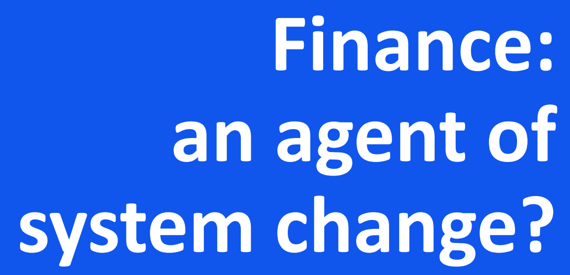

Finance: an agent of system change?

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1 Introduction

Finance is an extraordinarily powerful agent of change. Our starting assumption is that there is the potential for it to unlock a different trajectory of change. Finance is the cornerstone of any functioning economy, and is a significant contributor to GDP in its own right, employing millions of people around the world. It is a service industry, in service to two distinct but connected sets of clients. There are those who have capital, and whose capital is stewarded by sector professionals, managing risk and return in pursuit of their financial objectives. And there are the businesses and countries, to which the finance industry efficiently channels those funds, helping to deliver corporate and sovereign objectives.

What role does the finance sector have in response to the multiple chaotic transitions underway? Long-term economic growth and social stability are not a given. Planetary health and stability seem to be slipping from our grasp. Systemic risk is increasing. Although no one sector or system can control what happens next, finance can significantly influence the trajectory.

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This paper looks at some of the innovative ideas gaining interest in corners of the finance sector, primarily viewed through a capital markets investment lens, and from a European perspective. These capital flows are heavily concentrated (in terms of volume, and the power represented) in international financial centres in the global north.

The paper starts with the view that any general notion of these capital flows being 'neutral' is waning. And rightly so. As has been argued elsewhere, finance is not neutral. In serving its clients, it shapes the direction of change. So what role can the finance sector have as an agent of system change, for a sustainable future?

We start by noting how the climate crisis has already 'breached the wall' of finance-as-neutral, with increasing recognition of the role of financial institutions as agents of change. This is a profound shift. It is the first time that vast numbers of financial institutions, across investment, banking and insurance sectors, have acknowledged their impact on the planet *and their responsibility to act to mitigate that impact*, under the guise of long-term net zero goals.

Another significant step has just occurred at COP 27, where Article 48 of the draft decision includes, for the first time, a recognition of the need not only for financial flows, but 'transformation of the financial systems and its structures and processes' and recognising that this is not just about public finance, but involves the full array of financial actors.

Clause 48 of the Draft Text of COP 27 Overarching Decision

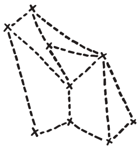
> 48. *Reiterates* articles 2, 4 and 9 of the Paris Agreement; and *highlights* that about $4 trillion a year needs to be invested in renewable energy until 2030 – including investments in technology and infrastructure – to allow us to reach net-zero emissions by 2050. Furthermore, a global transformation to a low-carbon economy is expected to require investments of at least USD 4-6 trillion a year. Delivering such funding will require a transformation of the financial system and its structures and processes, engaging governments, central banks, commercial banks, institutional investors and other financial actors;

In this paper we explore innovations that nudge in this direction. We briefly unpack the (loosely defined) ESG movement, its growth and the resulting backlash, suggesting there may be some more interesting seeds of change indicating where and how the industry might evolve.

These positive, potentially disruptive trends are:

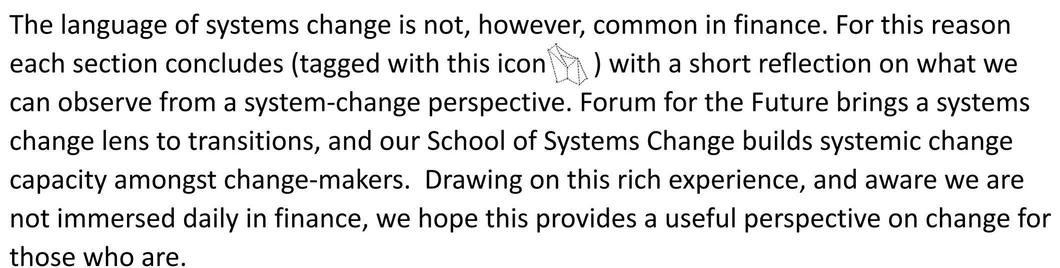
1. Impact investing
2. Incorporating thresholds
3. Influencing the rules of the game
4. System-level investing

We conclude by looking at what financial institutions embracing an agent of change role can do practically to advance these four trends.



In these seeds of change, we observe a growing recognition of the need for finance to drive systemic change in the economy, and a desire for systemic change in how finance operates. Indeed this paper is based on four assumptions:

- That the future we want requires fundamental change in entire systems (meaning shifts in rules, mindsets, resource flows and goals), not just several specific problem-solving actions.
- That finance is a powerful influence on how systems work and how systems change, whether that be in energy, food, trade, or inequality. So the finance sector is an agent of systems change.
- That for finance to truly drive systems change across parts of the economy, the system of finance itself also needs to change.
- That bringing a 'systems change lens' to the trends and options that we see in finance can help us to understand what is happening and what more needs to happen.



The language of systems change is not, however, common in finance. For this reason each section concludes (tagged with this icon) with a short reflection on what we can observe from a system-change perspective. Forum for the Future brings a systems change lens to transitions, and our School of Systems Change builds systemic change capacity amongst change-makers. Drawing on this rich experience, and aware we are not immersed daily in finance, we hope this provides a useful perspective on change for those who are.

2 Net zero: the breach in the wall?

Across the finance sector, climate change is by the far the most widely understood - and acted upon - environmental and social issue. Galvanised by the Paris Agreement of 2015, the sector is actively grappling with its role in halting greenhouse gas emissions. The ambition is that by halting emissions, whilst also removing some greenhouse gases from the atmosphere, we can and must reach 'net zero' by 2050 and limit catastrophic global warming.

There are numerous critiques of net zero, particularly around its reliance on the as-yet-unclear 'removing some greenhouse gases' part of the equation. But it is hard to refute its success in galvanising significant numbers of financial institutions to coalesce across different industries, asset classes and sectors around concrete targets. This has unleashed unprecedented levels of activity from top to bottom in financial institutions as they work out their exposure and what to do about it, however imperfect these plans might be.

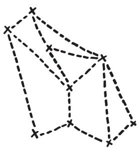
What is most profound about this shift is that it is the first time that vast numbers of financial institutions have acknowledged their impact on the planet *and* their responsibility for acting to mitigate that impact. This acknowledgement has been triggered by multiple motivations, foremost amongst them growing awareness of the systemic risk that climate change creates across the industry, with potential for considerable financial impact.

