysing the relative performance of different countries in this area, they concluded that achieving complete disclosure across these seven metrics will "*almost certainly require new types of intervention by regulators, including securities regulators and stock exchanges*".

Examining disclosure rates by region, the report shows that emerging markets-based stock exchanges - such as those based in Brazil, India, Mexico, Singapore and South

Africa - are quickly catching up to their counterparts in the developed world - such as the Deutsche Börse, the Euronext Paris, the London Stock Exchange, NASDAQ and the New York Stock Exchange. A key factor in this process is the leadership position that many emerging markets-based exchanges have established by embedding sustainability disclosure requirements into their listing guidance and – with the support of the listing authority – their listing rules. Leaders in this area include the Johannesburg Stock Exchange, the Brazilian stock exchange BM&F BOVESPA, and both the National and Bombay Stock Exchanges in India. The CK Capital report also finds evidence to support policies that are (i) mandatory as opposed to voluntary, (ii) prescriptive as opposed to principles-based, and (iii) broad as opposed to sector-specific.

In November 2013, the UN Conference on Trade and Development produced UN guidance (UNCTAD, 2013) setting

out how stock exchange regulators can promote sustainability reporting. The guidance sought to assist stock exchanges and corporate reporting regulators in the context of an international trend wherein stock exchanges and regulators in several countries are introducing new sustainability reporting initiatives.

The key recommendations of the UNCTAD guidance are as follows:

- Introducing voluntary sustainability reporting initiatives can be a practical first step to allow companies time to develop the capacity to prepare high-quality sustainability reports.
- Mandatory sustainability reporting initiatives can be introduced on a comply or explain basis, to establish a clear set of disclosure expectations while allowing for flexibility and avoiding an undue burden on enterprises.
- Stock exchanges and/or regulators should consider advising the market on the future direction of sustainability reporting rules. Companies should be allotted sufficient time to adapt, especially if stock exchanges or regulators are considering moving from a voluntary approach to a mandatory approach.
- Stock exchanges and regulators should consider highlighting sustainability issues in their existing definitions of what constitutes material information for the purposes of corporate reporting.
- With a view to promoting an internationally harmonized approach, stock exchanges and regulators should consider basing sustainability reporting initiatives on an international reporting framework.

Integrated Reporting is a market-led initiative that seeks to provide a more concise and relevant explanation to providers of financial capital about how a business is creating value over the short, medium and long-term. It aims to shape the future of corporate reporting by providing more useful information to investors, supporting their capital allocation decisions and contributing to a more financially stable and sustainable economic environment.

Integrated Reporting is defined as a process, founded on 'integrated thinking', that results in a periodic Integrated Report about value creation over time, and related communications regarding aspects of value creation by an organization.

Reporting of this type has been recommended by a significant number of the key reports considering what the SDGs should include. For example:

The UN High Level Panel Report⁸:

- *Governments can... prompt their large multinational corporations to report on the social, environmental, and economic impact of their activities.*
- *We suggest that a mandatory 'comply or explain' regime be phased in for all companies with a market capitalisation above \$100 million equivalent.*
- *The Panel proposes that, in future – at latest by 2030 – all large businesses should be reporting on their environmental and social impact – or explain why if they are not doing so.*

The Sustainable Development Solutions Network Report⁹:

- *Companies must be accountable for adverse environmental and social consequences of their actions, along the lines of the*

8. United Nations, A New Global Partnership: Eradicate Poverty And Transform Economies Through Sustainable Development, The Report of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda, May 2013

9. The Sustainable Development Solutions Network, An Action Agenda for Sustainable Development, Report For The UN Secretary-General, 23 October 2013

“polluter pays” and “payment for ecosystem services” principles. In particular this will require better ways of measuring the value and true performance of companies by internalizing externalities in companies’ reporting and ensuring transparent independent evaluation for all major corporations.

- *Target 10a: Governments (national and local) and business commit to the SDGs, transparent monitoring, and annual reports- including independent evaluation of integrated reporting for all major companies starting no later than 2020.*

The UN Global Compact Post 2015 report¹⁰:

- *Businesses must, importantly, be accountable to their stakeholders for taking action on corporate sustainability. This is best organized through annual disclosure guided by sustainability reporting initiatives and robust standards, including the framework provided by the Global Reporting Initiative.*
- *Governments should ask companies to enhance accountability and transparency through publicly disclosing sustainability practices – especially in an integrated fashion that recognizes financial, natural and social capital – and through frameworks such as the Global Reporting Initiative.*

Fortunately, therefore, it would appear that the SDGs are likely to address one of the key reasons for market inefficiency from the sustainability perspective. However, our concern that corporate reporting in isolation is not enough. In order to ensure that the capital markets use and reinforce the information published within the integrated report, the targets need to address the entire system.

Therefore, with reference to Figure 1 on page 22, we suggest targets addressing the entire supply chain of capital, and detail our suggested goals in Section 7 below. The key point is that by addressing goals that are bespoke to each of the key intermediaries in the capital market chain, the SDGs can help to ensure that the capital markets support sustainable development.

5.3: The Causes of Market Inefficiencies: a lack of education among market participants on the costs and benefits of corporate sustainability.

This is closely related to the corporate sustainability reporting issue where market participants need to be able to see corporate performance. However, simply providing this information does not guarantee that investors will be interested, nor ensure that they will know how to use it. There is a lack of concern among market participants on the costs and benefits of corporate sustainability that partly emerges due to a lack of knowledge about how much these issues matter.

