Social and alternative banking: project selection and monitoring after the New Basel Capital Accord

Alberto Lanzavecchia, University of Parma*
*Lucia Poletti**, University of Parma*

May 2005

Abstract

Any economic activity calls for the exercise of moral judgement. There are some economic activities that actively promote collective benefit as a primary or secondary aim, and there are others that aim to increase the value of a firm. Investment decisions always have collective impact, but collective returns may be ignored or considered less important in company management if the objective is the maximisation of shareholder wealth.

The allocative function exercised by banks in their credit activity may take this into account. Some banks nowadays focus on social profile, while others integrate the traditional approach with this new sensibility. But unfortunately banking regulations governing stability and soundness of the financial system make no mention of the social profile.

The New Basel Capital Accord was an opportunity to recognise that bank's objectives may not consist only of the maximisation of shareholder wealth. But it was a missed opportunity, in that it gave advantages to traditional commercial banks and not to banks focussing on collective goals. This paper puts forward proposals for integrating the Basel II framework with profiles of collective bank credit policy.
Social credit evaluation methods could help to identify those ethical banks which are more successful in meeting collective objectives. A sustainable credit appraisal methodology could have been examined by the Basel Committee and could have incentivated sustainable banking by giving it specific advantages.

JEL Classification: D61, G21, G31.
Keywords: social banking, alternative banking, socially responsible investing, investments appraisal, Basel II, new capital accord.

* Alberto Lanzavecchia is assistant researcher, University of Parma (Italy); alberto.lanzavecchia@unipr.it
** Lucia Poletti is Ph.D in Financial Markets and Intermediaries and assistant researcher, University of Parma (Italy); lucia.poletti@unipr.it
The Authors would like to thank Giulio Tagliavini and two unknown referees for their useful comments, remarks and suggestions on the first draft of this paper. We wish also to thank the chairman Daniele Previati and the other participants to the 5Th EURAM annual international conference (May 4-7th, 2005 - Munich) on "*Responsible Management in an Uncertain World*" for their constructive contribution to the discussion of this paper.

Introduction

The line of research into ethics and business and, in particular, ethics and finance, is very rich and diversified[1]. It is the task of ethics to debate the ultimate purpose of human action, and therefore of economic activities. Depending on the aims of the economic activity, the rules of the market operators' behaviour vary. If we modify the aim, it is logical to expect a modification in behaviour too. If the objectives of justice and equity are included among the economic agents' aims, their behaviour is influenced by these objectives.

The discussion about what should be the ultimate aims of economic activity is part of the debate in the equity and justice of the economic system. Economic actions and their results raise problems of distribution justice and behavioural equity[2]. This topic is particularly important for the financial intermediation system, as it is often felt that there is more danger of finance being estranged from ethics than for the world of business[3].

On one hand, applying economic-financial criteria in the selection of projects means favouring the allocation of resources to economically and financially self-supporting projects. This selection mechanism guarantees a place in the market for units efficient from an economic and financial point of view and, at the same time, guarantees the survival of the financial system.

On the other hand, the fact that investment analysis can also consider social and environmental profiles should surprise only the most superficial observers. Any economic activity calls for the exercise of moral judgement and there are some economic initiatives that actively promote a collective benefit as a primary or secondary aim.

We argue that the analysis of company decisions taken for profit motives can be strengthened by a logic that also pays attention to social and environmental profiles. Assessing and approving an investment means applying the right amount and quality of sensitivity in order to describe the decision-making framework. In some cases, this framework considers non-

[1] See, among others, Bianchi (1996); Boatright (1999); Caloia (1997); Cesarini (2003); Fondazione Giordano dell'Amore (1997); Perrini (2002); Sen (1987); Sen (1991); Sen, Williams (1982).
[2] See, among others, Arnsperger, Van Parijs (2000).
[3] Tettamanzi in Cesarini, Tettamanzi, Vigorelli (2003).

financial variables.

The allocation process of banks in their lending functions can also consider the non financial variables. Some banks have innovatively placed the social and environmental profiles in the centre of their activity[4]; others integrate this new sensitivity into a traditional approach[5]. The new regulations concerning minimum capital requirements (hereinafter referred to as the "B2 framework") pay no specific attention to this profile, and this is a shortcoming. Our paper makes proposals for integrating the B2 framework by including collective profiles of the banks' credit policies.

The paper is organised as fallows: section 1 offers an overview of the banks that set themselves collective objectives. Section 2 proposes a model to describe the project selection process according to final objectives: profit objectives and collective objectives. The framework highlights how hybrid cases play a primary role: there are a number of circumstances in which it is not clear whether the typical logical framework to be applied is that of profit investments or collective investments. There is also a surprisingly large number of cases in which it is useful to proceed with a more or less accentuated integration of the logics of analysis. Section 3 looks at the extent to which the new regulation on minimum banking capital considers these aspects, and suggests some areas for improvement in the regulation of social and sustainable banking.

[4] In Europe, examples are the banks federated in FEBEA (Fédération Européenne des Banques Etiques et Alternatives), European Federation of Ethical and Alternative Banks. FEBEA members are financial institutions whose aim is to finance social and solidarity-based economy. According to the Charter, the aim of the banks must not amount to seeking profit alone; the economic initiatives financed must follow goals of job creation (in particular social employment), sustainable development, ethical and cultural diversity, international solidarity, and fair trade. The federated banks are: Banca Popolare Etica (Italy), Bank für Sozialwirtschaft (Germany), BBK Solidarioa Fundazioa (Spain), Caisse Solidaire du Nord Pas-de-Calais (France), Caixa Pollença (Spain), Cassa Centrale Casse Rurali Trentine (Italy), Charity Bank (United Kingdom), Crédal (Belgium), Crédit Coopératif (France), Cultura Sparebank (Norway), Ekobanken (Sweden), Femu Qui (France), Fiare Fundazioa (Spain), Hefboom (Belgium), IGF (Switzerland), Merkur (Denmark), La NEF (France), SIDI (France), Tise (Poland), Fundació Un Sol Món (Spain), Vernus (Slovak Republic). (http://www.febea.org/index.html)

[5] For an exploration into the field of environmental and social dimension of sustainability in the banking sector, see Jeucken (2004). The research is focussed mainly on the environmental dimension of sustainability.