The industry's reaction reflects a breach in the wall of 'finance as neutral'. The commitments to net zero are an acknowledgement of finance as an agent of change (negative or positive). These commitments are at such a scale that it is becoming challenging for laggards to ignore or deny such a role. Members representing over $130 trillion of global capital have signed up to the Global Financial Alliance for Net Zero (GFANZ), encompassing nearly half of global banking assets. The growing debate over the detail and speed of institutions' commitments is a signal of the weight of this potential shift.

The net zero movement also represents an acknowledgement of sustainability thresholds. What has enabled this industry-wide conversation and action is the common denominator of a globally-agreed scientific-led consensus on the absolute threshold that we cannot breach, the 2 degrees and preferably 1.5 degrees of warming agreed upon in the Paris Agreement.

Further, it has provoked action not just at the underlying enterprise or asset level, which would limit climate change to being one factor amongst many that are integrated into individual stock picking (or lending, or underwriting decisions). Rather, leading institutions are grappling with what this means for their business models, at the systemic level, in recognition of the far-reaching consequences for portfolio construction and asset allocation, and their own potential survival. Whilst he was still Governor of the Bank of England, Mark Carney predicted that 'companies that don't adapt will go bankrupt without question [...] Just like in any other major structural change, those banks overexposed to the sunset sectors will suffer accordingly.'

This recognition of the responsibility and agency of finance is not sufficient on its own, but it is a crucial unlocking moment for wider change, and in enabling agency to actually be used. If net zero can be interpreted as the first topic to breach the wall of finance-as-neutral, what next?



Systems change lens:
The change catalysed by the climate crisis is significant because it has brought to the foreground the perspectives on finance as an actor, and a holder of responsibility. It has shifted the mindset from finance as neutral to one that is starting to see financial organisations as having individual and collective agency on what is both a highly regionalised and global challenge. This is a critical - though certainly insufficient - step in enabling organisations and individuals to then make use of their agency.

3 Social impacts: the cracks in the wall

Just as climate change cannot be divorced from its wider ecological interdependencies, it cannot be divorced from its social context. One macro force highly likely to disrupt our ability to successfully reduce emissions to the point of having a liveable planet is social unrest, and its political implications. Much has been written on growing global inequality, both within and across countries, and how the pandemic has exacerbated these inequalities. Global disruption continues, with rapid inflation setting in. Climate change may tip existing social tensions into turbulence. The disruption underway in multiple high-emitting sectors such as energy, automotives and utilities is

already impacting those sectors' labour forces and supply chains. This in turn triggers political reactions that can undermine the necessary climate transition.

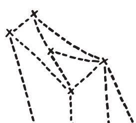
Concerns for a 'just transition' are rising up the agenda, in both developed and emerging markets, with a likely focus on this at 2022's COP27 in Egypt. The just transition has so far largely been interpreted through a relatively narrow lens, focused on the labour force and supply chain impacts within high-emitting sectors on the frontline of the climate transition such as energy, automotives, in response to domestic concerns. This assessment is a necessary starting point, one that will likely build out to include the bigger and more disruptive widespread societal impacts across multiple regions, sectors, value chains and communities in the face of a warming planet.

It also challenges a blind spot for the finance sector, which has a poor track record on mitigating and managing its societal impacts (in line with the private sector as a whole). The World Benchmarking Alliance assessed 1000 leading global companies across 60 countries against a 'social baseline' covering three fundamentals: respect for human rights, decent work and ethical conduct. The analysis found that 99% of corporates - 10% of which were financial institutions - fail to demonstrate these fundamentals of socially responsible business conduct.

This failure is not for want of global standards. The UN Guiding Principles for Business and Human Rights (UN GPs) clearly lay out the responsibilities of corporates in relation to human rights. Yet, ten years on from their launch, the OHCHR's roll call of good practice demonstrated by investors, insurers and banks is notably light. The Thun Group debacle marked a particular low point in 'misunderstanding' of banks' human rights responsibilities. Forthcoming regulation is set to force the issue, in the EU at least. Although delayed twice, the UN GPs' human rights due diligence requirements are likely to become mandatory for business in relation to supply chains. Leading voices, including companies and investors, are calling for this to extend due diligence obligations across the full value chain, embed mandatory requirements in appropriate governance structures, include stakeholder engagement to be an integral part of the due diligence, and set out credible accountability mechanisms including civil liability provisions. The forthcoming EU Social Taxonomy (also delayed, and fraught with complexity) is set to define what is or isn't deemed sustainable in relation to social factors, by providing a classification system.

Diversity, equity and inclusion (DEI) has received particular attention in recent years, with significant talk from the finance sector of what it expects from companies. There is a clear business case for taking it seriously. But until and unless the finance sector can tackle this inequity within its own organisations, its efforts on improving DEI elsewhere in the investment chain risk lacking both authority and authenticity.

In an era of rapid and confusing transitions, the knock-on impacts of a systematic failure to tackle these fundamental social issues, coupled with rising social and economic inequality, will be increasingly hard for financiers to ignore - hence the cracks in the wall.



System change lens:
From a purely mechanical lens on enabling economic transition, a net zero transition will not be politically and economically feasible if it is not socially feasible. For

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organisations such as Forum with an ambition for a just and regenerative future, the net zero transition is an opportunity for a much deeper transformation. This would not just be about 'addressing the S' of ESG but rewiring the economy to create, distribute and recognise value differently, working for the wellbeing of both people and the planet. This is a long way from where change is currently happening.

4 ESG: the first fix?

Most conversations about sustainability in finance revolve around 'ESG'. ESG stands for 'environmental, social and governance', a term used since 2004 as shorthand for the wide range of 'nonfinancial factors' that could affect financial risk and returns and therefore could be integrated into financial decision making.

Much of the confusion surrounding ESG is linked to its dual heritage:

- Its origins lie in ethical investing, the practice of (de)selecting investments based on ethical or moral principles. Most commonly, this has taken the form of an exclusionary screening of 'sin' stocks like tobacco, gambling or alcohol.
- But, emerging in the early 2000s, ESG's dominant form today is driven by a different motivation - ESG integration as risk management. Propelled by the first and still largest voluntary financial sector initiative in this area, the Principles for Responsible Investment, ESG integration takes nonfinancial factors and assesses their financial materiality to the stock or asset in question. According to the latest global survey of sustainable investing strategies, ESG integration has now for the first time replaced exclusionary screening as the dominant form of 'ESG'.

