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Corporate social responsibility and banks

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INTRODUCTION

The current turmoil in capital markets has affected a large number of economies, as well as the financial lives of individuals. Whereas sympathy has been shown from some quarters to losses on the markets, others have voiced their outrage – primarily on the grounds that the collapse of capital markets could have been avoided or was occasioned by the greed of a limited few. Whatever may have been the case, the fact remains that the financial lifeline of societies has been adversely affected by factors to which the affected entities or individuals did not contribute.

Bank failures usually take place due to bad risk-based investments. Risks are often perception-based; often a value judgment. The incidence of risks may be minimised or calculated in an optimistic fashion when driven by the perception of high profit-making, which has a blinding effect. In this process, the selfish interest of an entity or individual dominates and the best interest of the general public is relegated to a secondary position.

Given the very long existence of a successful banking system in the UK, it would be fair to maintain that bank failures in the UK are a rather rare phenomenon. But, then, why did Northern Rock and Halifax or HBOS fail, or alternatively why was the government required to nationalise Northern Rock, albeit hopefully for a short period of time? The market failure was due to multifarious reasons, one of which may be described as a "link factor" with the US market, the operation of which is based on a different risk culture. The question remains whether the UK banks should have followed the US banks' lending policy, particularly in regard to sub-prime lending.

Do capital markets have any social responsibility? Is it ethical for capital markets to be engaged in gambles at the cost of societal upheavals? The primary objective of this article is to discuss the issues raised in the preceding paragraphs.

THE SCENARIO

During the latter part of the 1990s and the early part of the twenty first century the major financial markets looked rosy, and ordinary people, particularly those with no knowledge of financial risks, took advantage of the privileges and facilities that the banks and other finance houses offered. Credit cards, bank loans and a variety of other credit sources became readily available. Finance houses offering such facilities made a fortune; the beneficiaries of loans and credits became overloaded with debts. In many cases the burden of debts proved to be unmanageable.

The sub-prime mortgage technique, which originated in the US and the wave from which struck British shores, was also principally based on what is known as the "self-certification of income" system. Everybody would be lured by this attractive offer, especially when the property markets became buoyant and many people lacked the financial capacity to purchase property under the existing system, which was linked to their income. Thus, all such lending was allowed with the consequence that people would, in the course of time, find it difficult to meet their mortgage liabilities; the risks must have been foreseen by the lenders and yet lending was still allowed.

During the late nineties, credit cards were made available to almost everyone, but in most cases the risks were not properly studied, and only credit checks were carried out. The purchasing power of people rose; consumerism spiralled, but in many cases cardholders could not meet their monthly payments. In England, many started paying off their monthly mortgage instalments with credit cards.

The credit crunch was in a way a self-induced crunch occasioned by lenders. In the meantime, with house prices decreasing negative equity beckoned for many if the downward price spiral was not halted. Lenders faced the option of going for repossession, and possibly not recovering their money from proceeds of sale, or holding on until the property market improved. One problem with the second option is that if interest rates are raised there will be fewer demands for property and the market will be depressed. It must be emphasised that the economy is very property-based, and all these changes directly affect the ordinary man.

Recent price rises of consumer products and other products, such as petrol, have created another disturbing dimension to the market. The lack of purchasing power will adversely affect the markets of products, consumer or otherwise, and will in turn affect industries. The social effect of this can be far-reaching. Incidentally, it should be remembered that one of contributory factors to the worsening of the debt position of poor countries in general during the 1980s was the availability of loans on easy terms at a high rate of interest from banks and/or finance houses.

The financial markets collapsed again in the UK during the 1990s for similar reasons, and as a consequence many home owners found it difficult to repay their mortgages. A large number of properties were classified as having negative equity. Loans when made easily available increase "consumerism" in a variety of forms; consumers acquire goods which are often beyond their purchasing powers only to become victims of the law when insolvency results – not something which will necessarily benefit lenders. It is a legal process which many lenders often foolishly want to complete.

The contention that borrowers, and particularly credit card holders, should understand the extent of their long term liability and spend the money they borrow responsibly is a rather false argument because, like drug-addicts, credit card addicts do not act in a responsible way. It is not a question of binding an individual by means of a credit agreement only; the risks attached to such arrangements must be studied from a pragmatic standpoint. As credit card holders are often unable to manage expenditure within their income, they frequently take out multiple credit cards, which should be regarded as an alarming development but unfortunately is not. Often credit card companies allow an individual to have five credit cards with reasonably high loan limits, and there are cases of people being allowed to hold a higher number. Rather than denying the facility altogether, a limit to credit card holding could significantly reduce risks.