1. Social and alternative banking

The expressions ethical banking, social banking, sustainable finance and alternative banking refer to forms of financial intermediation aimed at evaluating the collective aims of projects, and the implications of these projects for the stakeholders, in the widest sense of the term. There are some differences between them, but what they all share is attention to the socio-environmental aims and impact of the projects financed. They are instruments that do not consider the financial profile as the most important objective.

The concept of 'social and alternative banking' is closely linked to the development of microfinancial activities. The term microfinance is general, and it means "the promotion and diffusion of forms of financial intermediation in favour of marginal market segments, which are difficult to serve effectively through traditional channels and methods of contact with the customers, due to their size, income structure, or due to lack of information"[6]. It includes a wide range of financial services (current accounts, savings products, credit and insurance activities) and targets segments of customers whose needs are not satisfied by the traditional financial intermediation activity. These customers are generally socially and economically weaker subjects, who are thus excluded from traditional intermediation circuits. This exclusion may be total, if the subjects in question have no contact with the financial system, or may be limited to certain products or services, such as access to credit[7]. Among microfinance activities, micro-credit is the specific one that grants loans to these segments of marginal customers[8].

The supply of products and services that respond to the specific needs of marginal segments of customers is therefore an economic activity that also has a social function, to the extent that it breaks down barriers to the financial system. The causes of financial exclusion may be removed through the specific reorientation of financial services[9]. For example, they may avoid applying conditions that make financial products unsuited to the needs of marginal customers, or they may avoid mechanisms that restrict access following an unfavourable risks analysis. The so-called "alternative finance", and more specifically the "alternative banks",

[6] Viganò in Viganò (2004).
[7] See Anderloni in Anderloni (2003) and Financial Services Authority (2000).
[8] The definition of microcredit adopted in the 1997 Microcredit Summit is: "programmes extend small loans to very poor people for self-employment projects that generate income, allowing them to care for themselves and their families".
[9] About the causes of financial exclusion see Financial Services Authority (2000).

find their own niche in this area. This reorientation does not necessarily take place within informal finance channels, as happens especially in developing countries, but it may also take place within formal intermediation channels. Thus a space in the market exists for financial banking intermediaries to create products and services suited to marginal customers, while respecting economic and financial health of the intermediary[10].

[10] This emerged during the conference *Investing in Microfinance, The Role of Banks*, held in Milan, Palazzo Mezzanotte, 18 November 2004. See also Harper and Singh Arora (2005).

2. Investment evaluation criteria: the technical-financial profile and the socio-environmental profile

The typical problem faced by businessmen in private companies or operators in organisations with collective purposes is assessing the use of cash for activities and initiatives with a return in financial, social and environmental terms. For this reason, both operators require methodologies and criteria to measure the profitability of the investment: *ex ante*, for selection and acceptance and *ex post*, to satisfy the reporting requirements imposed by the stakeholders on the use made of financial resources.

There are two possible approaches to assessment: objectives of collective interest, and objectives of private profit. The collective interest approach has historically been the almost exclusive prerogative of public intervention, for which investment decision-making procedures have been oriented to assessing effects on the community. The private profit approach is typical of investment decisions made by private companies, banks and other financial intermediaries, traditionally based on strict parameters of profit making.

It is also true that the attention of companies towards the social and environmental effects of their actions is growing, as is shown by numerous initiatives based on *Corporate Social Responsibility*. A certain shift in this direction has been encouraged by the financial markets, which are becoming increasingly attentive to the behaviour and characteristics of the issuers. The rapid growth of ethical funds and the increasing attention to pension funds bear witness to the existence of a category of investors interested in the way company activities are carried out[11].

As they are responsible for channelling the savings deposited by surplus subjects among the various deficit subjects, financial intermediaries have the opportunity to select subjects and projects for financing. In this sense, they can influence company behaviour by subordinating the allocation of financial resources to the existence of precise economic and socio-environmental requirements.

The monitoring carried out by the financial intermediaries on companies traditionally consists

[11] According to Avanzi SRI Research and SiRi Company (2004), in Europe the number of socially responsible funds grew from 280 in 2000-2001 to 354 in June 2004 (+26%). The total amount of assets under management grew from 14.482 billion euros at the end of 2001 to 19.034 billion euros at the end of June 2004 (+31%).

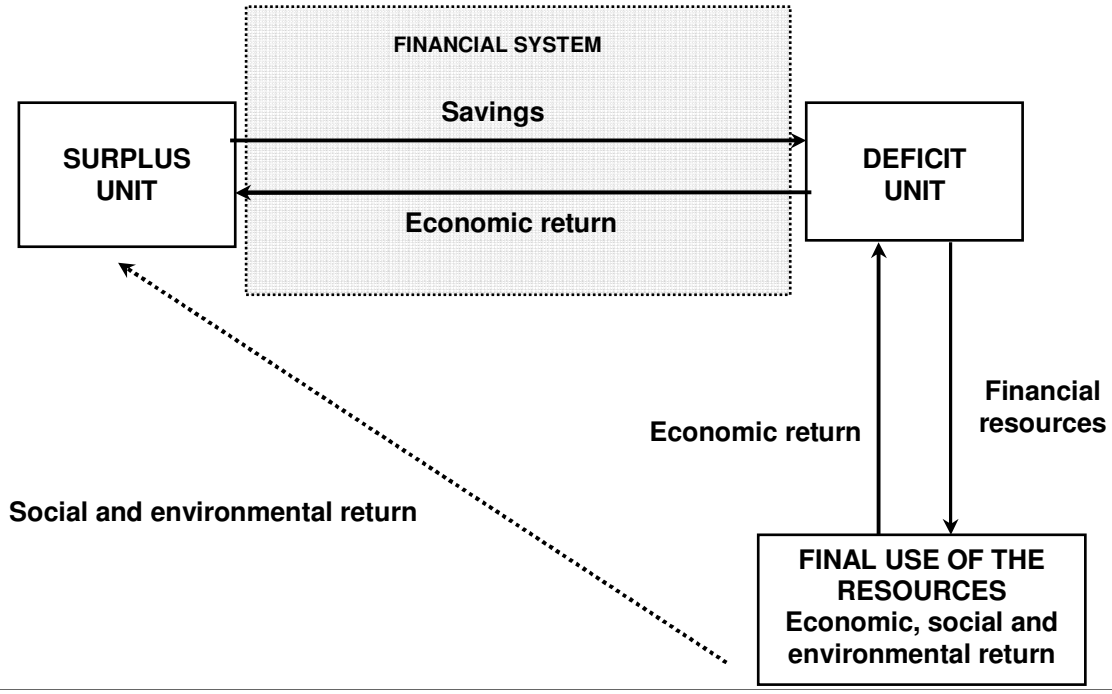
of monitoring return on investments and the solidity of the companies financed. Where collective demands emphasize other issues, the monitoring of the collective performance becomes important, as it is linked to the most important stakeholder objectives. This profile is not currently very important, but these issues are becoming progressively more like this.

