1 Capitalism Meets Multilateralism

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1.1 INTRODUCTION: THE THREE FAILURES OF CAPITALISM

The idea at the heart of capitalism is deceptively simple: prices signal which goods or services are to be produced, ensuring that supply and demand are matched. In Adam Smith's famous image, the 'invisible hand' of the market allocates resources efficiently between corporations and individuals.

Today, capital markets are failing to deliver on this promise in three related ways: they are failing the investors and corporations they exist to bring together, by forcing them to focus on short-term profit at the expense of long-term growth; they are failing to preserve the health of our planet, upon which we all rely; and they are ultimately failing the people of the world, by both destroying the resources upon which we also rely and assuming that the people who make up markets have no ethics. The invisible hand is choking the planet.

The evidence for these market failures is widespread, compelling and well-known. But some figures are so stark that they bear repeating: over a third of the world's agricultural land is now seriously degraded (see e.g. United Nations, 2017). Over 90 per cent of the world's marine fish stocks are now 'fully exploited, overexploited or depleted'.[1] An estimated half of the world's coral has been lost since the 1980s (Hughes et al., 2018). And we are on track for an average temperature rise of almost 4°C by 2100,[2] threatening drought and weather conditions that humanity has never before witnessed.

[1] According to the United Nations: https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1812.

[2] World Meteorological Organization (2019).

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Globally, one person in nine does not have enough to eat. Two billion people live on less than US$3 per day and over 70 million people are unable to find work. Yet, the world's richest 1 per cent now own more wealth than all the other 99 per cent put together,[3] with just the eight richest people in the world owning the same as 50 per cent of the world's population.

Increasingly, economists, investors and regulators are recognising that these issues, previously perceived in largely environmental and social terms, will also have severe financial and economic consequences if left unchecked. Unsustainable economic growth will harm people's pensions, savings and investments. Many sustainability issues, notably climate change, will harm long-term economic growth and create financial instability, as the chapters in this book set out.

This damage is not inevitable, however. The world does not lack the capital required to deliver the UN Sustainable Development Goals.[4] We lack imagination, compassion and equality of opportunity. And we lack capital markets that factor in people and planet, while making a profit.

Markets are built, operated and regulated by people. They respond to price signals that are a function of government policy and to regulations that are determined by domestic and regional supervisory bodies, and global standard setters. Policymakers and regulators therefore have levers at their disposal to alter market behaviour and deliver a more sustainable future.

We need to restore compassion to the heart of capitalism, by reconnecting the capitalists with their capital. Markets are amoral. People are not.

In this chapter, we examine the reasons behind capital markets' contribution to an unsustainable future, considering the distinction between market inefficiencies and market failures, and suggest five steps for policymakers and regulators to consider.

[3] See, e.g. Credit Suisse (2019).

[4] See: www.un.org/sustainabledevelopment/sustainable-development-goals.

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1.2 CORPORATE VALUE AND SUSTAINABILITY: MARKET INEFFICIENCY AND MARKET FAILURE

The valuation of every company helps it to compete: a higher market price means a lower cost of capital, which is a competitive advantage. In capital markets that functioned for the long term, sustainable companies should be able to raise capital more cheaply than unsustainable ones. 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. Both create substantial barriers to a sustainable financial system and wider economy.

1.2.1 Market Inefficiency

Market efficiency is a central concept in fund management. Markets are often hypothesised to work well in transmitting produce-relevant information. It is true that some markets are efficient, but many are not. Market inefficiency is what active fund managers attempt to exploit when seeking to outperform their financial benchmark. From a sustainability perspective, market inefficiency is the situation where it pays companies to do the right thing and be sustainable, but markets neither recognise 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, that is, the benefits of their behaviour become clear when they appear in the company's accounts.

As the market inefficiency argument cuts against the efficient market hypothesis (e.g. Malkiel, 1989), it is worth dwelling on the

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practical sources of some of these market inefficiencies. There are a number of reasons: a lack of complete and comparable market data on environmental, social and governance (ESG) factors and a lack of expertise on ESG analysis within institutional investors, or the syllabus of the chartered financial analyst qualifications. But arguably one of the main sources of market inefficiency is the incentives within the system that lead to 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 capital markets being too near-sighted in the way that they evaluate 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.