It is fast growing: ESG assets are forecast to hit one third of global assets under management (AUM) by 2025, or $53 trillion. Half of this is managed in Europe, with the US catching up and Asia and particularly Japan, predicted to follow suit. Part of ESG's rapid growth is down to its success at selling itself as a way to mitigate (financial) risk and/or boost (financial) returns. It continues to prove popular with clients, perhaps due to growing public awareness about sustainability, with ESG funds seeing a slower outflow than non-ESG funds in the recent economic slowdown.

ESG is often used interchangeably with 'responsible' or 'sustainable' investing, which mean different things to different people. And herein lies the problem. If ESG is so good for people and the planet, given its 30% year-on-year growth in the past five years, why do the UN Sustainable Development Goals (SDGs) seem increasingly out of reach, with growing capital shortfalls to meet them estimated at $4.2 trillion per year? This is because ESG integration never set out to meet the SDGs, or tackle climate change, or address social justice. ESG integration is about 'outside in' factors - the likelihood of external factors affecting the financial risk and return profile of an asset. Not 'inside out' factors - the likelihood of that asset influencing those external factors, like climate change, or human rights. Alongside potentially mitigating risk or boosting returns, integrating ESG in financial decision making *can* reduce corporate harm or boost benefits to company employees or other stakeholders, which is undoubtedly good for wider stakeholders as well as shareholders, but is unlikely to be the primary intent of the stockholding, or why the action was taken.

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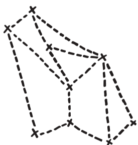
Mutual misunderstandings have arisen from these different 'inside out' and 'outside in' approaches to environmental, social and governance factors. Out of concern for greenwashing, or greenwishing, we are seeing a slew of new regulation. One of the main duties of regulators such as the US Securities and Exchange Commission, or the European Securities and Markets Authority, both of whom are actively reviewing ESG practices, is to keep markets efficient and transparent, and make sure clients are treated honestly and fairly. The rise in ESG regulation is a direct response to concerns regarding the perceived 'wild west' of ESG claims and the growing recognition of a looming sustainability crisis. It is furthest ahead in the EU, and set out in the 2018 EU Sustainable Finance Action Plan. The Plan includes measures such as the EU Sustainable Finance Disclosure Regulation (SFDR), which is already in force and sets out mandatory ESG disclosure obligations for asset managers and other financial market participants, at both entity and product level, in relation to both 'inside out' and 'outside in' considerations of materiality.

This regulatory drive is a key signal of what Professor Alex Edmans recently summarised as '*ESG's evolution from a niche subfield into a mainstream practice*'. This first major wave of ESG, as a voluntary, market-led response, is perhaps best interpreted as 'the 'first response' of a complex system to an abrupt new awareness of context', in the words of Duncan Austin. He sees this first response, perhaps inevitably, as a 'fix that fails' but one which can point us towards fixes that may succeed. This first wave of ESG has served to expand the understanding of a vast range of environmental, social and corporate governance factors among many thousands of financial sector professionals, as well as their clients. Real behavioural change has taken place amongst many thousands of companies as a result. The loosely defined ESG movement in all its myriad forms has proven an important training ground for a generation of financiers, with many now asking themselves, training for what?



System change lens:
ESG is scaling fast, but despite its size it is not currently acting as a lever for deep system change. So far, the focus on mitigating risk around the transaction rather than understanding and changing 'inside out' impact of the transaction is limiting its change potential. It risks driving a shallow transition, focused on risk-management and reporting, not a deep transition in the health of the economy, society and the planet. But the current backlash and debate is a signal that this instrument is maturing and not yet settled in its role in the system. Combined with other systemic shifts, such as clear focus on double materiality, tighter standards, rigour, information flows, and development of accountability, it could be something more fundamental.

5 Four positive, disruptive trends

How can this first ESG wave avoid becoming a footnote in the history of the finance sector, and instead prove a springboard for more profound change? How can it build on the potentially system-changing breach in the wall brought on by the existential threat of climate change? As the ESG discussion matures, we propose that it's more innovative edges lie in:

1. impact investing,
2. incorporating thresholds,
3. influencing the rules of the game, and
4. system-level investing.

5.1 Impact investing

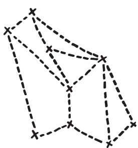
Impact investing is financing with the intent to generate positive, measurable social and environmental impact alongside a financial return. Some see it as a subset of responsible investing, whilst others see it as a distinct but connected discipline. Although intent is hard to discern, the most identifiable impact investing strategies involve:

- selecting strongly performing or growing private companies that have a positive environmental or social impact, and providing growth capital. The impact comes from providing 'additional' capital, because the growth, and ensuing company impact, would not otherwise have happened.
- as shareholders, engaging public (listed) companies that could improve their social or environmental performance. Engagement options include voting and/or active ongoing and targeted communication with company boards, with threat of divestment if change is not forthcoming.

Critically, for either strategy to qualify as impact investing, it would require pre- and post-investment impact target setting and measurement, and management of progress towards those targets.

Although impact investing remains niche in terms of size, at roughly 0.2% of the almost $30.7 trillion AUM identifying as 'ESG', impact investing has been a testing ground for multiple innovations, in both developed and developing markets. It has led to innovations not just in financial products and services but in furthering the discipline of how to measure and manage for impact. The discipline that has emerged in impact methodologies and frameworks can be applied beyond its niche, and is beginning to help sharpen the vast and growing range of sustainability-linked strategies now underway across the financial sector.

Impact investing is, however, open to the charge of impact being in the eye of the beholder. It can suffer from an incremental or contested interpretation of impact, lacking contextualisation that enables comparison or benchmarking. This brings us to the next trend – incorporating thresholds.



System change lens:
impact investing stands out because of the intentionality for positive and additional impact. The importance of stated vision is especially necessary in defining and adjusting behaviour in a dynamic system, and provides a foothold for wider system change. We see examples of how the core principles can be extended to other parts of the system, in the expansion of impact investing beyond private growth equity to public assets, and in the sharper thinking on impact methodologies that is spilling over beyond this niche.

