

Lord Sharman, chairman, Aviva plc, December 2011

How do the capital markets undermine sustainable development? What can be done to correct this?

Speech to *The Finance Lab* at ICAEW, London 7 December 2011

Thank you very much indeed for the invitation to speak here today.

Aviva's purpose is to provide prosperity and peace of mind to 44.5 million customers across the world.

For over 300 years, we've helped people protect what they have today and to plan, invest and save for their futures.

We want to encourage more people to secure their financial futures. We're committed to working with our customers, Governments, regulators, charity partners and business partners to find solutions that increase the financial well-being of both individuals and society.

We look after over 600 billion US\$ worth of funds on behalf of our customers....And they want to know we are acting responsibly with it - to protect their future - and our future - together - as a global community.

This sense of responsibility is spreading - and many of our institutional investors have now also signed up to the United Nations backed Principles for Responsible Investment, an initiative I am proud to say that we helped to found.

However, despite the \$30 trillion dollars now backing the PRI, we can see from the 2040 Vision for a Sustainable Economy – which Aviva Investors

commissioned from Forum for the Future - the capital markets currently allocate capital to corporate activity in a way that undermines sustainable development.

In my view, this need not be the case. In fact, I believe capital markets should be the primary facilitator of a global green and just economy.

Sustainable development itself was of course first defined by Our Common Future as development that meets the needs of the present without compromising the ability of future generations to meet their own needs. This is an important concept for investors as development that provides short term benefits but creates significant costs over the long term will reduce the absolute value of long term investment portfolios.

As an asset owner with long term interests ourselves, as well as being the manager of millions of pensions where the beneficiaries will not be drawing down for many decades is of understandable concern to us.

In terms of how finance relates to the capital market, electronic flows of money have no real impact on our physical environment, nor on our society. These impacts only arise when the capital is spent on the production or consumption of goods and services. Impacts also arise when capital is required for a development project but is not forthcoming.

It is perhaps obvious to say that the capital markets' physical impact arises when it finances or neglects to finance the development of real goods and services. However, how do we as asset owners and asset managers influence the allocation of capital by the companies that produce those goods and services?

The capital markets' influence over sustainable development

We believe our influence over corporate sustainable development originates via two principal routes:

1. Financial influence: Our buying and selling of equity shares and debt on the capital market influences the cost of capital for listed companies. The more a company has to pay for capital, the less it can raise. This limits the extent of the company's activity.

2. Our investor advocacy influence: Shareholders are 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.

From a sustainability perspective, I perceive two main problems with the way this system is working: (i) market inefficiency and (ii) market failure.

The principal difference between the two is that capital market inefficiency is a failure of the predictive power of investors.

Whereas capital market failure is a failure of the governments to create a market price mechanism that ensures that companies have to pay the cost of their externalities.

I would like to take the opportunity presented by this meeting of The Finance Lab to make a few practical proposals for how some of these market inefficiencies could be addressed. I will then turn to the question of market failure, how they could be corrected, and by whom.

The sources of market inefficiencies

There are three key reasons for market inefficiency:

- (i) Misaligned incentives within the financial institutions;

One of the main sources of market inefficiency is an excessively short-term view among the market participants. Too often concerns focus on short term costs of an initiative rather than the long term 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. This, in turn, motivates fund management institutions to incentivise and evaluate their individual fund managers and analysts based on performance over time frames that are excessively short, leading to too much attention on short-term financial performance.

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 as a whole. This 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, as many sustainable development issues are inherently long-term, short-termism is also a particular problem for sustainable development - it systematically erodes incentives for company directors to invest in a sustainable business.

We need to develop a set of proposals for how individuals and institutions should be incentivised in order that their ensuing behaviour promotes sustainable development. This work would need to be comprehensive and consider intermediaries throughout the capital supply chain, from the originators of the capital – people as individuals - through governments, banks, stock markets, companies, primary brokers, secondary brokers, exchanges, fund managers, investment consultants and other financial institutions via equities, bond financing and bank debt and up to companies.

I am pleased to say that - together with UNEP-FI, Korn/Ferry Whitehead Mann, Berwin Leighton Paisner and PwC - we have commissioned Tomorrow's Company to examine precisely these questions. I expect the report to be available in the second half of 2012 and invite those of you here today working within

financial services industry to work with us – either as full funding partners, or as interviewees.

- (ii) A lack of information from companies to the providers of capital;

A second key market inefficiency is the inadequate information on which many capital allocation decisions are made.

To improve corporate accountability and our access to performance data, we have been exploring how stock exchanges can work with investors, regulators and companies, to enhance corporate transparency, and ultimately performance on environmental, social and corporate governance issues.

Since 2008 we've been calling for a debate with all the listing authorities of the global stock markets to consider whether their corporate governance codes should be updated to include the 10 principles within the UN Global Compact.

Since then, we have been urging all stock market listing authorities to make it a listing requirement that companies consider how responsible and sustainable their business model is.....

.....And put a forward-looking sustainability strategy to the vote at their AGM...

.....As Aviva did last year – the first financial services company in the world to do so.

We have seen welcome action taken by the Singapore and Malaysian stock exchanges, who joined existing good practices in South Africa and Denmark.