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.

One of the most significant sources of market inefficiency here is the business model of the investment banks. The remuneration of brokers is directly linked to trading volumes. As a result, they have

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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. The pressures and commercial conflicts they are under are leading them to produce research that looks to enhance the profitability of investment banks at the expense of an efficient and properly functioning capital market.

In 2017, Aviva Investors collaborated with Tomorrow's Company and Extel on a study into this market inefficiency. Entitled 'Investment Research: Time for a Brave New World?', we anonymously surveyed the personal views of 342 sell-side analysts across the world. Our findings indicated that 90 per cent of mainstream analysts would at least undertake some additional caution when writing on topics sensitive to the bank. Over a third of mainstream respondents readily acknowledged that they should avoid damaging investment banking relationships if they are to have a successful career (Aviva Investors, 2018).

These commercial conflicts are well known and derive from the function of investment banks, which intermediate between issuers and investors in capital markets. The information produced by an analyst who works in the research department can be of use to the bank's investment bankers. To disparage a client or potential client of the investment bank would not, therefore, be beneficial for the bank or for the analyst's career.

This has consequences for the efficient functioning of markets. Significantly, 42 per cent of analysts agree that sell-side research has a detrimental short-term focus, and only 35 per cent agree that sell-side research tackles controversial topics and offers negative assessments of companies where appropriate. We also find that a mere 12 per cent of mainstream sell-side analysts' time is spent researching companies' prospects beyond a 12-month horizon.

This suggests that responsible investors with a long-term view need to ensure that the research payment accounts under the Second Markets in Financial Instruments Directive (MiFID II) reward the

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right kind of investment research. Furthermore, policymakers should look carefully at these commercial conflicts on the sell side if they want capital markets to focus on the long term and allocate capital sustainably.

1.2.2 Market Failure

In contrast to market inefficiency, market failure 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 (P&L) statement at all. This is largely because global governments have not taken corrective action to internalise the costs onto corporate balance sheets through, for example measures to price the externalities correctly.

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

The reason why this distinction matters to us as institutional investors (e.g. pension funds, insurance companies), is that we need to be strategically very clear about where our own spheres of responsibility begin and end. We have a fiduciary duty to attempt to capitalise on market *inefficiencies* in the pursuit of excess returns from our investment decisions. We also have a duty to behave as good owners – or stewards – of the businesses we own. But we cannot correct market *failures* by ourselves. Ensuring that the price mechanism works effectively and, for example, properly values environmental and social goods and services, is the role of governments, not investors. That said, investors can advise governments on the most effective way to achieve this – as we attempt to do later in this chapter.

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, fresh water,

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climate change and natural resource depletion. This is how sustainability issues become relevant to the corporate valuation work that informs most investment decisions, and how ultimately capital would be 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.

Arguably, the biggest contemporary market failure is climate change. As well as an environmental and social challenge, climate risk has become an exceptionally urgent and important economic and financial problem. In 2015, Aviva worked with the Economist Intelligence Unit (EIU, 2015) to calibrate the value-at-risk to climate change. We found that 6°C of warming by the end of the century could lead to a present value loss of US$13.8trn of manageable financial assets, roughly 10 per cent of the global total. These values are based on the discount rate of a private investor, a reasonable baseline, as the affected losses mentioned earlier will be on the privately held pool of global assets. However, as climate change is also a systemic problem, with issues of wider societal concern, it is often appropriate to apply a lower discount rate, consistent with public sector actors that have longer time horizons than individuals. When the expected losses are considered from a government's point of view, employing the same discount rates as the Stern Review (Stern, 2006), they rise dramatically. From the public sector perspective, the expected value of a future with 6°C of warming represents present value losses worth US$43trn – 30 per cent of the entire stock of manageable assets. The consequences for long-term economic growth would be catastrophic (EIU, 2015).