For projects, the main traditional selection criteria widely accepted by practitioners can be traced back to DCF (*Discounted Cash Flow*) methodology, which measures the value of an investment on the basis of the current value of future incremental cash flows. However, for "wider" assessments, the models based on cash flow alone must be integrated or supported by other types of evaluation.

Is financial return an objective or a constraint?

The implementation of a project, understood in its widest sense, always requires the use of financial resources, channelled through the financial system (Figure 1).

Figure 1 –The role of the financial system in meeting financial needs



Yunus suggests that the return from activities in which resources are invested comprises two components: economic/financial return and social return. Some entrepreneurs may be driven solely by the profit motive. Others may be driven by social consciousness, running their

activity as long as it is financially viable[12]. Doubt has been cast, in fact, on the simple diagram where the for-profit / financial objective / social constraints sector is counterposed to the non-profit / financial constraint / social objective sector.

Identifying where financial return is an objective and where it is a constraint may appear a simple problem. But this is not the case. In the traditional scheme, saleable goods and services are products designed to make a profit and belong to the profit field. Goods and services that are not saleable, when worthy of any attention at all, are offered through an altruistic logic, that of non-profit. The non-profit sector sees the financial profile as a constraint in reaching its own objective. The for-profit sector sees the financial profile as an objective to be achieved. The set of cases in which financial return is an objective and the set of cases in which financial return is a constraint are not strictly separate. Microcredit is an example of activity run either by for-profit or non-profit organizations, with the main aim of achieving social goals.

Investment policies and financial intermediaries

On the basis of the somewhat brief considerations made up to this point, we distinguish cases of financial behaviour where the profit objectives and the non-economic objectives vary between a range of possible extremes. Table 1 illustrates this distinction in behaviour, which can be operated by financial intermediaries in their role as project financers. The squares are shaded according to the importance to the financer of profit or social-environmental impact.

Policies A, B and C consist of financial operations with capital repayment on maturity, against which payment of an appropriate recompense of the risk is foreseen. The project financed may be profit-oriented, or non-profit oriented, but in any case it is financed against the obligation to repay the capital. Policy D, defined in the table as “grants”, consists of financing projects without any obligation to repay the capital. To all extents and purposes, therefore, it is a donation

[12] See Yunus (1998).

Table 1

			Aims of the investor	
		Policy	**Profit**	**Social-environmental impact**
Capital repayment area	A	Financing for profit projects		
	B	Financing for profit projects with social-environmental evaluations		
	C	Financing non-profit projects		
	D	Grants		
Objective				
Constraint				

The objectives of the financial intermediary influence the nature of the projects financed (profit or non-profit) and the nature of the analyses carried out during project selection. The existence of operators interested in taking action on all four levels clearly affects the space for those who decide on fund allocation (banks and foundations or charities). Various possibilities are therefore defined to implement projects that are oriented to varying degrees of both private return and/or collective return.

Differences between the various models of financial support can be seen in Table 2. The natural area of intervention of commercial banks is model A in Table 2. But over the past few years, in step with the increasing foothold of CSR, banks have begun to pay attention to the effects of the financed projects on the community, and have introduced assessment of social and environmental compatibility into the analysis of the credit-worthiness, thus moving towards B-type policies[13].

[13] See Jeucken (2004).

Table 2

	Policy	A	B	C	D
		For-profit projects	**For-profit projects with socio-environmental evaluations**	**Non-profit projects**	**Grants**
1	**Operativeness**	Traditional banks	Traditional banks Alternative banks Ethical mutual funds	Traditional banks Alternative banks	Foundations Charities
	Beneficiaries	Companies	Companies	Non-profit organisations	Public sector entities Private non-profit bodies Other foundations Other charities
2	**Investment evaluation criteria**	Solvency	Solvency Social and environmental compatibility	Extended solvency (new bankability) Social impact	Professional profile or reputation Social impact

Traditional banks also finance non-profit projects and organisations, somewhat marginally or as a secondary business area, in which in any case they evaluate solvency. Generally, traditional banks tend not to enter into the socio-environmental impact of the projects, following the classical credit analysis prior to granting loans. They rarely offer differentiated analyses that bear in mind the specific elements of the sector.

Financing policies for profit projects that pay attention to social and environmental issues are, on the other hand, becoming more and more common in mutual funds. In selecting the shares in the portfolio, “ethical” or “socially responsible” funds adopt criteria with varying degrees of selectivity. This sector is now universally known as SRI (*Social Responsible Investment*). Negative screening is the most simple selection criterion, involving the exclusion from the portfolio of shares in companies that manufacture products that are harmful to dignity, to fundamental rights, human health and/or in companies that work in the weapons industry. Alongside negative screening we may often see positive screening. Among those companies

passing the negative screening, the ones who are best positioned in terms of parameters based on the analysis of corporate social responsibility are selected. For positive screening, the following are examples of the elements assessed: internal social policy (e.g.: working conditions), environmental policies (e.g.: waste treatment and emissions), relations with the institutions and the local community. The CSR elements are usually assessed by external bodies, that are to all extents ethical rating agencies. In any case, socio-environmental screening goes hand in hand with the financial assessment, which concerns the progress of the shares in the market.

Investment evaluation criteria and logic: solvency or credit worthiness?

The different nature of financed projects affects the choice of criteria and the assessment logic used for investments. For A or B type financing as shown in Table 2, solvency, understood in the traditional sense as the capacity to face up to contractual obligations in a precise and punctual manner, plays a central role. It is the analysis of the solvency of profit projects that is sometimes integrated with socio-environmental assessments.

