SUSTAINABLE CAPITALISM -
THE FUTURE OF FINANCE AND THE FUTURE OF THE PLANET

Ladies and gentlemen,

Albert Einstein said: "The problems that exist in the world today cannot be solved by the same level of thinking that created them."

Today I would like to share with you some of the new levels of thinking which are driving the development and global implementation of Integrated Reporting and to give some idea of where we are heading.

I am truly delighted to be back in Japan, one of the most exquisite and interesting countries in the world. Thank you for the opportunity to visit once again, one of my favourite places. Japan is steeped in wonderful tradition, but constantly looking to and striving to improve the future. Where else in the world can one be captivated by the serene beauty of a Shinto Shrine and charmed by Asimo all in the one day?

Before I start I would like to pay tribute to the courage and resilience of the Japanese people in light of the terrible recent earthquakes and pay my respects to those who tragically lost their lives. As New Zealanders, having recently suffered an earthquake, we feel great empathy with this tragedy.

Japan is of course also one of the world's most important economies.

Just recently Madame Christine Lagarde, Managing Director of the International Monetary Fund was asked whether the world was likely to be flicked into another financial tailspin. Her reply was very interesting.

She said there were three major global uncertainties:

The first was how and when the European crisis will be addressed and resolved;

The second was how and when the fiscal cliff will be addressed and;

The third was the long term anchoring factors for the economic policies developed in say, the USA and Japan.

She pointed out that these uncertainties are preventing people making the investment decisions, hiring decisions and the foreign direct investment decisions which will help growth the world over.

How appropriate and timely then that we are meeting here today in Japan to discuss Integrated Reporting. This is a most exciting new policy setting and one I firmly believe, will be one of these important “anchoring factors" so vital to restoring global confidence. Integrated Reporting is a critical tool in restoring certainty and confidence to financial markets and in assisting us to address the issues which we face as a planet in the 21st century.

I congratulate WICI on the choice of topic for this important seminar. The alignment of objectives and values between WICI and the Integrated Reporting movement is very close and I know supporters of both are delighted to be here today. I also congratulate METI, WICI and Mr Sumita for their visionary work which has assisted the development of this important topic and their partnership with IIRC. The work on intellectual capital by WICI is an important ingredient in the development of the conceptual basis of Integrated Reporting. Thank you.

There is a revolution going on which is like many true revolutions, is not undertaken at the barricades but is manifested by a gradual consensus forming in the minds of thoughtful, innovative and creative people, determined to learn from the past and deliver a better future. It reflects concerns for the sustainability of the planet and for the sustainability of the global financial system which is captured by the notion of financial stability. Both concepts have been tested recently.

This revolution is born partly out of the grief and disappointment at the loss of wealth and living standards of millions of people through the Global Financial Crisis, its successor the Sovereign Debt Crisis and the promise of further loss by the changes to the worlds climate, environmental degredation and increasing depletion of the worlds resources. These are the two great challenges the world is currently facing, financial instabilty and sustainability of the planet. The Global Financial Crisis and the Sovereign Debt Crisis which followed it have stolen the future prosperity of a generation in some places and the climate change crisis may affect even more. If you ask any thoughtful 20 year old what we as the "Baby boomer" generation have to answer for, they will tell us we have wrecked the global financial system and the planet. Both of these need to be addressed and it is these challenges this quiet revolution is aimed at addressing.

This revolution is the transformation of the way we report and manage our businesses.

Reflecting on the issues of sustainability and financial stability many have begun to question the accepted norms of the way we do business. In this discussion I will look at these two issues and attempt to draw out the thesis that both need Integrated Reporting to address the flaws our current business practices have delivered. Integrated Reporting is about managing businesses in a holistic way. What gets measured gets managed and what gets reported gets managed. The businesses of the 21st century need to be managed in a way which encourages the protection of the planet, which creates long term value, permits the enterprise to exist sustainably and which encourages long term investment to enable financial markets to respond with the stability needed for economic growth and prosperity.