THE CAUSAL LINK

One need not look far to ascertain the causal link for this financial disaster in markets across the world. The risks were foreseeable; but in order to satisfy their greed, the market players became indifferent to the danger of causing misery to governments, ordinary savers, homeowners, industries and economies. The consequences of this risk-taking required governments to come to the rescue of markets which, in turn, caused taxpayers to suffer.

Many employees of broking firms in the financial sector have lost their jobs, and millions of ordinary people will also be asked to leave their employment, particularly in the private sector. But, who should be blamed for this? Neither governments, nor ordinary people – those at fault were the limited number of greedy people who were devoid of ethics in business or conscience.

Over the years a false money market has been created by certain banking firms with full knowledge of the consequences. Borrowing was made easier for almost everybody. The sub-prime mortgage system, which originated in the US, was primarily a system based on self-certification by a borrower of his/her income. This system passed the responsibility entirely to the borrower, without appreciating that the urge to own property may often motivate such a person to raise money against the hope of higher future income which may not materialise. Borrowers failed to maintain their repayments, and the incidence of repossessions of properties rose; the lenders could not retrieve the full amounts from their borrowers, and yet they kept borrowing on the financial markets.

The major money markets heated up by making credit readily available. Consumerism grew, but ultimately many credit cards holders failed to meet their repayment obligations, which in turn did not allow banks and finance houses to honour their obligations to their lenders. Thus, banks and finance houses borrowed to lend, but they became short of funds with which to repay their own lenders. To add to the problem, in many cases shares were overvalued.

As stated earlier, all these ventures were directed at short-term profits for a long-term loss which would affect people and business houses and industries across the world. In the early part of October, the British prime minister pointed out that financial markets lacked morals and took irresponsible risks. He also reminded everyone that wealth creation should not be treated simply as a privilege, and must be carried out responsibly. In the laissez-faire economy, unnecessary risk-taking by banks and finance houses compelled governments to nationalise or part-nationalise banks. Even Iceland, a small island country, was required to pay the price for an economic boom that saw its newly affluent companies go on a buying spree across Europe.

The reputation of the money markets in the west, particularly those in the UK and US, have been tarnished. The insolvency of Lehman Brothers, followed by Merrill Lynch being taken over and Goldman Sachs and Morgan Stanley having to become commercial banks, together were enough for investors to lose confidence in these markets. The US collapse followed falls in Asia and Europe.

Ironically, the head of Lehman Brothers was reportedly paid more than £170 million since 2000, and many other chief executives of large banks also amassed great wealth over a short period of time. The ethical aspects of financial business are examined in the next section of this article.

DO ETHICS HAVE ANY ROLE TO PLAY IN FINANCIAL MARKETS?

"Ethic" stands for "a set of moral principles; the moral principles by which any particular person is guided or the rules of conduct recognised in a particular profession or

area of human life" (*The New Shorter Oxford English Dictionary*, Oxford, Clarendon Press (1993)).

The obvious question that may arise is – whose ethics? In so far as financial markets are concerned, it would be the collective ethics of a market, that is, the ethical standards that a market may develop for carrying out its activities. Ethical standards may be achieved by means of codes of conduct, and a system can be put in place whereby any breach is dealt with by the appropriate regulatory body. In this way, codes of conduct may be legally enforceable. In the UK, the Financial Services Authority has the power to discipline recalcitrant dealers or financial advisers when they breach provisions of the Financial Services and Markets Act 2000 or rules made under it.

A code of conduct may be preferred to statutory provisions in that the former is directly concerned with the ethical standards set by a market, whereas the latter often presents interpretational difficulties and the wrongdoer may avoid any liability whatsoever. For this reason a code of conduct may be more pervasive than legislation. Indeed, before the 2000 Act was brought into force, the financial markets in the UK were broadly governed by codes of conduct. The scope of codes of conduct is much broader than that of any legislation, and as stated above there is no reason why such codes may not be legally binding. In England, most of the professions are governed by their respective codes of conduct, be they lawyers, doctors or accountants. These codes may also be applied in conjunction with the relevant legislation or common law rules where relevant and necessary.

Why are ethical standards so important for financial markets? Financial markets usually deal in others' money. These markets and the players on them are risk-takers. It is elementary that risks can yield profits as well as losses. It is through the skills and judgments of players on markets that the incidence of risks must be minimised for two reasons: (a) confidence in investors must not be lost; and (b) unnecessary risks must not jeopardise investment. In recent months, both these issues have been disregarded, apparently to satisfy the personal greed of brokers on markets; and if the issue of personal greed is denied, those involved have to agree that they were indifferent to risks which might lead to failures of financial institutions, including banks and insurance companies, in addition to corporate and non-corporate bodies (including charities) and individual investors.

