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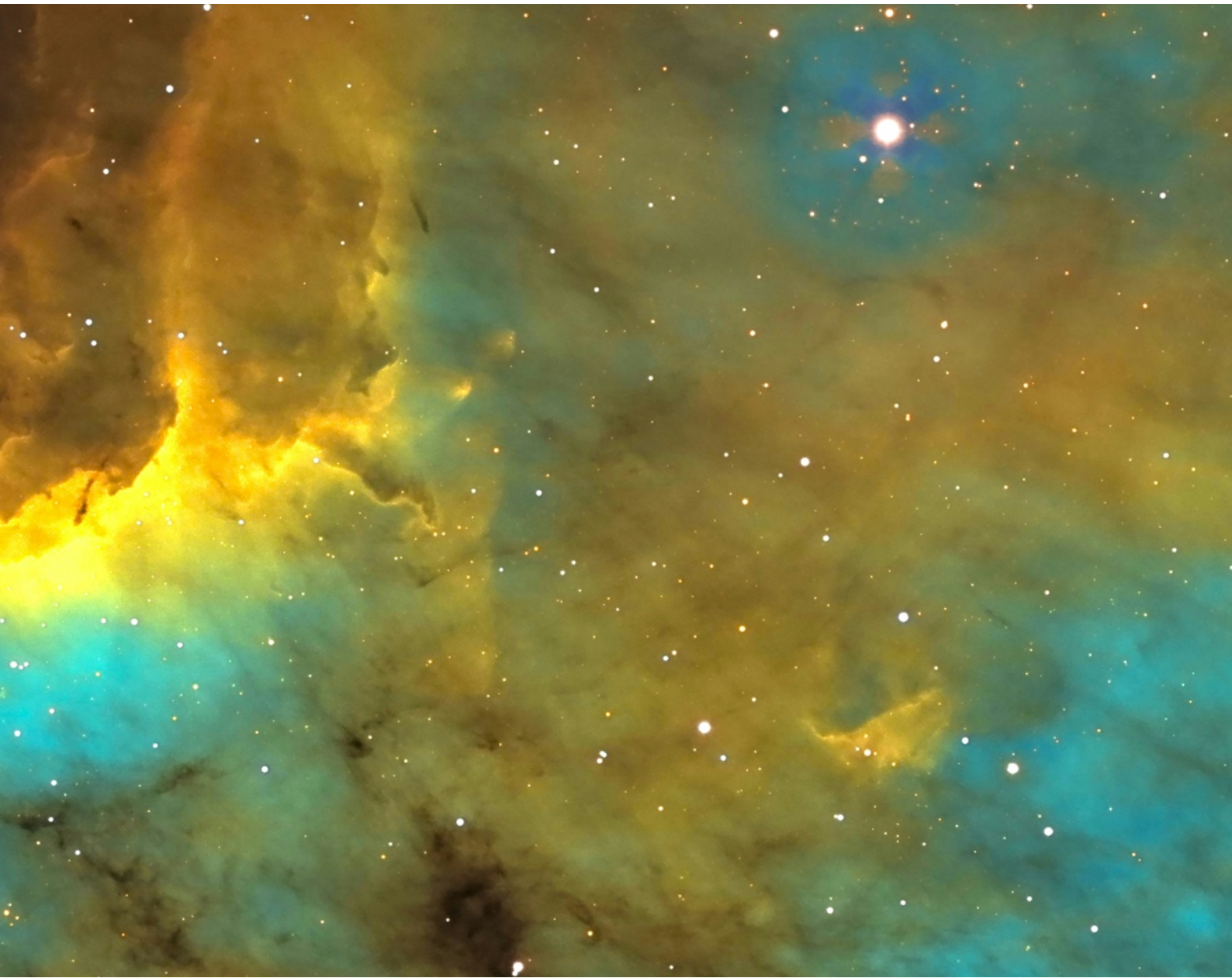
New rules for financing transformative change



To move towards a sustainable and just world, we need to embrace systems change and transform the way we invest. But how do we finance transformative change? The Deep Transitions Lab is on a mission to make this a reality. In November 2022, the Deep Transitions team alongside a cohort of 16 public and private investors from around the world published a Transformative Investment Philosophy. This proposed new principles, tools and metrics for financing long-term system change and a deep transition towards sustainability. Now Deep Transitions researchers have published the new paper "Transformative Investment: New Rules for Investing in Sustainability Transitions" by Caetano Penna, Johan Schot, and Ed Steinmueller, which critically analyses the current financial regime and its implications for sustainability transitions. The paper proposes a new set of rules grounded in socio-technical sustainability transition theory and the recent development of a theory of deep transitions. The aim? To guide transformative investments towards achieving both monetary and non-monetary value, such as societal and ecological resilience.