The second great challenge is that of sustainability, the challenges of climate change and the sustainability of our environment, our resources, our societies, our enterprises and economies. There is a clear need to develop a framework which will enable enterprises and economies to prosper sustainably. These issues are clearly and closely interrelated through commodity markets, oil and gas, food and carbon markets. I suggest to you that these two great challenges are actually vitally and totally interconnected. The two issues are intrinsically linked together. It is perhaps pertinent that the April 2010 Communique of G20 ministers called for strong sustainable balanced growth.

We will not deliver financial stability and sustainability unless we address both at the same time. Both require addressing short term behaviours and the drivers and incentives which lead to short term objectives being satisfied at the expense of the sustainable outcomes over time.

The shock and impact of great environmental degradation and the challenges of food security, and water security, scarcities of energy and fuels, some precious commodities and species, are a reality today. These scarcities will significantly affect the market price of these commodities and have political and social implications world-wide. But they will also provide the innovative business opportunities for tomorrow.

Sustainability is a growing movement which has moved from the margins, of interest to a few, directly into the mainstream, to the centre of the road, in most societies. Increasingly business leaders, investors and other stakeholders are realising that we cannot continue to exploit the natural resources of the world without thinking about the future. The short term thinking of the take, make, waste approach to business was never sustainable. It is now unconscionable. In the growing middle classes in China and India, concern for the environment is well established and growing as they refuse to tolerate polluted environments and look for innovative sustainable solutions.

The recent crises have led to some forecasting the demise of capitalism. The Occupy Wall Street movement and its cousins around the world have led some to speculate that capitalism is if not dead, is at least in its death throes. Many young people have lost confidence in the current system and think that capitalism is broken beyond repair. It is certainly nowhere near that.

The advocates of the death of capitalism conveniently forget that in the 25 years leading up to the current crisis, more people worldwide moved from poverty to the middle class than at any other time in history. It has been responsible for the great improvement in the health, prosperity and lives of millions of people world-wide.

Nevertheless, in its pre GFC guise, it is true that capitalism has been severely wounded. Confidence, which is a critical factor in market strength, is in short supply. The compensation excesses and following of selfish short term interests has caused a number to call for significant reform and many commentators currently agree that something needs to be done!

To touch on financial stability:

It was not until the Global Financial Crisis of 2008 that the realisation dawned that financial stability of the world’s economies did not rely merely on good prudential regulation of banks, but that good regulation of capital markets was also important. Only then did the political will emerge to ensure the full implementation of global securities market standards. This view of the "virtuous twins" of financial stability was essential to the focus of the Financial Stability Board and its masters, the G20, mandating global compliance with the IOSCO global capital market standards.

Underpinning this adoption lay academic work on the network theory of markets, but unfortunately it took the near death experience of the global financial system to gain the attention of the G20 in this way as many of the prevailing theoreticians still endorsed unbridled freedom of markets underpinned by the efficient market hypothesis. This hypothesis has at its core a belief in efficient markets based on the concept of information symmetry and transparency in disclosure.

This is why business reporting is so vitally important. Without effective reporting the very basis of our market philosophy falters. How can we have true information symmetry and comparability when so much about an enterprise remains in the darkness, un-transparent?

Could it be that in the technologically enhanced global market place has developed so far that reporting has been outpaced? As companies and other entities shine their spotlights on the financial report, a tiny sliver of a rear view mirror of one year in the annual report or merely 3 months in the quarterly report, the real game of environmental, social and governance risks the corporation, public sector entity or sovereign faces, plays out in the darkness in a completely un-transparent way around them, invisible to investors and other stakeholders. Investors are seeing only one small part of factors

affecting an enterprise's endeavours and consequently are unsure of its true risks and prospects.
Transparency actually matters.

