System Change Opportunity in the Financial Sector

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System change is by far the most important sustainability issue in the financial sector. Climate change and virtually every other major environmental and social issue only can be resolved through systemic changes at the sector and overarching system levels. The capital markets strongly influence corporate behavior. Over $20 trillion dollars are invested in the global socially responsible investing (SRI) market. Investor interest was a main factor compelling nearly all large companies to implement sustainability strategies.

The same mechanism can to used to drive system change. As institutional investors and other capital markets participants realize the critical importance of system change and take it into account when making investment decisions, companies will be compelled to engage in it. Investment funds based on system change performance have the potential to produce far greater environmental and social benefits than any other type of SRI or impact investing. Corporate system change ratings can be used to produce many types of investment products that provide superior financial returns. This article summarizes the system change opportunity in the financial sector and how investors can capitalize on it.

System Change

Modern economic and political systems were developed from a reductionistic perspective that ignores much of reality. These systems unintentionally place business in conflict with society. Companies usually are required to put profits and shareholder returns ahead of the environment, customers, employees and all other aspects of society. Very generally speaking, companies only can mitigate about 20 percent of tangible and intangible, short-term and long-term, negative environmental and social impacts in a profit-neutral or profit-enhancing manner. Beyond this point, costs usually go up. If companies continue down this path of voluntary corporate responsibility, they will put themselves out of business.

Flawed systems compel all companies, without exception, to degrade the environment and society. System change is about 80 percent of the sustainability problem and solution. But it gets relatively little attention compared to company change. Nearly all environmental, social and governance (ESG) ratings, SRI funds and corporate sustainability strategies are focused on unilateral efforts to mitigate negative environmental and social impacts.

As companies are forced to negatively impact society, impacts increasingly return to harm them. This pushback often takes the form of market rejection, reputation damage, lawsuits, inability to attract and retain a high quality workforce, weakened competitive position, and ultimately reduced profitability and shareholder returns. Companies and investors have strong financial incentives to reduce negative impacts. But the vast majority of impacts only can be mitigated through system change. To protect business, investors and society, the focus of corporate sustainability strategies, ESG ratings and SRI funds must be substantially switched from company change to system change.

Analyzing and rating corporate system change performance is more difficult than rating traditional corporate sustainability or ESG performance. Effective ESG rating requires understanding companies' negative environmental and social impacts. This enables analysts to see through greenwashing and assess whether mitigation efforts are effectively focused on the highest impact areas. Effective system change rating requires understanding necessary sector-level and overarching system changes. This enables analysts to determine if corporate system change efforts are effectively focused on the most important system changes.

The Total Corporate Responsibility (TCR®) methodology, developed in 2003, provides a practical approach for analyzing and rating corporate system change strategies. The model assesses traditional ESG metrics and system change performance. TCR defines two broad levels of system change – mid-level and high-level. Mid-level system change involves systemic changes at the sector, stakeholder or environmental/social issue level. High-level system change refers to evolving overarching economic, political and social systems into sustainable forms. A growing number of companies are getting involved in mid-level system change. But few businesses are engaged in high-level system change.

This is the most important sustainability issue. Flawed economic and political systems often do not hold companies fully responsible for negative impacts. This is the primary mechanism compelling businesses to degrade the environment and society. Holding companies fully responsible makes acting in a fully responsible manner the profit-maximizing strategy.

Our economic and political systems inevitably will evolve or collapse. Nature and reality force all flawed systems to change, as occurred with the American and French revolutions, end of slavery in the US and fall of communism in the Soviet Union. Attempting to maintain the status quo will cause traumatic, possibly catastrophic system change. Companies and investors are much better off taking a seat at the system change table and proactively managing the process.

A companion series of whole system books to TCR, called *Global System Change*, facilitates system change rating by describing hundreds of essential sector-level and overarching system changes. TCR and *Global System Change* provide the tools and information needed by the financial community to develop accurate and effective corporate system change ratings. Detailed descriptions of how to implement TCR and *Global System Change* in the corporate and financial sectors are provided in the last book of the *Global System Change* series – *Global System Change: We the People Achieving True Democracy, Sustainable Economy and Total Corporate Responsibility.*

Implementation

Substantially shifting the focus of SRI and corporate sustainability/ESG rating from company change to system change requires many actions. Important ones include raising awareness, convening collaborative efforts, working with standards organizations, helping ESG research groups to assess system change performance, helping SRI asset managers to develop system change-based investment products, and providing a strong business case for system change in the financial sector.

Raising awareness among ESG research organizations, SRI asset managers and the broader financial community is one of the most important actions needed to drive system change. Flawed systems that force companies to degrade the environment and society often provide high short-term shareholder returns. But they ultimately will harm companies and investors. Business is one of the most powerful forces in society. As a result, companies can strongly promote system change. Many will do so if they understand the benefits of it.