One practical way of changing this over time would be for the most highly regarded fund manager and analyst training centres around the world such as the Chartered Financial Analyst Institute to ensure that their training syllabus and – crucially – the charter holder examination¹¹ improve the ability of analysts to think through how the sustainable development work of companies will enhance corporate valuation. Universities should also update the content of their finance and business related qualifications – particularly the MBA and Masters in Finance – to include sustainability awareness.

10. UN Global Compact, Corporate Sustainability and the United Nations Post-2015 Development Agenda: Perspectives from UN Global Compact Participants on Global Priorities and How to Engage Business Towards Sustainable Development Goals. 17 June 2013

11. This is crucial because many providers of training for these examinations focus on past papers rather than on the broader syllabus. This leads to an environment in which the untested parts of the syllabus are overlooked.



6.0 The capital markets' ownership influence over corporate sustainable development

The capital market's ownership influence over corporate sustainable development originates mainly from the ownership rights associated with equities. It also exists to a lesser degree with holders of corporate debt. However, debt holders do not have the legal ownership rights that are associated with equities (partly reflecting the lower risks that corporate debt investors take due to them being repaid ahead of equity owners if the company is taken into receivership).

This ownership influence is closely related to the previous discussion on financial influence as investors are expected to voice their concerns to companies about issues that are financially relevant to the company and their holding. However, this is a distinct area as "voice" and "exit" represent alternative courses of action for investors. A full discussion on the interaction between shareholders, directors and a description of ownership influence can be found in Appendix 2.

So, from the perspective of sustainable development policy makers what needs to change?

As we noted earlier, the key sustainable development problem with the existing capital markets is that the cost of capital for companies is not significantly influenced by the sustainability of the company. This means that financial institutions operating in their short-term self-interest do not need to concern themselves with engaging with companies on sustainable

development issues, unless – that is – they are demonstrably relevant to a company and a potentially material impact on its cash flows. While a great deal of good work has been done by some in this area, engaging with companies on sustainable development issues remains uncommon. Where it does take place, it can be extremely effective. For example, see Box C for a case study of investor engagement on climate change.

BOX C: Case Study: Carbon Action Initiative

As founding signatories of the Carbon Disclosure Project, Aviva Investors actively engages with companies and organisations to reach consensus on ways to address climate change, both for companies and public policymakers as well as other stakeholders. In 2011 Aviva and Aviva Investors was the initial catalyst for the Carbon Action Initiative and provided seed funding to support its development. This initiative complements the CDP and encourages companies to make year-on-year emissions reductions, implement carbon reduction emissions and set targets.

Carbon Action helps investors advance understanding of portfolio company carbon management and energy efficiency initiatives and to improve risk management in areas including regulation, operations, fiduciary duty and reputation. It helps companies generate positive returns through carbon reducing and energy efficiency projects and so build long term sustainable businesses.

Companies are encouraged to:

- Make year-on-year reductions in emissions;
- Make investments in emissions reduction activities with a

satisfactory positive return on investment;

- Where companies have not reported a target to CDP, to set and publicly disclose an emissions reduction target that covers the principal sources of emissions in their business;

57% of the 256 companies in high emitting industries **set absolute and/or intensity targets** for emissions reductions in 2012.

Companies with targets **invested 1.1% of capital expenditure on emissions reduction** activities – more than ten times that of companies without targets (0.08%) – and achieved year-over-year absolute reductions in CO₂e of more than double the rate of companies without targets

Companies with published absolute emissions reductions targets were **10% more profitable** than those with intensity targets or no target at all.

As a key suggestion to further improve the area of carbon disclosure, Carbon Tracker has suggested that policy makers require reporting of fossil fuel reserves and potential CO₂ emissions by listed companies and those applying for listing (Carbon Tracker, 2011, p28).

There are fundamental problems with the ownership chain of influence. For example, it remains extremely difficult for the end investor to know how their AGM votes have been cast, what ownership influence has been exerted or even, in many cases, where their money is invested. Arguably most reasonable end-investors are interested in sustainable development issues and do not wish to invest in a way that undermines sustainable development.

In economic terms, responsible ownership

is a non-excludable public good. That is to say that the benefits of engagement are enjoyed by all owners, regardless of whether they behave as responsible long term owners by investing in stewardship. Consequently, the vast majority of profit-maximising commercial fund management institutions free ride and either do no real stewardship at all, or invest only token resources in this work.

The question remains, however, what can policy makers do to stimulate this market?

The starting point for policy makers should be to increase the market demand for stewardship in general, and on corporate sustainability in particular. It is for asset owners to voice this demand. The best way for asset owners to do this is for them to make it clear in their Investment Management Agreement precisely what is expected when appointing their asset managers (see, for example, the UNEP proposal REF). Policy makers can help by providing model contracts that do this well.

Policy-makers could stimulate the market further by establishing mechanisms that promote, encourage and require investors to maintain an appropriate oversight role of companies on environmental, social and corporate governance issues.

For example, asset managers could be required to publicly disclose their voting record and pension trustees to report to their beneficiaries on how their ownership rights have been exercised.

Proxy voting agencies also have significant potential to sway how ownership influence is exercised via the votes, as they advise a substantial portion of the market at shareholder meetings. It would be helpful if proxy voting agencies were encouraged to explain their rationale for their voting decisions to companies and investors, emphasising how long term issues surrounding corporate sustainability were taken into account.