For financing non-profit projects, the concept of solvency has a different connotation. In fact, solvency can be understood not only on the basis of economic-financial elements, but also with reference to the characteristics of the organisation and the methods used in relation to the outside world. The assessment of solvency can be based, therefore, on the economic situation and assets of the subject requesting financing as well as on direct knowledge of the subject (or organisation) or the reasons for project implementation. Widening the analysis may lead to the consideration of "bankability" for subjects that would not otherwise be deemed like this if evaluated on traditional solvency criteria alone. Also in microcredit the assessment of solvency is not based on any collateral, but on the flows from the projects and on trust[14].

The investment selection criteria mirror the choices of the intermediary on the type of activity they intend to finance and on the requirements of the activity being financed. So the intermediary is the filter through which financial resources are allocated.

The use of both economic-financial criteria and socio-environmental ones is translated into a two-fold result in terms of allocation: the destination of resources towards projects with better

[14] See Yunus (2003).

social-environmental impact, and, among these, the destination of resources towards more efficient projects.

This approach is very different from the traditional approach to investment selection. The traditional approach sees, on the one hand, the problem of choosing profit investments, to which a specific class of decision-making criteria is applied. On the other hand, it sees social and collective initiatives that are not oriented to profits, and therefore elude financial criteria. These initiatives are evaluated using completely different criteria. These differences in approach also have repercussions for operators dealing with the two types of assessment.

The traditional approach is too simple. We should by now be able to accept that there is a continuous spectrum of possibilities, from the exclusively profit-oriented initiative to those that are most radically non-profit[15]. In the in-between cases, which are the interesting ones, an assessment strategy has to be developed to combine the two profiles.

The integration of financial and collective criteria presents a number of precise applicational and logical problems:

- First of all, we need to verify whether a sufficiently shared system of values exists that can be used as a basis for the collective evaluation of investments;
- Secondly, we need to identify the most appropriate method of integration for collective and financial criteria.

Regarding the second point, it is useful to highlight that it is possible to identify the social/environmental merit of the project either as a binary variable, or as a continuous variable. According to the first point of view, collective merit either exists or does not exist; some projects are acceptable, others are not. If such cases were presented in real life, the problem of the coexistence between financial and collective criteria would be very simple. It would be sufficient for the initiative to pass the social/environmental test in order to then apply the financial criterion.

In reality, the ethical problem of the social and environmental consequences is much more

[15] See Yunus (1998).

complex. Only in the clearest of cases it is social merit at one end of the spectrum, and it is therefore of little concrete importance. We need evaluation logics for the intermediate cases, as the ethicality of behaviour is a continuous variable. It can have extremely low levels (such as the production of weapons of mass destruction or drugs), extremely high values (such as the production of medicines to fight rare diseases), but also levels that are much more difficult to determine.

The approach used by some practitioners highlights the need for the coexistence of the ethical parameter with the financial[16]. These operators manage an evaluation grid using two axes (Figure 2): the horizontal axis represents financial merit, meaning the effect on the shareholders, which can go from very high to negative, with the loss of the entire invested capital; the vertical axis represents the social/environmental merit, meaning the profile of the effects on the community; this can also be very high, but also limited, but always in a continuous but difficult evaluation.
It is clear that the combined social/environmental and financial selection criteria should exclude projects that do not satisfy both parameters.

The optimal working space is in the top right hand quadrant (quadrant I), which is satisfactory from all points of view. Projects that can be placed in quadrant I have good indicators both in socio-environmental terms and in economic-financial terms, and therefore do not present particular difficulties for the operator in charge of deciding on the financing.

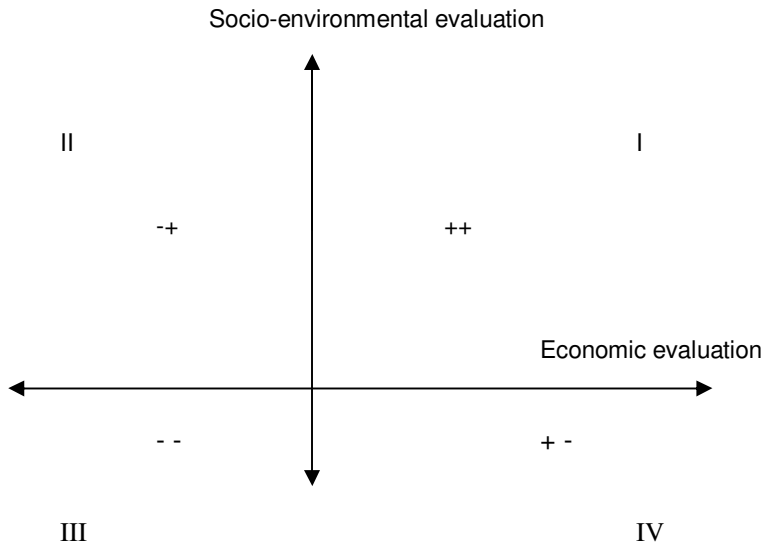
The top left hand quadrant (quadrant II) corresponds to projects that do not have an economic return but which are very important for the community. Non-profit organisations tend to be in this quadrant. This does not necessarily mean that these bodies should obtain financing simply because they provide services for the public good[17].

The bottom right hand quadrant (quadrant IV) should be excluded on regulatory grounds as well as through the ethical assessment.
Quadrant III should not be interesting for any operators, as it corresponds to activities that are not only harmful from a social and environmental point of view, but also produce negative

[16] See Bicciato (2000).
[17] It should also be remembered that the fact of being a non-profit body does not necessarily imply carrying out activities effectively useful for the community.

economic-financial results.

Figure 2 – Different types of evaluation



Source: Bicciato F. (2000).

The above situation underlines how the allocative function of the financial system must be judged from both an economic profile in its true sense and from a collective point of view. The social function of credit is a subject that is traditionally studied in financial intermediation economics, and there are areas of resource allocation for social purposes that are not traditionally managed by bank operators. The most significant experiences demonstrate that attention to the effects on the community reduces the incidence of insolvency in the loan portfolio[18].

Integration towards socio-environmental criteria

There is attention to socio-environmental aspects not only by those who believe that they can lead to improvement in economic and financial performance[19], but also by those who attribute an independent value to "responsible" behaviour of economic operators, whether these are companies or financial intermediaries. It is repeatedly stressed that economic operators should adopt ethically correct behaviour independently of the economic return that derives from that

[18] See the case of Grameen Bank.
[19] See Berman, Wicks, Kotha, Jones (1999).

behaviour[20].