It is my proposition that the current lack of transparency has a very distorting effect on market behaviour and leads to short term investment decisions which add to volatility and fragility in the global capital markets. It undermines financial stability in a critical way.

It could be that financial stability is underpinned by holistic transparency and effective disclosure as a vital component, supporting and balancing, effective prudential regulation and effective capital market regulation. How can they be effective without true transparency in markets?

Let's look at interconnectedness and short termism.

The global financial crisis and its successor the sovereign debt crisis taught us many things. Firstly it demonstrated the undeniability of the interconnectedness of global markets. Before the Global Financial Crisis, few would have believed that the selling of a mortgage to an unemployed person in the suburbs of Chicago could bring down a bank in Ireland or Iceland, but it could, and it did.

Interconnectedness is not a new subject and the ancients were perhaps more aware than we in the 20th century were, of the interrelated nature of the world. In his beautiful and profound book, Harmony, His Royal Highness The Prince of Wales points out that the Sufi tradition understood the curious interrelatedness of the world around us.
WICI also showed leadership in the framework development in this area and we thank them for this important contribution.

In our financial markets, prior to the Global financial crisis, largely because of the vast opaque and unseen, unregulated section of the market and our tendency to regulate within geographical borders, much of the risky global financial activity and its dangerous interconnectedness remained invisible.

The Global financial Crisis also greatly highlighted the risks of short termism.

During the GFC we saw one cohort of mangers of financial institutions fundamentally steal the future savings of millions of investors. They did this by engaging in short term strategies which permitted them to super remunerate themselves while the savings or pension funds they managed suffered. Driven by inappropriate incentives, they set themselves short term goals for returns which were unsustainable in the long term, to the detriment of the health of the institution they managed. Many of these institutions collapsed leaving investors without recourse.

Stability in a complex global system requires an understanding, assessment and management of both long and short term risks. The challenge of financial stability is to identify, respond to and if possible prevent, systemic risks emerging in the global economy. The Global Financial Crisis saw systemic risks emerge from the opaque parts of the capital markets and be transferred to the lit markets, banks and pension funds and ultimately sovereigns as efforts were made to prevent the global economy descending into free fall.

To quote Andrew Haldane, Executive Director for Financial Stability at the Bank of England, "The over whelming predominance of short termism in markets compounded by a system ill-suited to integrate and account for externalities simply removes many of the broader systemic risks from the financing and investment equation".

Removal of the systemic risks from the equation increased financial instability and was the recipe for the disaster we have just had and are still living through today. WICI members will be very much aware of this.

Short termism is of concern to to many trying to build the business case for sustainable investment. Al Gore and David Blood have recently suggested that the short term perspective is "driving our economies and our planet into liquidation". If this is so, why is it happening?

Is short termism greater now than it used to be? Unfortunately some important research by the Bank of England would suggest that it is definitely the case.

A fascinating article by Andrew Haldane (Short Termism: An Impatient Market is not a Happy market 3rd Sept 2010) sheds light on this.
He points out that markets are about matching saving to investment while realising the benefits of patience and the growth associated with this. He points out that investors tend to excessively discount future outcomes. He quotes Pigou's "defective telescope facility" which shows that discounting is not only myopic but increases through time, leading to hyperbolic discounting.

Just let us reflect on some figures for a moment. In the 1940s he points out the mean duration of US equity holders was around 7 years. For the next 30 years up until 1970 little changed. But in the subsequent 35 years the average holding has fallen spectacularly. By the 1987 crash the holding period had fallen to under 2 years and by the turn of this century it had fallen to below a year and by 2007 it was 7 months. Impatience is mounting.

Future cash flows, are undervalued by investors. According to Haldane cash flows for 4 years ahead are discounted at rates more appropriate for 6 to 10 years ahead. This trend seems to have grown in the 20th century.

So what has caused this retreat to short termism he so lucidly outlines? Is it merely the reduction of friction of transaction costs lowering, or could it be that the short term focus is in fact encouraged by the current reporting framework? Could the current business reporting framework be contributing to short termism and therefore financial instability?