It would also be helpful to build a standard that can be used by asset owners to ascertain whether certain minimum standards and procedures in stewardship are being adhered to by the asset manager. Building on the Principles for Responsible Investment and the UK Stewardship Code, a minimum standard and benchmark for best practice could be developed to improve accountability and good practice among asset managers. This would allow asset owners to easily assess which asset managers are well positioned to exercise responsible investment and stewardship commitments. It could be modelled on the International Standards on health and safety and environmental management, and

become a voluntary certification mechanism.

There could be regulatory enforcement measures of investor stewardship codes, with sanctions such as a vote against the stewardship statement and a delisting from the financial Reporting Council (FRC) web site when they are not met.

The premise is that although asset managers are expected to comply or explain against the Stewardship Code, they are not held to account on it by asset owners. The analogy is that companies are held to account for delivery on the Corporate Governance Code against which they must also comply or explain in part by investors voting at the AGM. This means that investors can evaluate the explanation and take action accordingly. Currently, no such equivalent forum exists where investors explanation for their own stewardship work can be formally evaluated by their clients. Consequently, the chain of accountability is broken.

For example, inspired by both the Kay Review and ShareAction's work in this area¹², we have suggested an Investment Industry Stewardship AGM. This would enable the asset-owning clients of asset managers to hold their asset managers to account. Instead of each fund or fund manager being asked to hold individual AGMs, industry-wide efficiency gains can be made by bringing the trustees and fund managers together.

Such an event could be convened by industry associations in each country. In the UK the National Association and Pension Funds could work with the Investment Management Association, and would benefit with support from the government. The CEOs of the asset managers could be asked to present their stewardship statements, with the audience being at least one Trustee from each of the NAPF's 1300 members having an opportunity to ask questions before voting on the statement (voting could be limited to those clients of the fund manager presenting).

Such an AGM would bring together trustees from the major pension funds and CEOs or CIOs of the major asset managers

12. <http://www.shareaction.org/greenlightcampaign>



to discuss stewardship issues and to vote on asset managers' stewardship policies. This could also serve as clarification from government of the fiduciary issue that Kay highlighted and would hopefully start to shift culture and approach to stewardship of pension trustees without the need for regulation or heavy handed intervention. The results of the vote could be disclosed, with the best statements singled out for special mention by the Government and NAPF, and the worst being asked to improve next year.

7.0 How can the Sustainable Development Goals promote capital markets that integrate sustainable development

As Jeffrey Sachs has argued in *The Economist*, the UN's forthcoming Sustainable Development Goals should matter to investors as they could unleash a wave of growth-creating investments (Sachs, 2013). We therefore welcome the High Level Panel (HLP) on the Post-2015 Development Agenda's specific reference to integrated sustainability reporting by companies. As mentioned in **Section 5.2.2**, transparency is critical for efficient markets and will help encourage more sustainable investment decisions. The HLP report is also very clear that the private sector in general and the finance sector in particular have an important role to play, which is also welcome.

However, we were disappointed that the report fails to consider how capital will be harnessed to promote sustainable development in the presence of market failure. We were hoping to see corrections to the many distortions in the pricing systems on fisheries, freshwater, climate change and natural resource depletion. This is how sustainability issues become relevant to our corporate valuation work and how capital is put to work in the right places (see **section 5**).

We were also hoping the HLP would explain how to encourage the integration of sustainability throughout the finance sector: corporate governance codes, stock exchange listing rules, and institutional investment mandates, for example (see section 4.2.3). As a consequence, we have given some thought to how the Sustainable

Development Goals could promote capital markets that integrate sustainable development, i.e. Integrated Capital Markets.

As mentioned in the introduction, we have used the definition enshrined within the Brundtland report to define integrated capital markets as: *capital markets that finance development that meets the need of the present, without compromising the ability of future generations to meet their own needs*.

In order to achieve this it will be necessary to make strategic interventions throughout the capital supply chain. In order to make such systemic recommendations, we have used the capital market diagram in Figure 1 (Section 3.1, page 25). Below we make proposals for how each part of the system can be encouraged by Governments to integrate sustainability. The recommendations are based on our view of existing best practices in integrating sustainability within each separate type of institution.

For example, with respect to the company, *Integrated Corporate Governance* ensures that the guiding mind of the company (ie the board) gives consideration to sustainable development issues. To expand on how sustainable development issues can be integrated into corporate governance, it is the role of the board to (i) ensure that the standards and values of the firm are set, understood and well met. These standards should include material sustainability issues. The board also (ii)

sets the company strategy, which should integrate sustainability issues. Similarly, they should (iii) set, monitor and report on key performance indicators for material sustainability issues and (iv) nominate an executive director to be responsible for leading the company's sustainability strategy, setting up a board sub-committee where appropriate. Of course, incentives matter and the board should (v) integrate sustainability performance into the balanced score cards of board members and the senior management, including performance related pay. And, (vi) they should ensure sustainability and board diversity is integrated into board succession planning and training in order to ensure that a culture promoting sustainable business practices pervades the firm (see also the forthcoming UNEP Integrated Governance report, 2014).