The different methods used by the economic operators to demonstrate their orientation towards social and environmental aspects comprise initiatives to integrate economic-financial and socio-environmental aspects.

Tools for integration are usually affected by so-called "*stakeholders view*". In the case of businesses and banks, this vision is shown externally basically through social/environmental reporting and the other CSR tools or measures of stakeholders protection. In the specific case of the banks, however, special mechanisms could be set up to further integrate the borrower assessment process in addition to the traditional economic and financial analyses.
It is not possible to identify a sole theoretical structure integrating the two approaches. Nevertheless, not exclusively financial criteria are included in lending processes in the following cases:

- verification of the respect of environmental regulations[21] to stop any possible sanctions or legal action from reducing the value of the portfolio. Banks see the value of their assets threatened above all by the risk of the financed subject being sanctioned by its non-compliance with these regulations. They may therefore wish to carry out screening for this purpose, especially to verify whether a cost risk exists that could compromise the financed subject's ability to repay the debt. This is the case above all for environmental issues, which are governed by precise regulations.
- The signature of voluntary agreements, for example the Equator Principles of project financing, which require the assessment of the social and environmental effects of the project.
- Social and alternative banking, with primarily social objectives, which therefore carry out double screening; economic-financial to verify the solidity of the initiative and socio-environmental to verify that the activity carried out promotes or at least does not hamper the achievement of the socio-environmental aims.

[20] See Shiva (2002).
[21] This aspect has become more important above all following the issue of the European Directive 2004/35/EC of 21st April 2004 on environmental liability concerning pollution prevention and control, which establishes that "the prevention and control of environmental pollution should be implemented by applying the "who pollutes pays" principle". When assessing loans, banks therefore should verify the environmental measures taken by a company, above all concerning the fact that environmental investments generally have a rather long return cycle.

Finally, it should be remembered that institutional investors (such as ethical or socially responsible funds) carry out a two-fold assessment of the borrowers, both socio-environmental and economic-financial. This directly places the investor in the condition of carrying out a broad-based selection of the activities to invest in.

This kind of analysis has been implemented by the so-called "green banks", which include conditions concerning environmental investments in their contracts and include these variables in the credit assessment process.

3. The effects of Basel II on Social Banking: excessive fears and missed opportunities

The Basel Accord and investor protection

There are basically two objectives of banking supervision stated in the revised framework of the "International Convergence of Capital Measurement and Capital Standards", better know as the "New Capital Accord" or "Basel II", issued by the Basel Committee on Banking Supervision[22] in June 2004 (hereinafter referred to as the "New Accord"):[23]

1) to strengthen the soundness and stability of the international banking system through the introduction of minimum capital requirements;
2) to reduce the competitive differences between banks operating internationally through the introduction of minimum common rules[24].

Both objectives should also achieve a reduction of the probability of banking crises, thus a higher protection for investors, without compromising international competition in the banking sector.

To this end, the Basel Committee defines the minimum capital requirements for financial institutions through three steps:

a) the definition of regulatory capital, directly from accounting figures, destined to "protect" the bank from unexpected losses;[25]
b) the assessment of the overall level of the bank activity risks, measured by the Risk Weighted Assets (RWA), through the measurement of the three main sources of risks – credit, market and operating.
c) the establishment of a minimum ratio, of at least 8%, between the regulatory capital

[22] The Basel Committee was established as the Committee on Banking Regulations and Supervisory Practices by the central bank Governors of the Group of Ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.

[23] Cf. paragraph 4 of the New Accord. Objectives that had already been explored in the title of the document: *International Convergence of Capital Measurement and Capital Standards. A revised framework*, BIS, June 2004

[24] See Wagster (1996).

[25] For an analysis of the role of capital in financial institutions see: Berger, Herring and Szego (1995), Koch and Macdonald (2003), Santos (2001).

and the RWA.[26]

Indeed, the strengthening of the soundness and stability of the banking system is also a social objective, as it aims to provide a greater protection to investors and small depositors. In fact, banks manage information, in brokerage activities, and mostly risks, in qualitative asset transformation activities, to gain an economic return[27]. The minimum economic capital[28] held by a bank provides a cushion to absorb losses and to remain solvent, by assuring that the value of the assets (e.g. investments) will never reach the value of the liabilities (e.g. depositor's and other creditors money). Bank capital also provides access to funds against liquidity problems[29] and it constrains growth and shareholder's returns[30].

The protection guaranteed by the banking regulation aims to protect the money entrusted to the banks by depositors and investors. Denying this ethical and social aim, accusing the New Accord of being a source of capital rationing or of any other damaging effects on borrowers, is a malicious and a poor interpretation of the facts.

The New Accord makes no proposals or provision on pricing and investment decisions. These

[26] Much banking literature (for example, Kahane 1977 and Di Cagno 1990) suggests that constraining the portfolio
composition of an intermediary or specifying a minimum capital requirement by itself cannot generally be regarded as an effective way of limiting the probability of ruin for a firm. However, a combination of these regulatory instruments may achieve the desired result. Lackman (1986) and Kim and Santomero (1988) show that different commonly used capital adequacy constraints have different effects on bank portfolios.

[27] See Bhattacharya and Thakor (1993). Borrowing-lending activity transforms maturity, divisibility, liquidity and credit risk of funds raised and capital employed. That's why it is often referred to an "qualitative asset and liability transformation".

[28] More formally speaking, banks should hold equity capital whose market value should be able to offset future, unidentified and unexpected losses (e.g. the value-at-risk of banking activities). Since the market value of equity has to be assessed, but a unique valuation method cannot be applied throughout different countries and banks, the Basel Accord has set up a proxy solution: the market value of equity is substituted by a "modified" book value of bank capital. According to Matten (2002, p.32), "these rules are necessarily crude, as they have to be applied to banks across a wide range of businesses, legal systems and accounting practices". This is consistent with the weaknesses of the new and the former Basel capital accord shown, among the others, by Koch and Macdonald (2003, p.484), and Sironi (2005). Not surprisingly, the Basel Committee is aware that interactions between regulatory and accounting approaches can have significant consequences on capital adequacy (par. 12, New Accord).