What influence has quarterly reporting had? Has the investing community found the very limited risk framework mandated under IFRS and USGAAP inadequate to accurately value the cash flows going forward and have decided to discount the future cash flows because the information they receive, while voluminous, is manifestly inadequate to assess the future risk profile adequately?

How can this be addressed? The answer may be to provide a much more holistic and concise information offering to investors to enable them to make more realistic assessments of those future cash flows through Integrated Reporting. The hope will be that investors and other stakeholders will take a longer term view when they can see the holistic risks and future prospects of an enterprise and that this longer term trend will lead to greater financial stability.

The information given to investors and other stakeholders also needs to be concise and digestible in order to make it comprehensible. We are all aware of the deluge of information that many enterprises produce, vast masses of impenetrable material which masquerades as full disclosure. The challenge going forward is to make relevant information truly transparent. Here also Andrew Haldane is helpful.

As you will be aware each year Central Bank Governors retreat to the beautiful hills of central Wyoming in the USA to discuss the state of the world's economy and issues for the year ahead. This year Andrew Haldane presented a paper "The Dog and the Frisbee", not a topic immediately redolent of Central bankers' speak.

In this paper, he argues that in relation to information, less may be more, because more information comes at too high a price. Drawing on psychology and economic theory, he gives researched analysis that concludes that selective unclogging of the cognitive inbox makes for better decision making. His focus is on the ever increasing mass of regulation, but it applies similarly to the ever increasing mass of disclosure. He exhorts simplification and streamlining for better decision making. He says and I quote" to ask todays regulators to save us from tomorrows crisis using yesterday’s tool box is to ask a border collie to catch a Frisbee by first applying Newton's laws of gravity".

Are we overburdening investors and other stakeholders with an unreasonable task in the analysis form of voluminous yet often partial and confusing data and models in their search for relevant information, instead of an accessible tool box of information ? I suspect so.

In relation to business reporting, we urgently need a new tool box. One which will enable better decision making by simplifying and streamlining the data investors and other stakeholders need to absorb. One which will encourage longer term investment horizons by including the holistic circumstances of an enterprise and enable investors and other stakeholders to make informed decisions, but which is streamlined and simple. One which will assist in our saving the planet and will make our markets more stable.

I sincerely hope that that the financial stability aspect of this debate will engage central bankers, the Financial Stability Board and the G20 to encourage the adoption of measures to limit short termism and to increase clarity and comprehensibility of reporting. Such a move would encourage financial stability, which is after all their mandate, and underpin sustainable capitalism.

Fortunately we have a proposition, which if implemented globally, I believe will go a long way to enhancing the quality of long term investment decision making and business sustainability.

This is of course Integrated Reporting. Integrated Reporting is the tool kit to drive this transformation. It goes to the core of the drivers of business thinking and behaviour. It is the language for sustainable business. In their White Paper on sustainable capitalism, Al Gore and David Blood have listed Integrated Reporting as a major driver of change. It is the means by which companies communicate how value is created over the short, medium and long term. It involves the production of an integrated report about the organizations strategy, governance performance and prospects leading to the creation and preservation of value.
It is the tool kit for the 21st century and it will transform the markets and the drivers of behaviour of the managers of enterprises.

It is the product of great thought leaders, HRH The Prince of Wales in his wonderful elegant and thoughtful publication Harmony, the legendary work of the truly amazing Professor Mervyn King QC whose Report King 3, transformed reporting in one of the most rapidly growing new economies in the world, South Africa, and has had great influence world-wide. Deep academic thinking and research led by Bob Eccles and Michael Krzus in their landmark One Report, combined with the work of the International Integrated Reporting Committee now Council, a stellar collection of influential people have made great contributions. Driven on by the extremely able CEO Paul Druckman with his small and very capable staff significant progress has been made in this revolution! Other stakeholders such as business, investors, environmentalists, GRI, WICI, and civil society have contributed hugely. The right people are in place to make a real difference.