New rules for Transformative Investment

1. Prioritise financial return from investing in system change: Financial return measurement should reflect investment that contributes to system change, considering the directionality of investments.

2. Abide by an expanded definition of fiduciary duty: Fiduciary duty should include considerations of system change and long-term value, acknowledging the certainty of shocks in the ongoing polycrisis.

3. Map unquantifiable systemic uncertainties: Investors should account for uncertainties associated with societal challenges, broader repercussions, rebound effects, and just transition considerations.

4. Maximise system change impact with a focus on long-term benefits: Investment should focus on advancing activities, projects, and companies that have the potential to foster system change, and be evaluated based on their contribution to long-term transformations.

In the paper, the new rules are set out in a table alongside their enabling conditions, summarising the kind of changes needed for these to be adopted as the dominant practice in investment decisions. Caetano Penna, Affiliate Researcher at the lab and co-author of the paper, discussed the types of changes needed to see this new rule set thrive with DT communications manager Natalie Laurence. "Cultural changes involve changes in mindset, which in term may need new training curricula for investment intermediaries to include basic climate science, socio-technical transitions or scenario-based methods. Institutional changes involve new laws and regulations, establishing an incentive structure that foster long-term investments that bring about systemic transformations. While practice-focused changes involve, for instance, the establishment of multi-stakeholder forums or working groups for collective scenario-building exercises."

Challenging the status quo

> "*Our perspective is controversial because it challenges the financial sector's status quo, criticising even its sustainable investing and ESG practices.*"

There will certainly be challenges on the road to transformation. Penna believes the biggest challenge will be the resistance to abandoning existing investment rules, such as the emphasis on short-term returns. Yet this highlights the need for a "paradigm shift in how investments are viewed and managed, particularly in terms of prioritising long-term sustainable outcomes over immediate financial gains. On top of this likely resistance, we also recognise the difficulty in integrating system change into investment strategies, which will require fundamental research on new metrics and indicators for transformative change and new methodologies and tools to appraise investments."

Changing mindsets

> "*The trade-off between short-term gains and long-term impact is a red herring, because what is needed is not measurements and techniques that can accommodate both, but a change in investor and investment intermediaries' mindsets that recognise that the actual value of an investment cannot be detached from its long-term impact.*"

For a long-term perspective to take hold in the investment world a cognitive shift is required. Penna explains that this "may involve advocating for legal and regulatory changes, such that long-term investments are incentivised, and implementing new investment strategies that focus on system transitions, which may require familiarity with this type of research." But overcoming entrenched short-term perspectives remains a significant challenge and making that shift is part of the work of the Deep Transitions Lab. However, developing new valuation and appraisal methods, systemic metrics, and transformative outcome indicators is one of the key areas for future research for the team. We have worked on this in several other projects, for example we used social network analysis to map transformation process in project portfolios of the EIT Climate-KIC.

Shocks and extreme events are coming

> "*Uncertainties in climate scenarios, like shocks and extreme events, cannot be predicted or forecasted. Nevertheless, based on the most recent scientific evidence and methods, as reported by the IPCC, we know they will occur more and more often.*"

We know the future promises to be unpredictable, complex and volatile. Yet many quantitative models of climate scenarios used in the financial sector are limited: based on unrealistic assumptions and failing to provide a holistic view of the impacts of climate change. Investors need better tools with which to assess real-world risks and opportunities. We looked at this when we helped develop new climate scenarios with Baillie Gifford. It's essential for investors to account for unquantifiable uncertainties and prioritise long-term systemic resilience over short-term gains.

Penna explains that "investors guided by current sustainable investment rules face issues in anticipating or responding to systemic risks due to their constrained traditional views of fiduciary duty. This limitation results in investments that do not effectively contribute to system change, because often high-return investments can be directly contributing to climate change. While the fiduciary duty is maintained in the short-term, in the long-term, it jeopardises value creation."

Read the full paper "Transformative Investment: New Rules for Investing in Sustainability Transitions" by Caetano Penna, Johan Schot, and Ed Steinmueller.