[29] Pringle (1974) argues that in addition to the traditional function of risk-bearing, capital is important in adjusting the maturity structure of liabilities. Pringle's main conclusion is that market-determined capital structures are preferable to those imposed by regulators and supervisors. However, Taggart and Greenbaum (1978) believe that the market-determined capital positions may vary widely according to the regulatory setting. According to Alexander, (1990) because of the lack of uniformity in bank accounting and disclosure, it is not possible to compare the performance of banks across European borders. Since regulatory capital is influenced by accounting standards, it has been argued by Buser, Chen and Kane (1981), that "asset side" minimum regulatory requirements, such as the "Federal Deposit Insurance", would be preferable.

[30] For an analysis of the effects of the capital structure on the cost of capital, see Davis and Lee (1997), Wall and Peterson (1998) and Sironi (2001).

are decided and implemented according to the objectives of each bank. While it cannot be denied that bank capital is a scarce resource, and therefore has to be optimised, it is also true that such optimisation must take place on the basis of a specific utility function.
From what has been stated above, it should be clear that the financial objective – to "create value" – is only sometimes the final objective of a firm, but at other times it is a constraint to the achievement of collective objectives.

The New Accord and freedom of choice in pricing policies

Equity capital is expensive since shareholders demand appropriate returns from risky investments. As a consequence, managers, in particular those of banks listed in a stock market, act defining and carrying out policies and decisions designed to increase the market value of the firm. The pricing policy in banks whose objective is the maximisation of shareholder wealth (e.g. "value creation") is very simple and clear. These banks might tend to transfer the marginal cost of the scarce resource – the equity capital – to another stakeholder: the customer. As the minimum capital requirement is a constraint to growth and profitability, the marginal cost that would otherwise be borne by the banks must be necessarily transferred downstream to corporate customers.

The transfer and the transformation of an explicit cost (e.g. the expected return of the bank shareholders) into a hidden cost, from a bank to its corporate customers, is carried out in two ways:

1. By asking the corporate customers to increase their own equity capital, offering in exchange the same spread for lending. This strategy allows the bank to absorb less of its regulatory capital (thus avoiding future increases in capital), by reducing the credit risk of the counterpart. The marginal cost of capital of the bank (explicit) is paid (implicitly) by the corporate customers through its own recapitalisation.
2. By increasing the cost of the financing (e.g. the "credit spread") to those companies that do not want to increase their capital, in an amount equal to the marginal cost of the regulatory capital absorbed.

Any commercial pricing strategy and banking operation policy is independent of the New Accord, which defines only the standards for international competition and minimum capital requirements. The pricing of the activities is left to the discretion of bank management, according to bank objectives.

Pricing considers the weighted average cost of the bank capital,[31] in which the cost of equity capital is only estimated and depends on the utility function of shareholders. In fact, in pricing their activities, banks with financial objectives will also include shareholders' expected return. Banks with collective objectives, but necessarily with financial and solvency constraints, will include all the monetary costs of funds and of their operating structure, but their shareholders expected return might not only be transferred downstream in the pricing, but might not even be a financial or market cost.

Social banks, or those with collective aims, are therefore freer than "traditional" banks to choose their own commercial policies, within the constraint of the New Accord.

The New Accord and customer differentiation according to credit risks: no penalisation for social banks

Banks that implement investment policies shown under letters B and C in the previous Table 1 do not gain anything by adopting internal rating systems for credit risk,[32] as most of them operate with customers in a retail portfolio (or Small and Medium Enterprises – SME).

For them, the alternative methodology will be to measure the credit risk in a standardised manner, supported by[33] external credit assessment institutions recognised as eligible for capital purposes by national supervisors.[34]

It is clear that, unless the supervisory authorities intervene, credits to companies will predominantly be weighted with a coefficient of no more than 100%,[35] that is the same it was

[31] See Watson (1977).

[32] For definition and the use of the "internal rating based –IRB" approaches to credit risk, see Second Part, Chapter III, of the New Accord, June 2004.

[33] It has been argued that this criterion is never applicable in developing countries because there are no rating agencies at all; even if there were, it would take a long time for them to set up and to test an adequate rating model. If this ever happens, the rating agency marginal cost will be higher than the marginal interest margin on lending. See the comments on the Third Consultative Paper on the New Basel Capital Accord (CP3) from Tanzania, Trinidad and Tobago, Zimbabwe, available for download from www.bis.org.

[34] However, it must be said that while internal rating systems are subject to the explicit approval of the bank's supervisor, the rating methodology adopted by ratings agencies is undisclosed and legally protected.

[35] Ratings are requested (and paid for) by companies: those with a rating below BB- will prefer to have not any rating at all and be classified as "unrated". However, claims on sovereigns or developing countries are now penalized, as the possible risk weights are 0%, 20%, 50%, 100%, 150% (depending on credit assessment) while under the first Capital Accord most of them fell under 0% or 20%; never above 100%. Associated with this fact, there is the wider concern that the higher capital absorption for exposures to most developing countries would

foreseen in the previous accord of 1988. Furthermore, retail clients and SMEs with no credit rating benefit very much[36] by the New Accord, if the credit satisfies the following four criteria:[37]

1. Orientation criterion: the exposure is to persons or to a small business;.
2. Product criterion: the exposure takes the form of revolving credits and lines of credit, personal term loans and leases, small business facilities and commitments.
3. Granularity criterion: the retail portfolio must be sufficiently diversified to reduce the risks in the portfolio as far as to justify a weighting of 75%.
4. Low value of individual exposures: the maximum aggregated retail exposure to a single counterpart cannot exceed € 1 million.

From this point of view too, the New Accord allows a reduction in capital absorption, even for banks that do not operate with financial aims. In fact, beneficiaries of social banking activities often fall into the retail or SME category,[38] and this will result in a lower risk weighting. If beneficiaries of social banking activities are corporate borrowers, adopting the standardized approach, capital absorption will be at maximum equal to that calculated under the previous version of 1988.