In the presence of market failure, integration of ESG into investment analysis can motivate the wrong behaviours, and engagement with companies is doomed to fail as one is essentially asking the company to go against the market incentives and lose money.

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1.3 FIVE POLICY STEPS TO BUILD FINANCIAL MARKETS THAT ARE FIT FOR THE FUTURE

In 2015, landmark agreements on climate change, financing for development and sustainable development goals were reached in the United Nations (UN).

Our financial services system should help deliver these global agreements: all three agreements reference the importance of private sector financial flows. Yet, in practice, as we have seen earlier, market failures and inefficiencies prevent finance from being directed where it will make the most positive impact.

It is the role of policymakers and regulators, guided by civil society, to shape financial markets to deliver the positive outcomes of the agreements to which the world has signed up. Yet few policymakers, politicians or civil society representatives understand how the many different financial services institutions work together to finance the world we live in today and will retire into tomorrow, and even fewer have considered systematically how to reform the financial system to promote sustainable outcomes. In the absence of appropriate oversight, society and the real economy currently serve financial interests, rather than the other way around.

There is an increasing number of examples of positive policy actions, however, to shape sustainable financial markets around the world. We have drawn on these to develop the following recommendations, which look at how policymakers and regulators at the national, regional and global level can develop more sustainable financial systems.

i. *Establish and strengthen international and national frameworks for sustainable finance*

- The UN, IMF and World Bank should work together to create a Global Climate Capital Raising Plan: this plan could inform national Capital Raising Plans, which include a view on the infrastructure required, the capital involved and the financing that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment,

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equity investment as well as sovereign and MDB debt. The UN's Addis Agenda notes that 'integrated national financing frameworks that support nationally owned sustainable development strategies' will be at the heart of countries' efforts, supported by an enabling international economic environment and international cooperation. At the High-Level Political Forum (HLPF) in New York in July 2019, however, only a quarter of the Voluntary National Reviews presented an investment strategy at all.

- Governments should establish an International Panel on Climate Finance (IPCF): this would be a capital market-focussed equivalent to the Intergovernmental Panel on Climate Change (IPCC), which focuses on the science base around climate change. Rather than look at the science base, an IPCF could support an assessment of article 2.1.c of the Paris Agreement – that is the 'consistency of finance flows with a pathway towards low greenhouse gas emissions and climate resilient development'. It would conduct an assessment of market-based analysis on the impact of climate policy. Observations would be secured from the various market disclosures by companies and investment analysts from various sectors and regions. The report would serve as a market test of policy effectiveness. Such a report would be provided to policymakers at each Conference of Parties (COP) and inform them about the view of capital market participants in relation to the likelihood of the delivery of the Paris agreement. The IPCF could also coordinate and assist on the creation of national Capital Raising Plans.

ii. *Ensure a greater share of all public sector financial flows are sustainable*

Many governments in the world have started the journey towards using public spending to support green and sustainable initiatives. But the scale and speed of this spending need to increase exponentially if we are to meet the challenge of the UN's Sustainable Development Goals (SDGs).

Public bodies should therefore look to 'green' a significant share of all public sector financial flows, including not only standard spending but also:

- Ensuring a proportion of all funded public sector pensions is invested in sustainable assets – for example if just an additional 5 per cent of US-funded state pension schemes were invested sustainably, this would amount to over US$300bn.
- Looking at how central banks can use their balance sheets to support sustainable investment, for example by tilting asset purchases towards

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sustainable investments. For example, the European Central Bank's asset purchase scheme since the financial crisis has seen it purchase over €180bn in corporate bonds.

- Ensuring Sovereign Wealth Funds (SWF) invest a proportion of their investments sustainably. Again, if an additional 5 per cent of SWF assets were invested sustainably, this would amount to almost US$400bn.

iii. *Shift private sector financial flows by adjusting pricing and other incentives*

Public bodies also influence sustainable finance by creating the incentives in which market forces operate. Much more needs to be done to shift these incentives towards sustainable investments.