Second, with respect to brokers and the opportunity to promote Integrated Corporate Brokerage, brokers play a key role in the investment chain and in investment decision-making. Crucially mainstream brokers provide buy, sell, or hold ratings on companies, in addition to associated research. If all ratings were to incorporate ESG factors then there would be great potential to redirect capital towards more sustainable assets. As an example, Kepler Cheuvreux were one of the first brokerages to sign up to the Principles for Responsible Investment. They now offer an "ESG integrated research model" focused around the following thematic areas: Corporate Governance, Social & Business Ethics, Environment & Climate Change, Human Capital analysis and Green Economy. ESG profiles for all companies covered are also provided. This work has been welcomed by a range of stakeholders and has won Kepler Cheuvreux a great deal of recognition. However, many brokers question the commercial basis for this work, claiming that fund managers do not reward research of this nature. This type of integrated analysis should be promoted by policy makers by requiring brokers to consider ESG issues in their investment research and encouraging brokers to

sign the PRI. Asset managers should also be encouraged to direct their research commission towards brokers conducting longer term research that integrates sustainability issues.

Third, with respect to investment consulting and the opportunity to Ensure Integrated Investment Consulting, since 2004, the investment consultant Mercer has had a dedicated team of Responsible Investment consultants. In 2008 the team started consistently evaluating investment managers on the degree to which they integrated ESG considerations into their investment processes. The highest ranking indicates a strategy where the investment team have demonstrated market-leading capabilities in integrating ESG factors and active ownership in some or all of these processes: generation of investment ideas, portfolio construction, implementation of active ownership (voting and engagement) and firm-wide commitment to ESG issues. Since 2012, these are incorporated into the ratings provided to clients as part of their selection and monitoring process. Investment consultants are extremely influential institutions (see Appendix 1 for an explanation), so this form of questioning has the potential to stimulate progress.

Unfortunately, Mercer is one of only very few investment consultants to assign ESG ratings across all asset classes as part of its manager research process. Other examples include Towers Watson, and Russell Investment Consulting, which have also made pioneering interventions in this area. However, these are the exceptions. Governments can harness the influence of investment consultants by encouraging them to integrate sustainability into their manager selection recommendations.

Returning to the HLP Report, this offered illustrative goals and targets in order to catalyse a debate. As our key contribution to this debate, we would like to make some suggestions to promote Integrated Capital Markets.

The targets listed below can be structured according the relevant thematic areas currently used by the Sustainable



Development Goals (SDGs) Open Working Group. These thematic areas would include, but are not limited to, Macroeconomic Policies, Sustainable Consumption and Production (SCP) and Governance.

Our specific SDG proposals are structured according to the relevant thematic areas used by the Sustainable Development Goals (SDGs) Open Working Group and are as follows:

“Goal: A resilient, sustainable economy that optimises quality of life for all”

Targets: Economic Growth

- Develop SDG Capital Raising Plans: for all Governments to develop national capital raising plans covering how they intend to finance the delivery of a zero-carbon economy and the Sustainable Development Goals; and for these national plans to be coordinated at the international level by the UN and World Bank. These will include a view on the money that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment, equity investment and sovereign and Multilateral Development Banks debt (see Box A on page 25);

- Establish Integrated Incentives: Governments to promote financial incentives along the investment chain that are fully aligned with long-term sustainable performance. This could involve reshaping the structure of individual remuneration along the capital supply chain;
- **Promote Integrated Financial Regulation: Governments to promote capital markets regulation that integrates sustainable development factors in the mandates of the supervision agencies of stewardship codes, listing rules and financial stability (*= key, see below);**

“Sustainable Consumption and Production (of financial services)”

- Improve Integrated Financial Literacy of the consumers and producers of financial services: Governments to have integrated sustainable finance into their national curricula by 2020; for the top fund manager and analyst courses such as the Chartered Financial Analyst Institute and for all the top MBA programmes to cover sustainable finance;
- Ensure Integrated Asset Ownership: Governments to ensure all asset owners¹³ with more than \$1 billion under management publish a report to the beneficial owners and society on how they have integrated sustainability considerations into their investment management agreements, or to explain why they have not done so;
- Ensure Integrated Investment Consulting: Governments to require all investment consultants advising on more than \$10 billion in assets under management (AUM) to

13. Such as pensions, insurance companies, foundations and sovereign wealth funds.

include a report to their clients and society on how well they think their fund managers are integrating sustainability, or to explain why they have not done so;

- **Develop Integrated Asset Management:** Governments to require on a **comply or explain basis** all fund managers with more than \$10 billion under management to be publishing an integrated report to their asset owning clients and society by 2030, including details of how they have integrated sustainable development into all AGM voting, or to explain why they have not done so;
- **Ensure Integrated Corporate Brokerage:** Governments to require all investment banks to have considered corporate performance on sustainability into all their recommendations to investors and advice to companies, or to explain why they have not done so;

“Good Governance and Capable Institutions”

- **Improve Integrated Corporate Governance:** Governments to ensure all national corporate governance codes promote integrated corporate governance – i.e. corporate governance that integrates sustainable development;
- **Improve Integrated Reporting by companies, investment banks, stock exchanges, asset managers, investment consultants, asset owners and proxy voting agencies:** Governments to establish a national legislative framework requiring participants in the capital market supply chain to be producing an integrated sustainability report to society

– on a mandatory comply or explain basis; (* = key, see below)

- Governments to call for proxy advisers to be integrating corporate sustainability performance into their advice to asset managers and asset owners on director (re)election, directors’ remuneration, and the quality of corporate integrated reports, or to explain why they have not done so;
- **Establish Integrated Investment Legal Duties:** for long-term sustainable development to be incorporated into the legal duties of market participants including, in particular, their fiduciary duty and duty of care of asset managers and investment consultants;

(* = Following a round table discussion with a group of sustainable finance experts, the above two proposals marked in bold and with an asterisk were regarded to be the two key next steps for policy makers that are seeking to integrate sustainability into sustainable capital markets.)