This is where ethics become important. There must be a procedure whereby ethical standards should guide brokers and other relevant institutions in determining whether a risk is worth undertaking. The sub-prime lending which became popular in the US flowed into other overseas markets, but the risks involved in this kind of lending were foreseeable to lenders. Doing something with the knowledge that it might harm others is totally unethical, even though the action in question may not be caught by any legislative provision.

Furthermore, legislation will only catch the culprit after the risky act has been committed unless, of course, regulatory authorities have been involved by somebody before the act was carried out. Codes of conduct should hit the conscience of the wrongdoer, and may prompt him/it not to do the wrongful and unethical act. Conscience-building within the financial markets will help people to determine whether a particular action is unethical; it is not difficult for someone to decide one way or the other. On the other hand, if the markets are solely governed by legislation, a wrongdoer, as stated above, might save himself/itself under the interpretational cloak.

Under the 2000 Act, financial advisers are required to serve their clients' best interests. This requires consideration of ethical issues, that is whether a particular piece of advice would be "just" for the client from an ethical standpoint and protect his/its interests. There is no reason why such ethical consideration may not be taken into account as regards stock exchange activities in which bonuses, large or small, are involved.

In this context one should reflect on the effect of de-regulation, which has allowed financial markets freedom from restrictions. This is an onerous task, and it places a very heavy burden on those who deal with investments, public or private. The current credit crunch and the collapse of markets confirm that the burden of well thought-out investments is not being appropriately discharged. In other words, the abuse of de-regulation has come to the forefront.

Strong ethical standards are required in addition to legislation to govern the admission of investments to markets. England has a remarkable history in this area, but sadly English markets have slipped recently from their traditional ethical standards and betrayed investors.

WHAT DOES GOVERNMENTAL INTERVENTION MEAN AND WHAT ARE ITS IMPLICATIONS?

Governments often borrow money from financial institutions, but ironically they are now required to lend them money for their survival and for the protection of depositors. These loans have to be funded primarily by taxpayers, which is an undue burden on them. Intervention in this form involves the government taking control of failing banks by investing in their shares/stocks, and exercising close supervision and control. This may be regarded as a form of nationalisation of banks (Northern Rock is an example). The government exerts control over the institution, and is of course involved in managing it. This is not an example of a public-private initiative; the bank is transformed into a government controlled body – a public institution.

From a legal standpoint, public institutions are stronger than private institutions. They need not necessarily be profit-driven, and nor should there be any assumption that

these institutions are, by nature, less efficient than private institutions. Depositors may have more confidence in such institutions, as the assumption always exists that in addition to providing legal protection the government will safeguard its interest in any way it can.

There is no reason however why such institutions may not be good players on stock exchanges; their methods risk study will be of a conservative / protective nature and that is what investors want. Rates of interest on deposits or loans need not be different from those that may be offered by private banks, as both types of institutions are governed by directions from same institutions.

This is not to suggest that private banks are less efficient than banks controlled and managed by a government. In a laissez-faire economy, private entities must be provided with opportunities to participate in all spheres of an economy, except those that may be kept under the exclusive control of a government for various reasons (especially in the public interest). But when abuses of the laissez-faire system become manifest an extra burden is imposed on the government in respect of the banks it controls, in addition to the general problems created when people's investments and deposits are placed in jeopardy.

WILL BAILMENTS BY GOVERNMENTS WORK?

The generally accepted view has been that by providing funds to failed banks or financial institutions, the governments concerned would be able to save them from even more financial disasters in that many would not be inclined to make investments in banks and other sectors of the economy. The published figures for bank bail-outs by the US and UK governments were enormous. In view of the amount lost by each of the affected banks, the amounts budgeted by the governments may not be enough. It is not a question of coming to the rescue of one bank or two – the "domino effect" may not be avoided, and in that event, the money provided by governments would be deemed to be an act of throwing good (taxpayers') money after bad.

There are three issues that should be born in mind in this regard: (a) that the banks' risk policies and risk studies were in themselves risky; they decided to take undue risks, which is contrary to the British banking policy, and failed themselves and the markets; (b) that banks, in general, seem to have run out of their cash to meet their commitments (a liquidity crisis) and also that lenders have no confidence that the borrowing banks have enough assets to cover their liabilities (a solvency crisis); and (c) that the supervisory bodies also failed to supervise and control the reckless actions of banks, finance houses and stockbrokers. From a pessimistic standpoint, it can be said that banks, finance houses and stockbrokers have created what may be described in popular jargon as "bottomless pits"; can government hand-outs give those pits bottoms of some kind?