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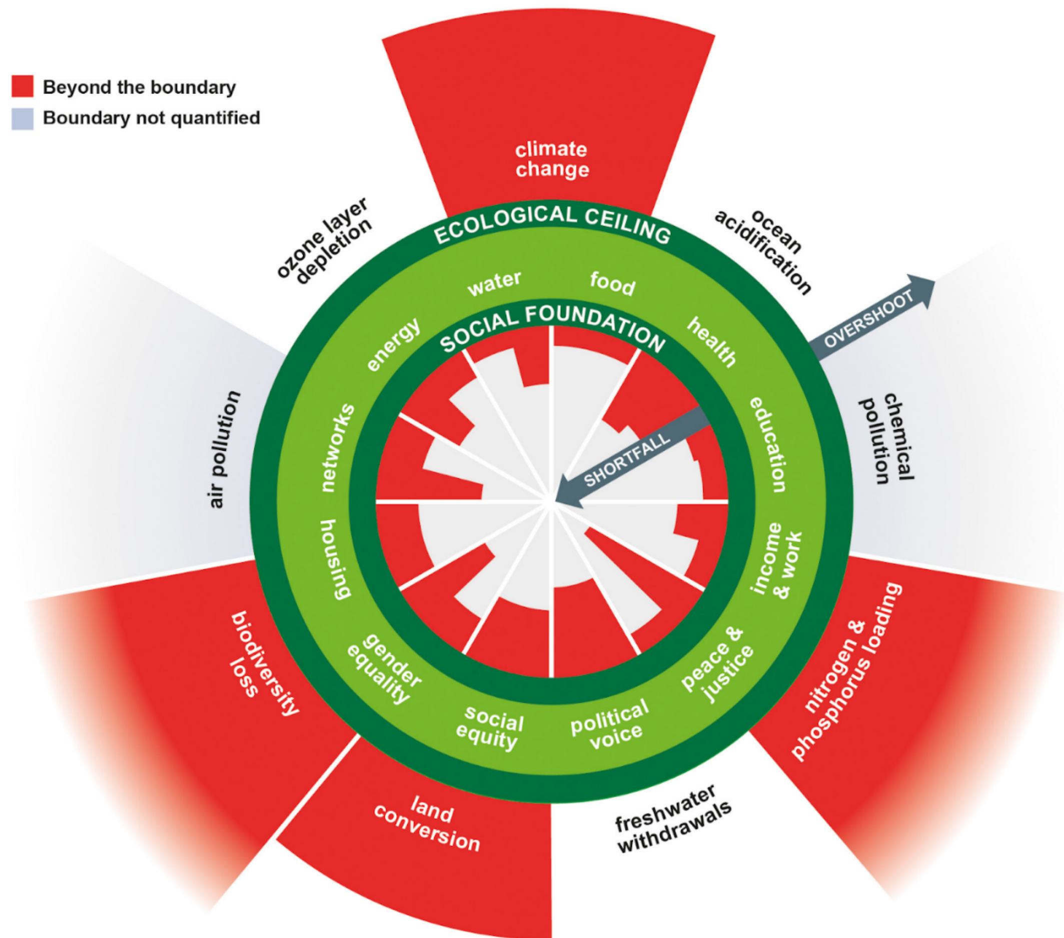
However, most impact investing is still playing 'within the current system' though seeking to deploy capital for an aim beyond financial return. Given its small relative size, it remains an innovation 'in the niche' though with some demonstration influence on the mainstream.

5.2 Incorporating thresholds

One of the most profound developments underway is the attempt to reclaim the language of sustainability to mean what is actually sustainable. A sustainable future is one in which no one falls short on life's essentials, and where we collectively do not overshoot Earth's life-supporting systems. Within this definition, an action or product that has the potential to have an incrementally less bad outcome for the planet or people is not a 'sustainable investment'. Initiatives such as r3.0 are at the forefront of the drive for the finance industry to 'mature into a more robust definition of sustainability grounded in *thresholds'* [Blueprint, my emphasis].

Societal and ecological thresholds are identified via science (e.g. climate thresholds) and global societal conventions (e.g. the Core International Human Rights Instruments). They are neatly illustrated by Kate Raworth's 'doughnut' (see Figure 1, below). Outcomes are only 'sustainable' if they come within the acceptable range determined by social foundations or ecological ceilings. As the Impact Management Platform states ' They are distinct from other types of targets that organisations might set themselves which are not explicitly linked to a scientific assessment of what constitutes a sustainable outcome. The Paris Agreement goal is the most commonly understood response to a globally recognised ecological ceiling, or threshold.

Figure 1: The Doughnut of social and planetary boundaries
Credit: Kate Raworth and Christian Guthier. CC-BY-SA 4.0



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Whenever an organisation uses a shared resource or is part responsible for preserving or producing one, a further step is required to establish a fair allocation of the responsibilities involved. This becomes an organisation-specific threshold. For example, climate change involves apportioning shares of the responsibility to achieve an overall global carbon reduction target to individual emitters. *Allocation* is the process of apportioning the responsibility to maintain thresholds in fair, just and proportionate ways that are specific to an organisation, enabling them to set their own targets for measuring and managing true sustainability performance (for more on this in relation to finance, see Impact Management Platform).

This approach is in its infancy, and is only recognised at any scale in relation to climate change. Any individual organisation seeking to integrate such thinking is struggling against the weight of a system that ignores such thresholds. As such, to truly change the system, such thinking would need incorporating across the system.

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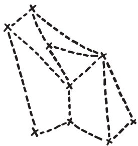
A deeper - but far more revolutionary transformation, beyond the financial system recognises that 'sustainability is a property of the whole, not the parts. We don't need a 'sustainable economy' and 'sustainable businesses' so much as the economy and businesses of a sustainable culture.' (Duncan Austin). That concept brings us neatly to the next innovation, shifting from choosing how to play the game to influencing the rules of the game.



System change lens:
The principle of sustainability thresholds is an example of redefining success: success needs to be judged by what is needed, not just what is better. The difference between the two may not be immediately apparent but is actually fundamental. For example, the Three Horizons framework by Bill Sharpe, names the current Horizon (H1) which will decline over time, the future Horizon (H3) which is only just emerging, and the pathways leading from Horizon 1 are termed Horizon 2 (H2). There is a core distinction between H2plus and H2minus pathways: the former enable us to transition from H1 onto the preferred H3. The latter, H2minus, simply prolong the current system and delay decline. The shift from 'better than last year' to 'delivering to thresholds' can be seen as a shift from H2minus to H2plus pathways.

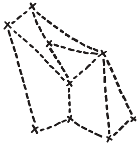
5.3 Influencing the rules of the game

The global pandemic has further eroded trust in governments around the world, with trust in business at a relatively high rate compared with trust in governments. Considerable space has been given over to the private sector, which is bigger in relative GDP terms and more powerful than at any point in history.

Corporate political engagement has until relatively recently been one of the most overlooked, at least, amongst ESG and impact investing practitioners, yet most powerful ways that financial institutions can have impact. Political engagement happens directly but also indirectly through industry associations and other third party lobby groups. Both forms occur overtly, through public channels, and covertly through private connections and 'the revolving door' between private and public sector. Engagement with regards to sovereign bond holdings is not usually considered part of corporate political engagement, but it is a form of influence over governments. Covert influencing happens globally, but lobbying politicians and regulators directly and openly is a particularly western phenomenon.