Credit risk assessment based on internal ratings (IRB) is coherent with the financial objective of maximising the value of a firm. In fact, IRB is required in order to ensure the optimisation of returns on the scarce resource (e.g. the equity capital) or to transfer its marginal cost downstream to the customers. A bank operating with non-financial aims has no interest in differentiating its customers on the basis of credit risk in order to apply differentiated pricing. Either the initiative is worthy of the credit, or it is not. The credit risk is not evaluated (and priced) on every single investment decision, but rather on the basis of an overall portfolio of credits (which acts as a financial constraint). This means the standard approach is preferable for these banks[39] and, therefore they have nothing to fear from the New Accord.

---

result in a reduction in capital flow, or in an increase in the credit spread. Both situations would impede, or further slow, the development of markets and economy in these regions.

[36] In terms of a weight of 75% on the bank exposure.

[37] See paragraph 70, New Accord .

[38] It has been argued that the company turnover threshold for defining SME borrowers, € 50 Mln (par. 273, New Accord), does not take into consideration the differences in the level of economic development in different countries. The absolute threshold of € 1 million regarding the "Low value of individual exposure" criteria is also misleading, and an indexed version would be preferable. See comments received by Basel Committee on CP3 from World Bank and Developing Countries on BIS web site.

[39] This statement is consistent with comments expressed by the European Association of Co-operative Banks (2003) on the third consultative document "The New Basel Capital Accord" (CP3), Basel Committee (2003):

A missed opportunity: the differentiation between traditional and social banks

The New Accord was designed for and is applied to internationally active banks.[40] No distinctions are made between banks operating within a national boundary and international banks. Moreover, the New Accord makes no distinctions between value-oriented banks (shareholder view) and those with collective objectives (stakeholder view).

The distinction between value-oriented and social banks is not intended to remove the depositors' protection mechanism from the latter, but would recognise on one hand that these banks often operate on a strictly local basis (sometimes not even nationally), and on the other hand, the peculiarity of the credit rating mechanism might produce relatively high recovery rates.[41]

From the "operating area" distinctive point of view, the absence of international competition would allow social banks to operate with lower minimum capital requirements, without damaging or distorting the international competition too far. Investor protection could be guaranteed through the constitution of a special consortium guarantee fund (such as that offered by "Confidi regulation" in Italy), or through the insurance of the deposits.[42]

From the second distinctive point of view, seeing that for sustainable and social banking the credit risk acts more as a constraint to growth than as a driver to obtain proportional economic returns, an internal evaluation model should ideally differentiate activities on the basis of the credit worthiness.

"*the standardized approach must remain a serious (and competitive) method for smaller banks and institutions*", p.2.

[40] We remind that Basel Committee was established by the central-bank Governors of the G-10 countries. Evidences of the G-10 environment. Banks active on developing countries face a very different economic environment (such as the absence of rating agencies; deep different thresholds that defines small businesses etc.) and risks (currency risk is higher).

[41] For example, Grameen Bank's recovery rate of 90 per-cent (with 94 percent of its loans made to women) is higher than the rate recorded by the Bangladesh National Bank, which only recovers 25 percent of its loans (ICDF, 2002). In fact, according to van Bastelaer (1999), when the lender is closely related to the borrower, the role of interpersonal ties is a central element in ensuring repayment. If there is no *a priori* relationship between the borrower and the lender, social factors are less likely to be central elements in explaining credit discipline, and their mobilization requires significantly more effort. Thus, a critical factor of success is the quality of the relation between the borrowers and the lender and the existence of trust between them. The capacity of microfinance organizations to instigate high levels of trust is one of their main characteristics, and it reflects their ability to draw on the diverse social elements of their environment in developing successful credit activity.

A collective objectives bank would have as a trade off a penalisation or an incentive according to the level of the credit worthiness of the financed initiative. A credit portfolio with a high value in collective terms is worth more than one with a low value, assuming of course the full respect of the solvency and liquidity of the bank.

Coherently with the financial objectives of the "traditional" banks (e.g. value creation and shareholders' return), the New Accord has introduced an approach based on internal ratings: these banks can now improve their return on capital using this option. The New Accord favours value-oriented banks, but has not helped banks with collective objectives (of course, as we stated, that it has neither penalised them).

However, it would have been possible for the New Accord to provide for the needs of social banks. In fact, it could have allowed them the managerial option to better achieve their objective, that of benefiting the community. For example, it would have been possible to differentiate social banks introducing a two-stage procedure for the lending process: one economic-financial (credit risk) and the other social/environmental (credit worthiness).

Commercial banks have seen, with good reasons, their own need to optimise the scarce resource (equity capital) to reach their own satisfied objectives (shareholder's returns). But social banks have not received equally favourable differential treatment for the achievement of their own objectives.

[42] See Buser, Chen and Kane (1981).

4. Conclusions

Investment decisions are taken to achieve an objective: private benefits and/or collective benefits. In analysing banking investments, the decision makers need a formal framework to reach their decision to accept or refuse a loan. Such a framework has been used and formalised for a long time to analyse financial objectives, but investment decisions on projects with collective objectives are a relatively recent phenomenon.

The logical distinction between profit projects (financial objective-collective constraints) and non-profit projects (collective objectives-financial constraints) is not always identifiable, rigorous and constant over time. Precisely for this reason, there is a need of an analysis methodology that combines financial and collective logics. From the point of view of the banks, this translates into assessment processes that are not based only on the expected returns, but also on the collective effects generated by the project or by the borrower.

The recent New Accord on minimum capital requirements was designed for financial intermediaries from G-10 countries, more sensitive to shareholder's wealth. The New Accord outlines a framework that could further strengthen the soundness and stability of the international banking system, and, at the same time, achieve a collective object: the protection of depositors.

The revised framework does not penalise microcredit and loans to private and small and medium businesses, and in some circumstances it favours them. However, it has principally met the needs of those banks managed for maximizing the shareholders' wealth or the return on capital employed. In fact, facing important investments in credit risk assessment systems, these banks can now benefit from a reduction in capital absorption or can transfer the marginal cost of the absorbed capital downstream to their customers.

As they do not have the objective of optimising the return on the scarce resources (equity capital), social banks, or those with collective objects, do not find this innovation advantageous at all, and will probably continue to work with the previous method - the standardised approach. In this sense, the New Accord represents a missed opportunity to recognise and handle the huge differences within the banking sector: the economic environment, geographic boundaries and firm objectives. Commercial banks from developed countries have benefited from it, while others, and in particular social banks, have not.