The above systemic interventions will work in concert, reinforcing each other and ensuring continuity throughout the capital supply chain. These will be positive steps towards *capital markets that finance development that meets the need of the present, without compromising the ability of future generations to meet their own needs*. It will also improve the ability of the market to reinforce sustainable development interventions, where governments seek to correct price signals.

8.0 Conclusion

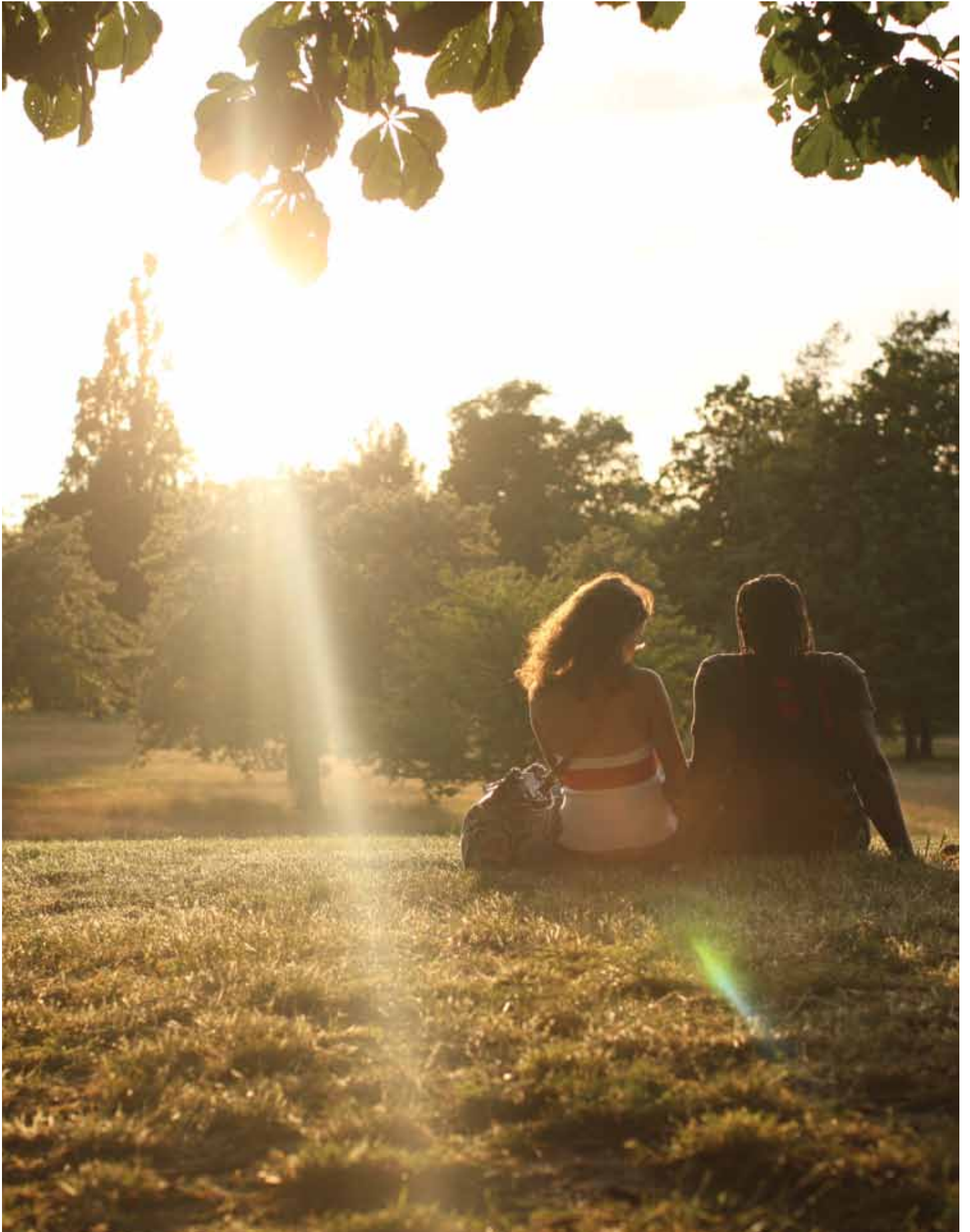
While capital markets are central to the achievement of sustainable development, they currently do not need to understand nor reward sustainable behaviour. This is either because the markets are inefficient and do not reward good behaviour, or because market failures mean that investors do not need to worry about the very long term costs as they are outside of their investment time horizons.

There are measures that we can take now to change this problem. This is particularly true where the issue is simply that markets are inefficient and do not reward good behaviour. For example, the transformation to a sustainable economy should focus on the incentives of all key players within the capital market such that they are sanctioned and incentivised on their sustainability performance. We also need much better market information, which almost certainly will require a change to global listing rules that mandates the disclosure of strategic sustainability reports, and provides the owners of companies an opportunity to vote at the company's AGM on the report. Better training of market

participants on the materiality of sustainability issues as well as how they can be factored into valuation analysis would also help.

However, before capital markets can be genuinely sustainable, we need capital market policy makers to have greater regard for future generations when setting policy. For the health of the economy, society and the environment, policy makers should integrate sustainable development issues into capital market policymaking. We need policy makers to internalise corporate externalities onto company accounts via, for example, increased use of fiscal measures, standards and market mechanisms. We also need to ensure that the culture within global financial services firms is not one where the many conflicts of interest are exploited. Some of this will require greater government intervention, particularly around the regulation of investor action on responsible ownership.