The importance of Integrated Reporting in sustainability and social and governance terms cannot be underestimated. Through the framework and the interrelationship of the capitals deployed, an enterprise will be required to reveal aspects of environmental,social and governance elements of the business which will serve to reassure investors and improve valuation.

A fascinating consensus appears to be appearing. Recently Hillary Clinton, said" The only future is a sustainable future". Sir Richard Branson recently led a discussion on with his twitter followers on “How can business change the world for the better". He has established a Plan B for capitalism and he has teamed up with Jochen Zeitz who is Chairman of Puma and they are currently recruiting members from developing and developed countries. Proper accounting for environmental impact, an end to quarterly reporting are amongst their priorities. These initiatives give reason for optimism that people all over the world are thinking and reflecting on the way to create a more sustainable capitalism to serve the generations to come.

Recently a coalition of investors NGOs and universities urged the Bank of England to investigate how exposures to polluting and environmentally damaging investments might pose a systemic risk to the UK financial system and long term growth.

The investor community has also demonstrated increasing interest, and activity by investors, has increased markedly the signatories to the UN

Principles of Responsible Investment. Since the global financial crisis these principles have being increasingly embraced until entities holding over 3 trillion assets under management are signed up, approximately 20% of the world' s global capital.

Over 80 of the world's largest global companies are piloting Integrated Reporting, and they are a very impressive and very diverse list indeed. Many of them will be familiar to you. From Japan they include, Ernst and Young ShinNihon LIC, and Takeda Pharmaceutical Company Limited. They also include Volvo, Unilever, China Light and Power, HSBC, Microsoft Corporation, Marks and Spencer, New Zealand Post, Rabobank, Novo Nordisk, the Russian Atomic Energy Corporation ROSATOM, The Coca Cola Company and many others. The lessons that are learned from these pilots will inform the IIRC to enhance the draft Prototype Framework to come out later this year!

Recently the RIO+20 conference in Brazil was a great success for Integrated Reporting. Paul Druckman attended and worked tirelessly to promote the importance and the IR revolution was rewarded with acknowledgment throughout the communique of the importance of Integrated Reporting. It also saw a number of stock exchanges sign on the the UN Sustainable stock exchange Initiative, Brazil, Egypt , Istanbul and OMX NASADQ were amongst them promising to encourage companies listed on them to embrace sustainable principles. These are very encouraging developments.

Increased focus on the investor community's responsibilities and challenges to counter short termism are also featured in two recent reports in the UK. In September 2012 the UK Financial Reporting Council, issued its Stewardship Code which aims to promote the long term success of companies in such a way that the ultimate providers of capital prosper through the effective stewardship by investors. Another UK initiative was the recently released

Kay report, which also focussed on long termism. It calls for an end to quarterly reporting, research around the clarification of fiduciary duties of advisers and trustees, alignment of incentives of remuneration to long term business objectives among other things. This report notes that the provision and dissemination of information is central, and describes the proliferation of incomprehensible data as a major concern.

These developments and others in the quiet revolutionary movement have the capacity to radically change the face of capitalism. The short term focus of the first decade of the 21st century will be replaced with a more sustainable business model, embracing concise yet holistic communication with investors and other stakeholders.

So much of the conceptual thinking is in place or in train, but where are we now in the journey towards global adoption of Integrated Reporting?

While there is still work to do, the Framework is shaping up very well indeed and great progress is being made in the technical areas of business model, value, connectivity, materiality and capitals. Important work on assurance and user informational needs is being planned. The pilot companies are on board in most cases to assist in the push for implementation, and we hope soon to have a Draft Prototype to assist those still struggling with the concept, to gain a more tangible handle on what Integrated Reporting will actually look like. It will hopefully dissipate some unfortunate misconceptions about Integrated Reporting. It will serve to reassure those who are concerned that Integrated Reporting will attempt to rewrite current financial reporting or other global, environmental or governance standards or be an increased compliance layer. Hopefully they will see clearly that Integrated Reporting builds on recent financial,environmental, governance and reporting developments, it does not try to replace or redo them, and that it strives for concise, clear reporting. It embraces the "less is more" approach.