However, the vast majority of stock exchanges are yet to embed sustainability into their listing rules. It is clear to us that without the support of global governments, they are unlikely to unilaterally do so.

Yet, the problem has not gone away. We can see from our Bloomberg screens that less than 1 in 4 globally listed companies publishes any data on their environmental, social and corporate governance performance.

We know markets are driven by information. If the information they receive is short term and thin then these characteristics will define our markets.

Simply, if companies do not provide an assessment of the broad Environmental, Social and Governance risks and opportunities to which their business model is exposed how can the market assess the sustainability of that company's growth?

To move this agenda forward, I am proud to say that we have convened the Corporate Sustainability Reporting Coalition. So far, this has the explicit support of approaching \$2 trillion of assets under management, including organizations as diverse as FTSE Group, the Association of Chartered and Certified Accountants, the Global Reporting Initiative, and the UN Stakeholder Forum.

We have also heard positive comments from representatives of the Brazilian, Norwegian, Croatian and UK governments.

With the Earth Summit on sustainable development having its 20th anniversary in Rio in June 2012, we collectively believe the time has come to invite Heads of State and Heads of Government to take action.

We are collectively proposing that the United Nations member states at the Earth Summit develop a Convention requiring companies to produce an Annual Report and Accounts that integrates sustainability throughout.

We are also advocating that the quality of the integration of sustainability - or the explanation - be put to an advisory vote at the AGM.

For our part, Aviva Investors has committed to integrate the data into our buy, sell and hold investment decisions.... into the feedback we transmit to the companies that we invest in.... and into our voting at company AGMs.

So - can we work together on an Earth Summit conference agenda.....that sets out how capital markets can be better harnessed for the creation of a sustainable future?

I would very much like to do so.

- (iii) A lack of education among market participants on the costs and benefits of corporate sustainability.

However, simply encouraging companies to provide this information does not guarantee that investors will be interested, nor will it ensure that investors will know how to use it.

This is a third key market inefficiency and it arises from a lack of education among market participants on the costs and benefits of corporate sustainability.

One practical way of changing this over time is via increasing education and awareness among analysts. The most highly regarded fund manager and analyst training centres around the world such as the Chartered Financial Analyst Institute should ensure their training syllabuses improve the ability of analysts to think through how sustainable development enhances corporate valuation.

I welcome the work of the CFA in this area, however, it is time to ensure that the charterholder examination framework includes these issues. This is crucial because many providers of training fail to focus on the broader syllabus.

Market Failure

While we can deal with these market inefficiencies, the key reason as to why the capital markets fail to integrate sustainable development issues sufficiently broadly is *market failure*.

Markets are said to fail where, if left unchecked, they would lead to sub optimal social welfare outcomes. This is where it pays companies to do the wrong thing and be unsustainable.

In conventional welfare economics, market failure is of course the guiding principle behind the need for government intervention.

The sustainable development capital market failure is government's failure to sufficiently internalise companies' environmental and social costs such that they matter to corporate profit and loss statements - thus ensuring that the price signals promote economic development that is fully sustainable.

As a result, the capital market does not incorporate companies' full social and environmental costs. Indeed, until these market failures are corrected, it would be entirely irrational for investors to incorporate companies' full social and environmental costs. They do not appear on the balance sheet and, therefore, do not affect companies' profitability or earnings per share over the investment time horizon.

On a related point, even if significant costs accrue due to a sustainable development failure, they can be negligible today because the markets heavily discount future cash flows.

Therefore, while financial markets are key in the pursuit of sustainable development, they currently do not need to understand nor reward sustainable behavior. This is either because the markets are inefficient and do not reward good behavior. Or because market failure means that they do not need to worry about the very long term costs as they are outside of their investment time

horizons.

So, what needs to change?

It is unrealistic to expect market participants to move towards a discount rate that takes account of the very long term costs of unsustainable development. This is because there is a time value of money and considerable uncertainties and therefore risks associated with forecasting the future.

In many countries, policy makers often defer to the market when formulating policy. This is wrong. The capital market discounts the future in a way that policy makers should not. If the short-term financial consequences of government interventions are expensive, then this alone is not reason to stop. Government policy should be set on the basis of a full and non-discounted long term cost benefit analysis.

The role here of investors is to engage with policy makers. Where we find market failures, then we should highlight them and support corrective action. This may include fiscal measures, market mechanisms and – indeed – market supporting regulation.

Conclusion

In closing, I commend those of you that had the vision to set up the Finance Lab. At challenging economic times such as these it is important to think through the long term implications of sustainable development for our financial system.

I have suggested three ideas that will support the incremental transformation to a sustainable economy.

1. A focus on the incentives of all key players within the capital market.

2. Much better market information from companies, which almost certainly will require a government intervention.
3. And better training of market participants on the materiality of sustainability issues as well as how they can be factored into valuation analysis.

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.

While capital markets are key in the pursuit of sustainable development, we need to take stronger collective action before the markets can be considered sustainable.

It is my hope that - together - we can extend sustainable prosperity and piece of mind to many, many more people in the years to come. Thank you for listening.

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