The systemic implications of climate change - the first breach in the wall - are triggering leading financial institutions to seek to influence the rules of the game by proactively engaging with regulators and governments. For example, industry leaders, pre-COP26, calling on governments to enact climate-related disclosure regulation is a form of this 'macro stewardship'. Such calls are not limited to climate change, however, with coalitions of companies and investors, often in tandem with civil society, demanding regulatory change in other areas of risk and impact, such as the call for mandatory human rights due diligence to be enshrined by the European Commission. Such calls are an explicit recognition that the current regulatory context requires adaptation in the face of the transitions ahead, but also of the critical role of government intervention in capital markets.

Indeed, some are calling for a reworking of the Bretton Woods institutions, updating their mandate to drive sustainability transitions from their original focus on post-war growth. It remains to be seen whether the industry's move to corporate political engagement will extend to acting to support democracy more widely.



System change perspective:
It is welcome that the rules of the game are now receiving attention as they, in turn, shape what else happens. The rules of the game tend to be one of the least visible, but most influential part of the system. As the saying goes, goldfish don't see the water they swim in. For finance actors to turn their focus and power to influencing the rules of the game is a major step forward and a small reversal of what has long been established - the less visible lobbying to defend status quo rules.

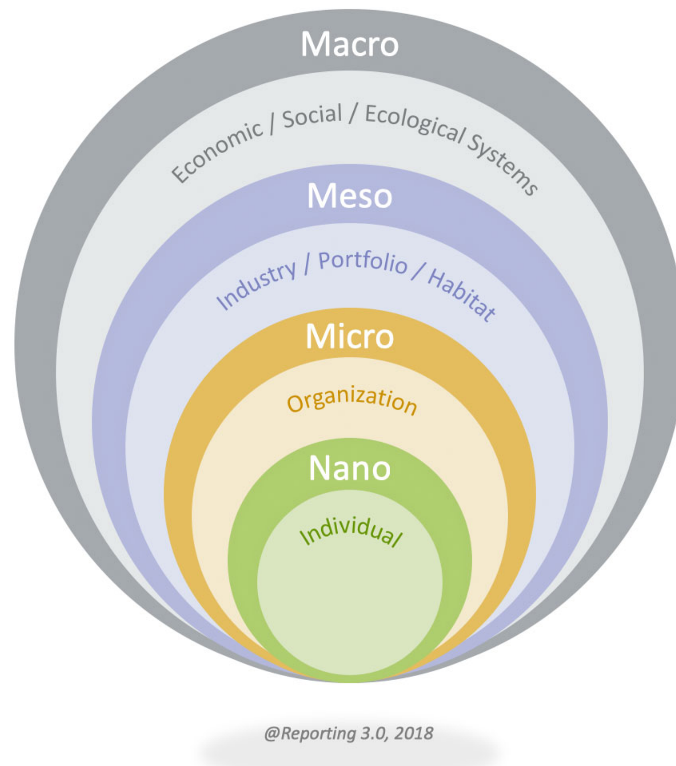
5.4 System-level investing

Political engagement is not the only way to actively seek to influence the system. System-level investing is defined as *'the intentional consideration by investors of the bigger-picture environmental, social or financial system context of their security selection and portfolio construction decisions'*. Coined by The Investment Integration Project (TIIP), system-level investors recognise that as a collective investment community, they can foster an environment and society that promotes long-term growth, not at the expense of long-term investment prospects but in support of them. It is the difference between focusing solely on assessing, mitigating and managing the impacts of financing individual assets or enterprises on environmental and social issues versus seeking to assess and influence the impacts of the market on such issues.

Distinct from following the market (beta) or trying to beat the market (alpha), system-level investing is action to inform and influence a better beta. It is the recognition that acting to inform and influence the market as a whole can be central to, rather than in conflict with, enhancing long-term investment returns. It is linked to the concept of universal ownership, with large institutional investors seen in effect as 'universal owners' given their highly-diversified and long-term portfolios that are representative of global capital markets. It is further recognition that financial actors have agency in system change.

In practice, system-level investing incorporates all of the disruptive trends identified above (impact investing, incorporating thresholds, influencing the rules of the game), *intentionally* deploying these levers through an overarching investment strategy, as opposed to through individual funds or in engagement with individual enterprises (i.e. acting at the 'macro' or 'meso' rather than 'micro' level, see Figure 2 below).

Figure 2: Different levels of financial institutions' influence



Examples of what this looks like at the macro level include:

- ***Investors pressuring firms to mitigate behaviour that, although profitable for the individual company, damages the market overall***. Consider Shareholder Commons' Fox News resolution, in which shareholders were asked to vote in support of insisting Fox stop spreading disinformation about climate and vaccinations. The argument being that the majority of Fox's shareholders hold shares across the wider market and, therefore, benefit from a well-functioning market. If a company spreads disinformation that undermines market functioning, the result is a bad outcome for those shareholders, even if it is lucrative for the individual company.

- ***Engaging with standard setters to inform international standards, in order to adopt these into their own investment processes.*** Consider the Coalition for an International Panel on Climate Finance which is calling for a new financial architecture to leverage public and private finance into the carbon transition.

- ***Revisiting the responsibility investors have in multiple jurisdictions to maintain market integrity.*** There is potential to widen interpretation from the current focus on market integrity as relating to issues such as bribery and corruption to incorporate wider sustainability matters that threaten market integrity.

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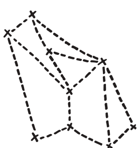
Although designed for asset owners and large asset managers primarily, this thinking on system-level investing can also be applied by banks.

Example of what this looks like at the meso level include:

- Development finance institutions, Indian and international banks are joining convenings and conversations in India with renewable energy developers, government officials, NGOs and community representatives to build a vision for how renewable energy can be scaled as a sector that enshrines responsibility including over land rights of communities, worker rights in mining rare minerals, and diligence in Environmental Impact Assessments. Through a collaborative Responsible Energy Initiative convened by Forum for the Future, and a wider consortium, financial actors are a key part of creating a different vision and being able to follow through with their screening of new investments.
- Venture capital funds, family offices and community development finance institutions (CDFI) in the US are actively leaning into regenerative agriculture, to unblock challenges to adoption and scale. Akiptan is a CDFI aiming to deliver creative capital and transform paradigms that enable Indian agriculture and food economies to thrive. Several financial sector organisations are joining cross-sector dialogues of over 100 players in 'Growing Our Future' on how to address systemic blockages to scaling equitable regenerative agriculture, including how to alter financial mechanisms to enable farmers to make the transition.
- In South East Asia, financial actors are joining conversations about the future of the protein system, and how to shift from the current chase for unicorns in the alternative meat sector, to a wider and much more ambitious vision for a protein system that meets multiple needs, social and environmental, and is more adaptive to the disruptions ahead.