The draft Prototype will also provide greater transparency about the process of development of the Framework, which should be in place in 2013 .

The vision for the future of Integrated Reporting is to ensure there is a globally scalable model able to be implemented world wide from 2014. It is an exciting and challenging vision!

Currently we have a general direction of travel towards that wonderful vision. We are now in the process of developing a precise roadmap which will calibrate the steps we all need to take to achieve the goal. The period of the next 2 years 2012/2013 is the transition phase where the final refinement and agreement on the Framework will happen.

We will work with the pilot companies and others, building support in the business and investor communities as this is a business led initiative, to be ready for the implementation phase from 2014 onwards.

Another important initiative over the next 2 years is to extend our outreach to other stakeholders who can assist in promoting Integrated Reporting. This outreach has been greatly enhanced by the series of important meetings here in Japan this week. Thank you, JICPA, Tokyo Stock Exchange and WICI for these opportunities. Future meetings in Australia, with the OEDC, World Economic Forum and the UN amongst others are planned.

We will also engage stock exchanges, regulators and policy makers around the world to educate and inform them of the need for Integrated Reporting to be globally adopted, and to persuade them to encourage adoption around the world. Global standard setters, policy makers, major players in financial stability and leaders in environmental, social and governance issues around the world will be vitally important in the debate and in the final successful result. This will be a very demanding time.

In my view, in order to be truly successful we also require the narrative about the importance of Integrated Reporting to be understood by the wider investor community. One which engages with all investors, not only institutional investors but retail investors as well.
These include young people whose pension funds are their security for the future and who are also increasingly aware about the need for a sustainable future for the Planet. I believe we need to develop a narrative which readily and easily connects integrated business reporting with the sustainability of the planet, a "People Planet Profit " type of message; outlining the rationale and mechanisms proposed and ultimately persuading by an articulation of the sort of world we want sustainable capitalism to deliver.
The current thoughtful work of accounting, finance, environmental, reporting, preparer, issuer, governance, social, business and investor professionals needs to be translated so it resonates with the thoughtful 20 year olds I mentioned at the start. Social media, popular celebrities and modern communication tools need to be used to spread the messages we now understand, more widely! If Lady Gaga's millions of followers could grasp the importance of this phenomena we could have an "little monster "army of great advocates! We need to engage popular imagination about the sort of world we envisage, the sort of capitalism we envisage which delivers a sustainable planet and sustainable growth and progress into the future. Businesses which drive the sustainability of the planet as well as profit.

There needs to be some rethinking and significant changes in order for the world our children inherit to be a sustainable, enriched environment; a place where capital is efficiently employed to raise economic performance around the world. The businesses of the future need to be sustainable so that long term investment can take place, where markets are less volatile and the standard of living of those millions coming after us can continue to be raised through sustainable productive capitalism in an environment which enables a sustainable planet.

A place where business lifts all boats and where businesses are valued on the basis of their true long term worth and where they are rewarded for long term, sustainable practices.

Interestingly a global consensus is growing regardless of the domestic political framework of the people involved. In China, Spain, India, Russia or the USA, there is a growing realisation that capitalism needs a new compass to enable the rest of the 21st century to be different from the first decade.

Our challenge is to provide that compass; the appropriate frameworks, incentives and tools to align business behaviors with the needs of investors and other stakeholders, which will ensure both financial stability and global sustainability. Integrated Reporting will show the way to the new sustainable capitalism! It will provide the new level of thinking Einstein suggests is needed to address problems in a new way and this important revolution in thinking and practice will provide a more optimistic future for the generations inheriting our planet in the 21st century!