In this way, capital markets can become the primary facilitator of a global green and just economy.



Appendix 1 - An Introduction to Equity Capital Markets

The capital markets are a place where debt and equity can be raised, bought and sold. They formally include the market for share capital, short and long-term loan capital (e.g. corporate bonds and bank loans) and government bonds. The equity market and the money market are the two principal sources of external capital to industry.

The equity market is the key capital market in focus in this report and is defined as *"a market where specialised intermediaries buy and sell securities under a common set of rules and regulations through a closed system dedicated to that purpose"* (Michie, 1999, p3). To place this into its proper historical context, in the UK the London Stock Exchange was formally founded in 1801, with the first Official List of prices being issued in 1803. However, the market for securities pre-dates this time. From the 17th century onwards, with the appearance of national debt and transferable stocks issued by Joint Stock Companies such as the English East India Company (founded in 1623), the volume of business generated by securities was sufficient to warrant the beginnings of professional intermediation and organised markets (Michie, op cit).

The operations of the London Stock Exchange fall within the scope of the Financial Conduct Authority (FCA) in its role as the UK Listing Authority (UKLA). The FCA is an independent non-governmental body that has been given statutory powers by the Financial Services Act 2012. Its role is to ensure that the system remains effective

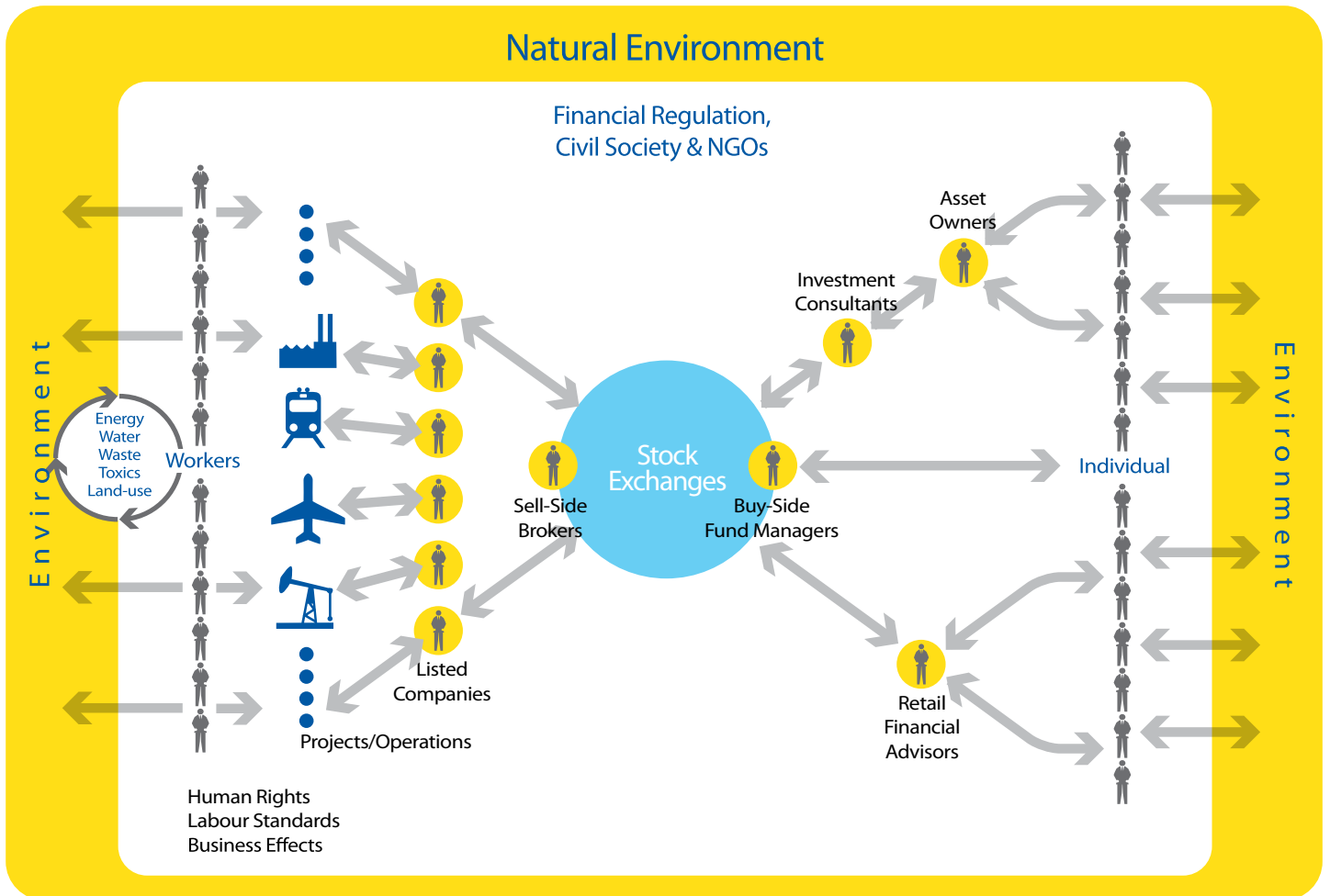
and credible by policing the stock exchange, investigating and, where appropriate, using its criminal prosecution powers against firms that have contravened market rules.