Such practice is in its early stages. As practice and standards evolve, more frameworks and indicators for system-level indicators will likely emerge.



System change perspective:
Investing for the health of the meso or macro system is the big step forward that has potential to unlock significant change, though it is early days still. It entails a fundamentally different perspective, prioritising the health of the whole, not the health of the asset or financial institution. It is the epitome of a systemic approach.

6 What embracing an agent of change role might look like for leading financiers

The financial institutions that survive the upcoming transitions will lead from the top, embedding systems-level thinking and action into their culture. Rather than championing current forms of capitalism as *the* solution, their leaders can actively engage with and acknowledge the failings of the current approach to endless growth. These institutions can invest time and resources in

working with academics, economists, non-profits, those testing alternatives at local levels, and sustainability-driven financial institutions to explore alternative economic and business models and what this might mean for the future of finance. Systems-level thinking requires exploring these questions not just at the underlying enterprise and asset level, but also in terms of what a sustainable economic system might look like and the role of distinct financial industries and institutions within that.

6.1 Leading practice at the edge

Specifically in relation to the trends referenced earlier, these are examples of what leading practice amongst financial institutions might include:

1. When it comes to **net zero** developments, leaders are avoiding the 'easy route' based on convenient assumptions or asset sales, and focusing on maximising what they can do to drive real economy decarbonisation.

   Net zero has attracted criticism that it '*helps perpetuate a belief in technological salvation and diminishes the sense of urgency surrounding the need to curb emissions now.*' The fear is that technological innovation, and the associated capital requirements, are nowhere near the levels needed to meet a net zero future and that they may be a distraction from the continued investment in fossil fuels that are putting such a trajectory out of reach. As a result, fossil fuel commitments, particularly bank exposure to such assets, and by extension other financial sector actors exposed in turn to those banks, are likely to attract growing shareholder and civil society activism.

   Leading institutions will not just be on top of the latest accounting methodologies, such as the Platform for Carbon Accounting Financials (PCAF) the banking standard when it comes to how to report on-balance sheet assets, but will also set science-based targets that reflect decarbonisation in the real economy (see RMI's PACTA methodology, also SBTi's methodology). These methodologies will continue to attract critique, as theory meets practice.

   Leadership requires a firm commitment to phasing out fossil fuels, with clear commitments across distinct sectors as to when financing will be phased out. It means not taking the 'easy' route to decarbonisation, through asset transfer which simply offloads the issue to another financier. Instead it requires a commitment and strategy that looks at the impact (or 'delta') of financing activities, such as a decrease in the carbon emissions of the underlying financed asset, most likely through company engagement. In practice, this is complex, but it is likely that leading financiers will display far more transparency regarding what is in underlying investment, loan and underwriting portfolios, including off-balance sheet finance, requiring improved data quality throughout the investment chain and supporting infrastructure. It means having transition plans for distinct sector investing and lending teams, with skill redeployment required. Other likely outcomes include shifting and labelling assets into 'dying economy' versus 'growth economy' portfolios, with specialist funds introduced as specialised structures to manage the retirement of fossil fuel assets in line with a just transition.

Given this is uncharted territory for all involved, it requires co-creation and co-design with other financiers, and across public, private and civil society actors. No financial institution can grapple with a transition of this magnitude in isolation, nor without an upskilled employee base. The **operational and execution risk** is significant at present, with a gap between what most now understand needs to be done and the human and technical resources available to deliver it at speed. Leading financiers will be active participants in burgeoning semi-private 'safe spaces' where multidisciplinary groups discuss solutions and how to implement them, such as the Climate Safe Lending Network (CSLN). This mainly UK/US initiative is working with a loose coalition of leading banks, and has produced practical guidance, such as the Good Transition Plan, designed to be fully compatible with thresholds and allocations thinking. It provides co-creation platforms and fellowships for bank 'intrapreneurs'. These are employees from any business segment who want to contribute to their organisation becoming climate safe, working alongside policy makers, civil society actors, investors and advisors.

2. When it comes to confronting the **uninvited 'S' guest**, good practice starts with a comprehensive understanding of the UN GPs, integrated into due diligence across the investment chain. Expect living wage commitments, like this year's resolution at Sainsbury's, and other labour-related issues to come to the fore in future corporate engagement from investors, alongside continued pressure to improve DEI practices, where a multitude of frameworks and metrics are available to support better practices.

   Beyond shifts in leadership, leading institutions will champion a wider systems perspective on societal risks and impacts. Research and tools are increasingly available for those seeking to take a more systemic approach to confronting the impacts on inequality of their portfolio construction and asset allocation decisions. The Taskforce for Inequality Related Financial Disclosure (TIFD) is a nascent body seeking to take a multidisciplinary approach to establishing reporting and disclosure standards for inequality-related risks and impacts. Similarly to its climate and biodiversity focused forerunners (TCFD and TNFD), it needs financial institutions' engagement and support to succeed.

3. There is exciting work happening across a number of disciplines, not just climate, in relation to **thresholds**. As take-up of SBTi and PACTA methodologies is increasing, the principle of working with ecological ceilings and social foundations is extending. The Science-based Targets for Nature Initiative (SBTN) is developing science-based targets for companies in relation to land, freshwater and oceans, and five associated pressures of use change, resource exploitation, climate change, pollution and invasive species. The World Bank, BNP Paribas and Robeco are working together with SBTN on a science-based biodiversity collaborative engagement concept, modelled on the Climate Action 100+ initiative.

   UNRISD and r3.0 are taking a more holistic approach to thresholds and allocations. Together they ran a pilot with a few dozen companies (including a handful of financial institutions) to trial context-based metrics that could enable companies to measure and manage their sustainability impacts in respect of absolute thresholds, with results captured in this synthesis report. These are mapped to the SDGs, and therefore cover

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both environmental and societal needs. Pioneers such as GSL Bank in Germany have committed to reporting their impact using a values- and capitals-based approach, using context-based metrics illustrated by example in its 2020 annual report.

Beyond pioneering such reporting themselves, financial institutions can press, as users, for the uptake of context-based thresholds in current market infrastructure from reporting standards through to regulation.

4. In terms of **influencing the rules of the game**, political engagement is a double-edged sword. When set against the challenges laid out earlier with regards to rising inequality, and the problematic role of the finance sector in this, there is a paradox. It can be argued that the private sector has no place influencing regulatory and policy makers, given their self-interest. So how to ensure the 'right kind' of lobbying, that supports rather than hinders system change?