References

Alexander W. (1990), *What's the Score?*, in ABA Banking Journal, August.

Anderloni L. (edited by) (2003), *Il social banking in Italia. Un fenomeno da esplorare*, Giuffrè Editore, Milano.

Arnsperger C., Van Parijs P. (2000), *Éthique économique et sociale*, La Découverte, Paris.

Avanzi SRI Research and SiRi Company (2004), *Green, social and ethical funds in Europe*.

Berger A.N., Herring R.J., Szegö G.P. (1995), *The Role of Capital in Financial Institutions*, in Journal of Banking and Finance, 19:3/4:393-430.

Berman S. L., Wicks A. C., Kotha S., Jones T. M. (1999), *Does stakeholder orientation matter? The relationship between stakeholder management models and firm financial performance*, in Academy of Management Journal, 42:5.

Bhattacharya S., Thakor A.V. (1993), *Contemporary Banking Theory*, in Journal of Financial Intermediation, 3:2–50.

Bianchi B. (1996), *Settore non profit, fondazioni bancarie e finanza etica*, in Mondo bancario, 2:3-10.

Bicciato F. (edited by) (2000), *Finanza etica e impresa sociale. I valori come fattori competitivi*, Il Mulino, Bologna.

Boatright J. R. (1999), *Ethics in finance*, Blackwell Publishers.

Buser S. A., Chen A.H. and Kane E.J. (1981), *Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*, in Journal of Finance, March.

Caloia A. (1997), *Cultura, etica e finanza: i nuovi termini della questione*, in Il Risparmio, 45:4/5:805-820.

Cesarini F.(2003), *Attività bancaria, etica e terzo settore*, in Quaderni dell'Università dell'Insubria, no. 22.

Cesarini F., Tettamanzi D., Vigorelli G., "*Orientamenti morali dell'operare nel credito e nella finanza*", documents from the conference "*Orientamenti morali dell'operare nel credito e nella finanza*", Milan, 24th November 2003, in Quaderni ASSBB, no. 207.

Davis D., Lane K. (1997*), A Practical Approach to Capital Structure for Banks*, in Journal of

applied Corporate Finance, pp 33-43.

Di Cagno, D. (1990), *Regulation and Banks' Behaviour towards Risk*, Dartmouth Publishing Company.

Financial Services Authority (2000), *In or out? Financial exclusion: a literature and research review.*

Fondazione Giordano dell'Amore (1997), *Finanza etica. Un primo bilancio delle esperienze italiane*, Conference Proceedings.

Harper M., Singh Arora S. (2005), *Small customers, big market. Commercial banks in microfinance*, ITDG Publishing.

International Cooperation and Development Fund (2002), *The Importance of Microcredit Programs in Sustainable Development,* Annual Report.

Jeucken M. (2004), *Sustainability in finance*, Eburon Academic Publishers.

Kahane, Y. (1977), *Capital adequacy and the regulation of financial intermediaries*, in Journal of Banking and Finance, 1:207–18.

Kim, D., Santomero A. M. (1988), *Risk in banking and capital regulation*, in Journal of Finance, 43:1219-33.

Koch, T. W., MacDonald S.S. (2003), *Bank Management*, The Dryden Press.

Lackman, C.L. (1986), *The impact of capital adequacy constraints on bank portfolios*, in Journal of Business, Finance and Accounting, Winter:587–96.

Matten C. (2000), *Managing Bank Capital, Capital Allocation and Performance Measurement*, John Wiley & Sons.

Perrini F. (2002), *Finanza etica: principi, prospettive e performance*, in Amministrazione & Finanza, 17:13:3-15.

Pringle, J.J. (1974), *The capital decision in commercial banks*, in Journal of Finance, June.

Santos J.A.C. (2001), *Bank Capital Regulation in Contemporary Banking Theory. A Review of the Literature*, in Financial Markets, Institutions & Investments, 10:2:41-84.

Sen A. K. (1991), *Denaro e valore: etica ed economia della finanza,* Banca d'Italia.

Sen A. K. (1987), *On ethics and economics*, Basil Blackwell, Oxford.

Sen A. K., Williams B. (edited by) (1982), *Utilitarianism and beyond*, Cambridge University

Press.

Shiva V. (2002), *Water wars*, South End Press, Cambridge.

Sironi A. (2001), *An Analysis of European Banks SND Issues and its Implications for the Design of a Mandatory Subordinated Debt Policy*, in Journal of Financial Services Research, pp 233-266.

Sironi A. (2005), *Rischio e valore nelle banche. Risk management e capital allocation*, Egea, Milano.

Taggart, R.A., Greenbaum S.I. (1978), *Bank capital and public regulation*, in Journal of Money, Credit and Banking, 10, May, pp. 158–69.

Tagliavini G. (1996), *Gli investimenti etici*, in Bancaria, 52:9.

Van Bastelaer, T. (2000), *Imperfect information, social capital and the poor's access to credit*, The Global Development Research Center.

Van Bastelaer, T., *Imperfect Information, Social Capital and the Poor's Access to Credit* (1999), University of Maryland, IRIS Center Working Paper No. 234., http://ssrn.com/abstract=260058.

Viganò L. (2004), *Microfinanza in Europa*, Fondazione Giordano Dell'Amore and Fondazione Europea Guido Venosta, Giuffrè Editore, Milano.

Viganò L. (1996), *La capacità di credito: analisi delle determinanti e strumenti per la valutazione nelle economie in via di sviluppo*, Fondazione Giordano Dell'Amore.

Wagster J.D. (1996), *Impact of the 1988 Basle Accord on International Banks*, in Journal of Finance, 51:4:1321-1346.

Wall L.D., Peterson P.P. (1998), *The Choice of Capital Instruments*, in Federal Reserve Bank of Atlanta Economic Review, 74:2-17.

Watson, R.D. (1977), *The marginal cost of funds concept in banking*, in Journal of Bank Research, Autumn, pp 136–47.

Yunus M. (1998), *Poverty alleviation: is economics any help? Lessons from the Grameen Bank experience*, in Journal of International Affairs, 52:1:47-65.

Yunus M. (2003), *Expanding microcredit outreach to reach the millennium development goal: some issues for attention*, presented at the International Seminar on Attacking Poverty with Microcredit, Dhaka, 8-9 January.