The two principal functions of a stock exchange are to provide:

1. a primary market where companies can raise new investment capital by issuing new stocks, shares or corporate bonds; and
2. a secondary market for dealing in existing securities. Although referred to as a secondary market, this is by no means a secondary role as most of the trading that takes place is in previously issued securities.

The stock exchange allows the original owners of the firm to spread the risk of their company over a large number of investors by issuing shares. Similarly, it allows investors to spread their risk among a variety of shares, and to realise the current value of their investment by selling in the secondary market. The stock price represents the market's view of the discounted value of future income streams (including dividends) and, at any one point, reflects the market's aggregate view of the company's financial value.

"Prospects for any particular company... [are] always uncertain. Some people rate the company... more highly than others. The market price is the average of everyone's



valuations, weighted by the amount of money they are able to mobilise behind their views" (Kay, 2003, p142).

The key capital market financial institutions and their inter-relationships

The stock exchange intermediaries and institutions include, among others, stockbrokers, fund managers, issuing houses, merchant banks (now more commonly called investment banks) and, as general buyers and sellers of securities, the central bank, commercial banks, pension funds, insurance companies, unit trusts, investment trusts, open ended investment companies, and company treasuries. Here they collectively represent the main types of capital market financial institutions in question.

The introduction highlights that it is necessary to set out how the main types of financial institutions relate to each other so

we can be clear about the chain of influence that makes the capital market of interest to policy makers. The following section describes the capital market institutions that facilitate the flow of capital from investors (which supply the capital) to companies (which demand the capital).

Figure 1 depicts the relationship between the financial institutions that operate the market between the demand for and supply of capital. The different roles of the financial institutions are important as each role reflects the nature of the influence. (This systems map also provided the structure for making recommendations for SDGs.)

Figure 1: The structure of the capital market

Figure 1 shows that in the UK, the supply of equity capital originates from two main areas:

Figure 1: The structure of the capital market

1. Individual Investors – individuals, either as scheme beneficiaries or directly as ‘retail’ investors, purchasing stocks and shares from an investment broker, or investing in pooled schemes such as OEICs, SICAVs, unit trusts and investment trusts managed by fund managers; and,
2. Institutional Investors – such as company and local authority pension funds, insurance companies, investment trusts, charities and organisations operating unit trusts and investment trusts.

In 2013, the UK fund management industry was responsible for around £5.4 trillion of funds. Around two thirds of these funds were managed on behalf of UK institutional clients (TheCityUK 2013 Fund Management Report).

The demand for equity capital comes from companies (PLCs) listed on Stock Exchanges. Globally, the value of all companies listed on stock exchanges in 2012 was over \$53 trillion. These PLCs use the services of investment banks to underwrite the new issues of their shares (it should be noted that in many developed markets the use of equity finance by listed companies is becoming a less significant source of capital for companies than finance via corporate debt – see, for example, Kay 2012).

Investment banks also have a role in facilitating mergers, acquisitions and new placements on the exchange. Furthermore, many investment banks include sell-side¹⁴ broker operations that act as intermediary agents between companies and investors, maintain markets for previously issued securities and offer advisory services to fund managers. This last advisory service role is that which renders sell side brokers important to policy makers working on sustainable development issues. Fund managers place considerable authority in the views of these analysts, with the consensus in their forecasts being a

closely monitored factor by many analysts. Therefore, where the views of the most influential brokers change, markets also tend to move: consequently, the broker’s view on sustainable development issues will be influential.

Buy-side¹⁵ fund management houses buy and sell their equities via sell-side brokers. They may also use their advisory services. It is the job of the individual fund manager to make individual portfolio investment decisions in accordance with the stated aims of the investment fund, and may also employ their own internal analysts. The client’s aims are set out by the asset owners in the investment mandate, which is also known as the Investment Management Agreement.

Similar to retail investors seeking the advice of independent financial advisors (IFAs), institutional investors place considerable authority in the views of investment consultants who advise as to which fund manager has the most robust investment process and can meet the investment needs of the investment scheme. This is particularly the case in, for example, the UK, the United States and Canada. Therefore, being able to articulate a robust investment process that impresses investment consultants is of central importance to fund managers. This is because they need to be able to convince the investment consultants that they have the people, investment philosophy and investment process that should deliver consistent performance in order to win business. Consequently, fund managers spend a considerable amount of time and effort on the areas that investment consultants rate as important aspects of a good process.

Investment consultants are highly relevant to policy makers because they significantly influence an institutional investors’ choice of fund manager. As a consequence, if investment consultants indicate that they believe that something is important, this sends a powerful market signal to fund managers, who are more likely to invest more resources in this area as a result.

14. ‘Sell-side’ refers to institutions that sell equities to investors for a percentage commission.

15. ‘Buy-side’ refers to institutions that buy and hold securities in the expectation of a return on investment.



Appendix 2 – The Ownership Influence of Investors

In the corporate governance literature, shareholders are regarded as the “principals” of the business and can exercise their rights of share ownership over their “agents”, the company directors. They do this by sending explicit signals regarding the management of the company. This is referred to in much of the corporate governance literature as ‘voice’ to distinguish it from the option of selling the stock, which is known as exit (and part of the mechanism for the cost of capital impact highlighted above). As an example of voice, at the end of a company director’s term, common stock investors can vote for or against that director’s re-election at the AGM. In an increasing number of jurisdictions, they can also vote on their pay structure.