   A first step is ensuring that direct and indirect political engagement is fully transparent. This is a challenging tightrope to walk, particularly in the US and other regions with increasingly bipartisan public debates. But most leaders are aligning with science and the global mood, and acting accordingly.

   To keep tabs on such behaviour, NGOs like InfluenceMap track companies' and fund managers' lobbying activities and score them in relation to positive/negative influence in meeting the Paris goals. Preventable Surprises' Corporate Lobbying Alignment Project **(CLAP)** is in turn looking at investor engagement with high-emitting industries on the issue of corporate political capture. Leading institutions can engage with such initiatives, use their research to inform corporate engagement, and take an active role in discussion platforms such as those offered by CLAP.

   In the US, where corporate political engagement is endemic, initiatives like the Corporate Political Responsibility Taskforce are seeking to redefine what the landscape could look like. It is working with a handful of US companies to explore alignment of their political influence with their sustainability commitments, and alternative models from history and other regions to identify how proactive, principled firmwide approaches can bring benefits.

5. **System-level investing** practice is relatively nascent. It incorporates aspects of all the above trends. Coalitions of actors are working on practical guidance and solutions, targeting asset owners and managers. TIIP, for example, is working on a 'turnkey solution' that enables investors to map and act on system-level issues, beginning with the topic of social inequality. The Predistribution Initiative and Responsible Asset Allocator Initiative are together convening investors to explore how to strengthen alignment between investment and stewardship teams, and how to integrate external data on externalities into investment analysis and decision making, at a systems level.

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Widening the solutions space

The above all seem promising. They also all suffer the same concentration of capital issue that mainstream capital markets display – the concentration of decision making in relatively few hands, reflecting the experience and concerns of a global elite. There is a huge concentration of capital in a handful of international financial centres, and gross inequity in global capital flows. Less than 4% of global wealth flows to lower- and upper-middle-income countries (excluding China), yet they comprise 50% of the world's countries. This is in stark contrast to the more than 80% of financial flows servicing high-income countries, according to the OECD. The UN Secretary General, Antonio Guterres, was widely quoted in early 2022 when he stated, 'The global financial system is morally bankrupt. It favours the rich and punishes the poor.'

Debate within ESG and impact investing circles, including on DEI, has not been as vocal regarding this disparity. The sector's main response has been in calling for more blended finance, the strategic use of development finance,often governmental, for the mobilisation of additional private finance towards sustainable development in developing countries. This mobilised an estimated $166 billion of capital towards sustainable development in developing countries in 2018, according to Convergence, a fraction of global capital flows.

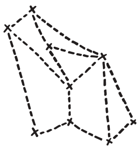
This may be linked to finance's seeming difficulty with any serious attempts to tackle social issues (our uninvited guest, S), particularly in comparison to environmental efforts. Inequality is a challenging topic for the finance sector to get to grips with. Behind it sits an uncomfortable question of whether the finance sector is a net negative contributor, to inequality in particular. And whether it is in a position to address this, or whether doing so acts against its own self-interest. Academic research suggests that an overdeveloped financial sector fuels inequality, as is the case in the US, or UK, for example, particularly when that financial sector is primarily market-driven rather than bank lending-focused. Much has been written with regards to the worsening inequality that is a direct effect of monetary policy in recent years, designed to prop up a faltering economy, post-2008 financial crisis and now post-pandemic. Many in the financial sector called for such intervention and directly benefited from it, indicating a conflicted role.

The overwhelming concentration of capital is not the only reason why there is a paucity of capital flowing to emerging markets; to underserved groups running businesses; or to those primarily trying to serve underserved groups (e.g. women, or any minority communities), but it is one of the barriers. Finance is at its heart rooted in relationships, trust and risk-taking, and it flows to what it knows.

There is a need to 'widen the solutions space' across **all** the trends discussed so far, to quote Dr. Gillian Marcelle, a blended finance advisor experienced in economic development and capital mobilisation. This requires these initiatives to proactively invite and collaborate with 'knowledge bearers from social, cultural and political worldviews different from their own'. As Dr. Gillian Marcelle also attests, what comes next 'cannot be about extending an unsustainable financial infrastructure, moulded by a handful of countries, to the rest of the world.' Just as we saw in the grossly unequal distribution of the COVID vaccine, which has contributed to continued mutations and outbreaks, the global sustainability issues we currently face cannot be solved without the

active involvement of emerging markets to any solutions proposed and a fairer distribution of resources.

Of all the trends referenced so far, impact investing is perhaps furthest from the dominant financial system, with the widest range of global participants and therefore ideas and solutions including participatory investing. Its origins lie in private or social investing, funded locally and/or by philanthropy or government funding, that is, being far from global capital markets. The question remains whether it can scale, most likely by being co-opted by the dominant financial system, and still continue to serve those communities that have been marginalised by today's global financial system.



System change perspective:
There are multiple ways in which financial actors can intervene at different levels of the system, and act on different levers. They will shift mindsets, rules, incentives, and flows of information and finance. Change cannot be done by financial actors alone, but only in collaboration with other system actors. Indeed, finding solutions that really put us on an 'H2+' pathway to a just and regenerative future will need creativity and different perspectives that will only be found outside finance, because they need alternative visions of what is possible and desirable.

6.2 Organisational and cultural shifts

Against this backdrop, what will distinguish leading future industry leaders in this increasingly chaotic decade is **a strong corporate culture.** Given the lack of a playbook for how to manage what comes next, value will come from organisations that can innovate and rapidly adapt, and therefore prove resilient. Top things to consider in preparation include:

- **A commitment to interdisciplinary systems thinking,** starting from the top. The Predistribution Initiative is working with TIIP and others to develop investment government template documents that would enable institutional investors to adjust their practices, such as adjusting investment belief statement, investment policy statements, and other policies and procedures which flow from these standards and that can support an institution in fully aligning with system-level investing principles.

  More cross-disciplinary sustainability initiatives will emerge. These will span investment, banking and insurance disciplines (see for example the launch in June 2021 of the Investment Leadership Programme, bringing together PRI and UNEP FI members on initiatives 'considered ambitious, but not ready for mainstream investment adoption' (UNEP FI press release). Collaborations currently dominated by the private sector, such as the UN Global Investors for Sustainable Development Alliance, the Coalition for Inclusive Capitalism, or the US only Business Roundtable, will need to expand their reach and commitment to action. Those financial institutions with an active leadership role in these groups must include at the table thinkers from outside high-income countries, across the

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political, scientific and civil society sectors, if they are to avoid being 'insider' talking shops.