- Carbon pricing is fundamental to internalising the externalities of climate change. All governments must work together to agree and implement a meaningful cost of carbon. But we cannot wait for everyone to agree before individual countries act. Where countries move ahead of others in pricing carbon, they should also consider carbon border adjustments to ensure a level playing field. At the same time countries must transition away from fossil fuel subsidies that prop up polluters while damaging citizens' long-term future.
- A major factor in institutional investors' decisions about what to invest in is based on the amount of capital they must hold against each investment. If regulators set capital levels to reflect the long-term risks of assets to financial stability, thereby incentivising more investment in green assets and a transition away from polluting assets, the largest investors in the world would move money in a more sustainable direction without costing governments a penny.
- Governments could also look to support measures to ensure that the polluter pays to clean up the pollution they have created, thereby making them far less attractive investments – the EU's Producer Responsibility Directive, for example, could be extended to ensure that fossil fuel extractors and utilities are required to pay for the cost of carbon capture and storage.
- Governments also need to remove damaging fossil fuel subsidies that create perverse incentives to fund emissions. Yet fossil fuel subsidies in 2018 actually increased by a third, to more than $400bn globally.[5]

[5] See: https://energypost.eu/400bn-in-global-fossil-fuel-consumption-subsidies-twice-that-for-renewables.

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iv. *Improve market information to make the sustainability risks and rewards of financial assets clearer*

- Currently, not only are market incentives misaligned, but there is very little consistent information on environmental issues available in financial markets.
- Central banks could help support the production of sector-specific reference climate risk scenarios for corporate boards – particularly banks, insurers and investors – to see as input and base their own scenario plans upon (Bank of England, 2019). This would significantly help the process of scenario planning within financial institutions and assist the comparability of the scenario plan outputs, which are currently based upon disparate assumptions.
- Global regulators and standard setters should also look to make the analysis and disclosure of climate risk mandatory for all companies. The International Organization of Securities Commissions (IOSCO) could begin by recommending that all stock market regulators make listed companies adopt the governance and strategy recommendations of the Task Force for Climate-related Financial Disclosures (TCFD, 2017).

v. *Educate people about the connection between their personal finances and sustainability*

Most people that own capital through their pensions and investments have no idea how the financial system works, or how their money impacts the world for good or ill. More can be done to correct this.

- Governments should provide strong backing for civil society campaigns that would look to mobilise their supporters. Actions that government and non-governmental organisations (NGOs) could jointly take include NGO sustainable finance education initiatives that teach people about the climate impacts of their investments and encourage them to think about how it impacts everyone on the planet and shapes all our futures. Teaching the owners of capital how to care about the climate impact of their assets would change the nature of the supply of capital overall as well as what concerns are raised via investment.
- Governments should back at scale public league tables ranking the actual climate disclosure reports, sector by sector. For Aviva's part, we have also helped to set up and then finance the World Benchmarking Alliance to work with a group of allies including the Carbon Disclosure Project to build climate change benchmarks. The benchmarks will use

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the new disclosures created by the TCFD as the underpinning framework. When they start to come out towards the end of 2020, the youth movement and mainstream investors alike will be able to use these benchmarks to hold companies to account for their climate impacts on the most climate impactful sectors. However, it needs many more allies from across the spectrum if it is to be successful.

- NGOs should also look to move the considerable influence within finance, so that it focusses on this area more. For example, they could build a Global Youth Movement of shareholder activists within the youth community inspired by Greta Thunberg's strong action on climate change, working with financial institutions that run their parents' pensions to attend company AGMs and call on the boards to take strong action aligned with the Paris agreement.

1.4 CONCLUSION

If incentives are aligned, capital markets have the potential to substantially aid the transition to a more sustainable global economy. However, despite some notable exceptions, current legislation and regulation actively exacerbates unsustainable investment behaviour.

Policymakers and regulators around the world must therefore massively accelerate the shift towards innovative, forward-leaning regulatory approaches to correct market failures and expose market inefficiency. Only with bold action can the world be set on a sustainable course in time to avoid the worst ecological, financial and human damage to which we are exposed. We now need to add a guiding mind that considers the sustainability of people and planet to Adam Smith's 'invisible hand'.

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