When seeking to understand the theoretical foundations of Ownership Influence, it is useful to understand the legal context of Investor Advocacy. In particular, those sections dealing with the ownership, control and accountability of a company are important. The following discussion focuses on these aspects.

The principle behind why ownership influence exists can be traced back to Adam Smith, who argued that optimal market efficiency required the owners of capital to be directly involved in its management because they tended to be more vigilant with their own money (Smith, 1776). Where a company lacked oversight by the owners of the money, Smith argued that company directors, “*being the managers rather of other people’s money than of*

their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own... Negligence and profusion, therefore, must always prevail, more or less in the management of the affairs of such a company.” (Smith, op cit, p700).

The law of business organisations around the world originally derived from the common law of England. In the UK, the opportunity for ownership influence is a legal attribute of the corporate form as established in UK Company Law. This is defined in The Companies Act, which sets the legal form of PLCs. The main legal principles of a publicly listed company are as follows (adapted from Mackenzie, 1993, p29):

- The Company: once incorporated, the company becomes a ‘legal person’ on its own account. The directors are appointed by the shareholders to manage the company.
- The Directors: the law variously considers the directors to be the agents of the shareholders, the controllers of the company and the company’s servants. The articles of association confer on the board overall control of the company’s activities. The board typically appoints executives to exert day-to-day management

control. As a counterpoint to this power, the Companies Act gives the board formal responsibilities to its shareholders, employees and the company as a whole.

- The Shareholders: individual and organisational shareholders become 'members' of the company when they buy the shares. At the Annual General Meeting, they are expected to oversee the activities of directors and may vote on their (re-)election. Shareholders may alter the Articles of Association – a founding legal document of the company – and, in some companies and in certain circumstances, may direct the board to follow specific policies.

provides shareholders with considerable Investor Advocacy Influence over corporate practices.

The specific legal rights conferred upon shareholders by Company Law include certain rights of access to the company directors: entrance to annual general meetings, the ability to vote on resolutions, the appointment of the directors, approval of the annual report, approval of the remuneration report and, in specific circumstances, the ability to table a shareholder resolution directing the company to take a particular course of action or call for an Extraordinary General Meeting.

As a partial aside, despite the common impression to the contrary, shareholders do not legally own companies as a whole. In a 1948 landmark test case, Lord Justice Evershed concluded that "*Shareholders are not, in the eye of the law, part owners of the undertaking* [the company]. *The undertaking is something different from the totality of the shareholdings.*" (Gower, 1969, p522). The intellectual basis of this judgement was, in part, the fact that in law a company is regarded as a 'person', and is therefore beyond ownership.

Nevertheless, a large part of Company Law exists in order to prevent shareholders' interests being abused by company directors and confers onto shareholders certain legal rights. As mentioned above, in Company Law, shareholders are expected to oversee the activities of directors. Directors are therefore accountable for their performance to the shareholders who elect them to act on their behalf. Furthermore, the law conveys a collective responsibility on shareholders to ensure that 'negligence and profusion' does not prevail in the management of the company.

So while it is true that a company is more than a mere item of property, a legal relationship exists between company shareholders and company directors that

Appendix 3 – Generation Investment’s Manifesto

Generation Investment has also set out a manifesto for change. This manifesto for sustainable capitalism has helped catalyse this debate on the role of public policy in relation to responsible investment and we endorse their ideas as follows:

Source: Generation: Sustainable Capitalism, February 15, 2012

“The challenges facing the planet today are unprecedented and extraordinary; climate change, water scarcity, poverty, disease, growing inequality of income and wealth, demographic shifts, trans-border and internal migration, urbanisation and a global economy in a state of constant dramatic volatility and flux, to name but a few. While governments and civil society will need to be part of the solution to these massive challenges, ultimately it will be companies and investors that will mobilise the capital needed to overcome them.

To address these sustainability challenges, we advocate for a paradigm shift to Sustainable Capitalism; a framework that seeks to maximise long-term economic value creation by reforming markets to address real needs while considering all costs and stakeholders.

The objective of this paper is twofold. First, we make the economic case for mainstreaming Sustainable Capitalism by highlighting the fact that it does not represent a trade-off with profit maximisation but instead actually fosters

superior long-term value creation.

Second, we recommend five key actions for immediate adoption that will accelerate the mainstreaming of Sustainable Capitalism by 2020:

- 1. Identify and incorporate risks from stranded assets;*
- 2. Mandate integrated reporting;*
- 3. End the default practice of issuing quarterly earnings guidance;*
- 4. Align compensation structures with long-term sustainable performance; and*
- 5. Encourage long-term investing with loyalty-driven securities.*

In addition, we also believe that there are five broader ideas that merit ongoing support and attention. Specifically, we think there is a need to:

- i. Reinforce sustainability as a fiduciary issue;*
- ii. Create advisory services for sustainable asset management;*
- iii. Expand the range and depth of sustainable investment products;*
- iv. Reconsider the appropriate definition for growth beyond GDP; and*
- v. Integrate sustainability into business education at all levels.*

Ben Franklin famously said, “You may delay, but time will not, and lost time is never found again.” We have the opportunity to rebuild for the long term and an obligation to seize it. Sustainable Capitalism will create opportunities and rewards but it will also mean challenging the pernicious orthodoxy of short-termism. Now is the time to accelerate the transition.

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A document of this nature cannot hope to do justice to the incredible complexity of capital markets, let alone how it can be harnessed in support of a topic as huge as sustainable development. Nevertheless, I hope that our incremental suggestions for improvement help move the debate on sustainable capital markets forward.

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