Transfusing money into the bodies of banks is a laudable act on the part of governments. It is timely and conscientious, but one important issue should be remembered in this respect. A transfusion is a short-term emergency measure; investors must be encouraged to invest again, and confidence in British banks must be created in their minds. No active efforts seem to have been made by the government in this regard. On the contrary, to make things even worse, newspapers have been constantly singing pessimistic songs which have adversely affected the property market, in disregard of the fact that the economy is very property-linked. Pessimism all around at a time of distress does not help. Sterling has been taking a battering; the importation of foreign products will cost the country even more, and the downward slide will be sharp.

Suggested measures to control the risk-takers would have satisfied current or prospective investors, and encouraged them to invest again. A revised supervision plan by the regulatory authorities in the UK should have been published by now; these bodies should perhaps be advised to return to the supervision policies embodied in the Banking Act 1987. One must not forget that the credibility of the British banking system is at stake. The ordinary public and investors may not be parties to the blame game and the disaster, but they should be treated with respect. They contribute to the banking system, but neither the government nor the banks seem to have saved enough, as a form of budget surplus, to avert or cope with this situation.

CORPORATE SOCIAL RESPONSIBILITY

Much has already been published by academics on the concept of corporate social responsibility, although its meaning and connotations still provoke controversy. The concept of corporate social responsibility entails a degree of vagueness, and it fails to explain why "corporate responsibility" should not prevail over "corporate social responsibility". This latter concept perfectly suits the perceptions and aspirations of the international community if corporate bodies, in practice, demonstrated their responsible behaviour towards societies. But, the extent to which their responsibility should be extended is not clear.

Generally speaking, the popular belief has been that corporate bodies should not be concerned with profit maximisation, and that they should not do anything which may be termed as "unethical", such as pollution of the environment; employment of child labour; "black" employment; a lack of transparency about corporate management, investment in controversial sector or countries; a discriminatory employment policy etc. A corporate body can be compelled by legislation to observe these responsibilities; indeed, in countries in which the law of negligence exists, it becomes much easier to take corporate bodies to task. The so-called corporate social

responsibility concept becomes otiose when corporate bodies are required by legislation or under common law to perform their duties to society. Thus, law can help corporate bodies to satisfy their corporate social responsibilities."

Furthermore, codes of conduct developed by corporate bodies may help them set an example and satisfy statutory requirements while raising the ethical standards of both the bodies and their employees. High ethical standards observed by employees, founders and managers will in turn help to satisfy the exercise of corporate social responsibility by corporate bodies.

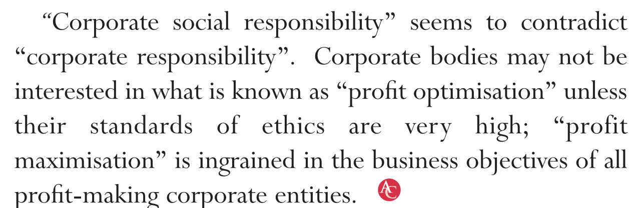
However, the dilemma remains whether the concept of corporate social responsibility is more important for a corporate body than corporate responsibility. There is no denying the fact that corporate bodies are required to demonstrate their sense of responsibility towards societies and the international community, but the issue remains that the bodies' principal responsibilities are towards their shareholders (corporate responsibility). Anyone accepting that premise is also obliged to accept the view that profit maximisation for shareholders should be the prime objective of corporate bodies. It may be maintained however that within the process of profit maximisation, corporate bodies must not depart from the theme of corporate social responsibility.

A corporate body can satisfy the requirements of corporate social responsibility by meeting the required minimum level of responsibility under the law, but the domain of corporate responsibility is limitless. Shareholders must be rewarded with the maximum amount of profits by any means, provided the minimum level of corporate social responsibility according to the law has been satisfied.

Relating this discussion of corporate social responsibility and corporate responsibility to the recent credit crunch and collapse of the financial markets, it may be stated that banks, finance houses and stockbrokers were predominantly, if not exclusively, concerned with corporate responsibility (profit maximisation) in total disregard of the consequences of their actions for depositors, investors and the public in general. Indeed, as stated earlier, they were in breach of laws, regulations and codes of conduct in achieving their limited goals – maximisation of profits for themselves.

Whereas corporate social responsibility may be governed by legislation and codes of conduct, nothing exists within contemporary UK business practice to restrain the abuse of corporate responsibility. Greed and motivation for profit maximisation prevail in profit-making corporate bodies. Implementation of the concept of corporate social responsibility seems to be more likely in non-profit making institutions, for example, those in the public sector or non-governmental and non-profit-making bodies.

"Corporate social responsibility" seems to contradict "corporate responsibility". Corporate bodies may not be interested in what is known as "profit optimisation" unless their standards of ethics are very high; "profit maximisation" is ingrained in the business objectives of all profit-making corporate entities.



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