The financial community has greater influence over business than any other segment of society. This puts investors in a strong position to drive system change. Many investors will encourage system change efforts when they realize the essential need for and benefits of it. Awareness raising is key to engaging the financial community in system change.

As noted, high-level system change is by far the most important sustainability issue. It will be impossible to resolve climate change and other major problems as long as myopic economic and political systems force companies to act unsustainably. Evolving these systems in ways that align what's best for business with what's best for society is essential.

These types of complex and far-reaching systemic changes only can be achieved voluntarily through collaboration between business, government and civil society. Institutional investors, asset managers and other financial community players will be essential participants in high-level system change collaboration. The financial community can strongly promote the convening and success of such efforts.

There are several types of sustainability standards for the corporate and financial sectors, including GRI, Ceres, GIIN, B Corporation and ISO 26000. These standards usually are heavily focused on unilateral corporate efforts to mitigate negative environmental and social impacts, for example, by selling environmental and socially responsible products, taking better care of employees, reducing pollution, and establishing high quality accounting, reporting and governance systems.

But as noted, these factors and metrics only address about 20 percent of the sustainability problem. To achieve sustainability and real prosperity, it is essential that sustainability standards be expanded to include mid-level and high-level system change metrics and performance assessment. Encouraging standards organizations to move in this direction will greatly facilitate system change.

Helping sustainability/ESG researchers and SRI asset managers to integrate system change analysis into their approaches is an essential component of increasing the financial community focus on system change. TCR and *Global System Change* are intended to facilitate all of the above actions. TCR is based on conventional ESG analysis methods. It enables system change assessment to be easily integrated into existing ESG rating and SRI asset management approaches.

The *Global System Change* books use a whole system approach to clarify the root causes of major challenges facing humanity, necessary system changes and processes for achieving them. They provide the comprehensive, whole system analysis needed to support awareness raising, collaboration and standard setting activities.

Clear, compelling communication will be essential for system change success. Questioning systems that focus on maximizing economic growth and shareholder returns (instead of the actual well-being of society) could threaten asset managers and other financial community participants. Making a strong business case for system change and providing practical, non-disruptive ways to achieve it are essential for engaging the financial community in system change.

Expected Outcomes

High-level system change probably is the most complex challenge ever faced by business and humanity overall. Some people might argue that it is not possible to voluntarily evolve our economic and political systems into sustainable forms. This could be true. If it is, business and society almost certainly will face highly traumatic and painful changes. We have an obligation to at least try to voluntarily change our flawed systems before nature and reality change them for us.

The technological sophistication, coordination and symmetry of nature are nearly infinitely greater than that of humanity. As parts of nature, we can achieve the high levels of sustainability and real prosperity seen there. Human society has shown itself to be tremendously creative and adaptive. We have the potential to be far better than we are now. Business has driven many positive transformations in society. Through practical, logical collaborative efforts, the corporate and financial sectors can play major roles in the most important transformation needed in human society – high-level system change.

Ongoing environmental and social degradation will make sustainability the primary business issue of the 21st Century. System change provides a huge opportunity for the financial sector. Institutional investors, SRI asset managers and other financial sector parties focused on system change will be seen as the true sustainability leaders. Like current sustainability leaders, they will receive many financial and competitive benefits.

TCR can be used to develop investment products that provide far greater and environmental and social benefits than any other type of SRI because the approach is focused on the most important sustainability issue – system change. TCR funds also can provide superior financial returns in large part because system change performance is an excellent indicator of management quality, the primary determinate of financial and stock market performance. System change is a complex management challenge. Success in this area indicates that management has the ability to succeed in other areas, and thereby earn superior returns.

Substantially shifting the focus of ESG rating and SRI asset management from company change to system change will provide extensive investor and societal benefits. Many institutional and other investors are concerned about declining environmental and social conditions. Superior sustainability and financial performance will enable TCR and similar system change-based funds to capture a substantial share of the global SRI market. Asset managers can use TCR to provide the most attractive, highest performing SRI products. At a broader level, high-level system change represents the best, and perhaps only, way for business and society to achieve sustainability and real prosperity.

Frank Dixon *oversaw the sustainability analysis and rating of the world's 2,000 largest companies for many years as the Managing Director of Research at Innovest Strategic Value Advisors, formerly the largest corporate sustainability research firm in the world. Institutional investors used Innovest research to develop high-performing socially responsible investing products. Extensive corporate sustainability experience made it clear that flawed systems compel all companies to degrade the environment and society. Frank Dixon developed the TCR® approach to provide a practical and profitable way for companies and investors to engage in system change. Following Innovest, he provided sustainability and system change consulting to companies in the US and Europe. Most recently, he wrote the Global System Change series of books. Using a whole system approach, the books describe the major economic, political and social system changes needed to achieve sustainability and real prosperity.*

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