- **Recruitment and retention of diverse expertise.** Environmental, social and corporate governance expertise remains in high demand in Europe and North America at present, given the growth in ESG assets and impending regulatory changes. This is likely to grow in Asia also. But diverse expertise goes beyond having ESG on a CV. It requires bringing in perspectives from different backgrounds, cultures and disciplines, given the far-reaching transitions underway. Attracting and retaining such staff requires a firm-wide, deep commitment to sustainability. Not all financial institutions will survive the upcoming disruption, and savvy employees are weighing up their options accordingly. Employees' higher expectations of their firm's commitment to sustainability brings a desire to learn and contribute.

  The flipside is that such employees may be more likely to call out poor performance, potentially even whistle blow (see for example the DWS Group within Deutsche Bank, currently under investigation following a former employee's claims). There needs to be internal coherence and consistency on corporate commitments and action, and a strong corporate culture in support of sustainability to avoid 'organ rejection'. This includes mechanisms to support and incentivise intrapreneurs to work across teams and rapidly develop and roll out ideas, products and responses. Coutts Bank, for example, recently tasked its group of identified future leaders with critiquing its climate plan, as a way to bring in next generation thinking and engagement with the banks' strategy.

- **Open commitment to collaboration,** and the sharing of knowledge and expertise. Many sustainability topics are still, in truth, in the pre-competitive phase, with practical progress being made via informal and formal sector collaborations. John Fullerton of the Capital Institute includes edge effect abundance amongst his principles of regeneration; as in natural ecosystems, the most resilient and diverse life is found at the edges of systems, with innovation less likely to come from within siloed, specialist areas. As leading institutions commit resources to these collaborations, it will be critical to discern between when to push for proprietary versus market-building efforts. It is also imperative to engage meaningfully with civil society actors, as both a source of information and of influence. In the chaotic upcoming transitions where no one sector or discipline dominates, nimble civil society groups are likely to have outsize impacts (primarily through litigation, see for example Friends of the Earth Netherlands court action against Shell, but also by capitalising on cancel culture).

As a final note of reflection on the importance of culture, the 'breach in the wall' of climate action amongst financial institutions reflects an increasing gap between the internal logic of finance and the reality of the world (see for example the detailed rebuttal of Modern Portfolio Theory by Jon Lukomnik and James Hawley). There is a mismatch, for example, between traditional linear economic models that are the dominant paradigm within the financial industry, and the complexity of the systems it both influences and is influenced by. There are alternative economic models, such as complexity economics, which sees '*the economy not as a perfectly humming machine but as an ever-changing ecology of beliefs, organizing principles and behaviours'* (Denise Hearn). Or Kate Raworth's doughnut economics, with its aim not of increasing GDP but of creating

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a society that can provide enough materials and services for everyone, while utilising resources in a way that does not threaten our future security and prosperity. Or just and regenerative approaches to business and finance, which seek an economy that sustains the wellbeing of all and the capacity of our natural world to replenish itself, while enabling long-term, broad-based prosperity.

These models are not - yet - seriously gaining traction in mainstream financial decision making. Nor do they seem to be seriously discussed within the world of ESG, where the hand wringing underway is symptomatic of an 'unhealthy field'. Psychological research indicates that when fields are healthy there is an alignment between doing *good* (high quality work that produces something of use to others) and doing *well* (achieving wealth, professional advancement). For individuals, such alignment can be psychologically powerful - work has meaning. But it also has obvious significant benefits for the field as a whole. Since the beginning of this century, the responsible investment narrative within finance has been that doing good, ESG practices that have environmental and social benefits, aligns with doing well, in traditional financial terms. Indeed, many hoped it could realign finance with society. But this link is now openly challenged, including by regulators. If doing good aligned perfectly with doing well, capital would flow accordingly, with no need for regulatory interference to steer the market toward less negative environmental and social impact.

So in this moment of growing maturity, remembering that the loosely defined ESG movement is relatively young, and has grown extremely rapidly, there is an opportunity to redefine coherence within the system, in line with the real economy whose wheels it oils. *'The word 'coherence' [...] is usually used to refer to a system, an idea, or a worldview whose parts fit together in a consistent and efficient way. Coherent things work well: A coherent worldview can explain almost anything, whilst an incoherent worldview is hobbled by internal contradictions [...] An incoherent profession [...] spends a lot of time on self-analysis and self-criticism. Most people know there's a problem, but they can't agree on what to do about it.'* says Jonathan Haidt in The Happiness Hypothesis.

If this first wave of ESG has been the training ground, then the next three to five years present a critical opportunity for the finance sector to coalesce around and build on the significant foundations and disruptions of recent years:

- The public acknowledgement *at scale* of the agency that financial institutions have in terms of impacts on our future sustainability.
- The recognition that financial institutions, individually and collectively, can make commitments, set strategy and report progress on their impacts on sustainability.
- Acknowledgement that there are different levels at which financial institutions can influence, that extend beyond a narrow focus on engaging individual companies or assets and to the system itself.

In her seminal essay, 'Places to Intervene in a System', Donella Meadows honed in on the **mindset or paradigm** out of which the system - its goals, power structure, rules, its culture - arises as being the number one place to intervene to be effective. The coming decade presents a test of whether all those who are part of the dominant financial system of today can shift that paradigm, and re-establish finance as an active agent of change in servicing the needs of people and the planet.

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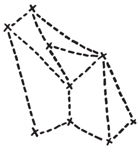

System change perspective:
Acting to shift the system cannot be done without addressing internal ways of reflecting and acting, the mindsets that dominate the profession, and the diversity of perspectives. For finance to step up as an actor driving change in macro and meso systems, there will need to be an authentic shift within the finance system too.

This report was produced by Forum for the Future based on dialogue with financial sector actors. The dialogues were led by Caroline Ashley in February 2022 with leading contribution from Emilie Goodall, in her capacity as Forum for the Future Affiliate. Updates were made in mid 2022 prior to publication and on the basis of feedback from a range of generous colleagues in the sector including Lydia Hascott, Francesca Spoerry, Karim Harji and Graham McMillan. All content is the responsibility of Forum for the Future.

We recognise that this opinion paper is necessarily partial – a fraction of trends and the dynamism of the finance sector are represented. We acknowledge that these insights are reflective of the position and biases of authors and contributors, based largely in the global north, and working as part of an international sustainability organisation, originally founded in the UK.

Further information

Blogs related to this paper can be found on the Forum for the Future website, from both 2021 and 2022.

Forum for the Future and the School of Systems Change are running a 'School of Systems Change for Finance', with sponsorship from Aviva Investors. This builds on ideas in this paper to help change-actors within finance to develop their own systems change capacity. Information on the School can be found here.