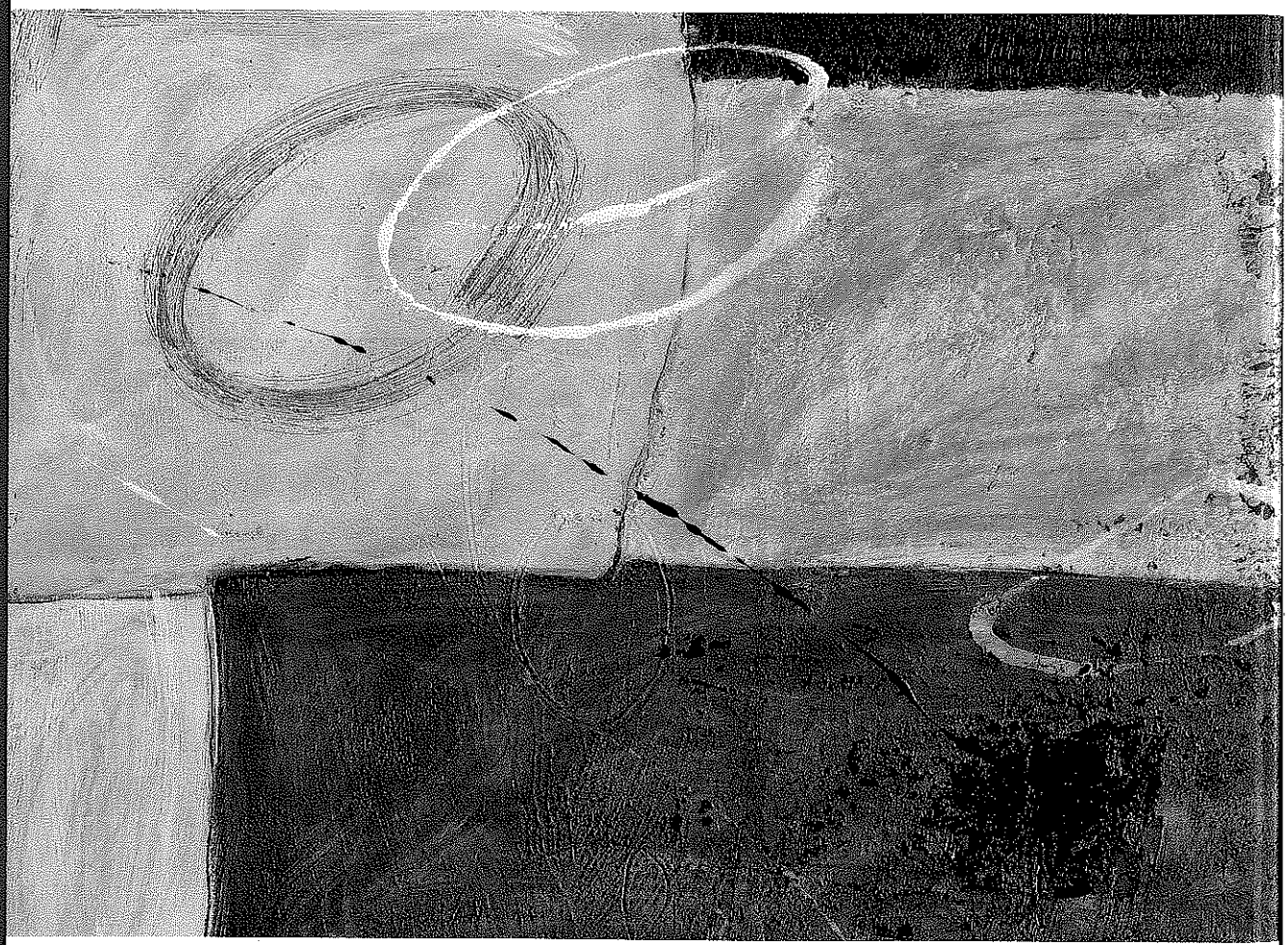
FINANCE ETHICS

Critical Issues in Theory and Practice



John R. Boatright, Editor

KOLB SERIES IN FINANCE

Essential Perspectives

Zelizer, Viviana. 1978. Human values and the market: The case of life insurance and death in 19th century America. *American Journal of Sociology* 84:591–610.
———. 1983. *Morals and markets: The development of life insurance in the United States*. New York: Columbia University Press.

ABOUT THE AUTHORS

Julie A. Ragatz joined the Center for Ethics in Financial Services at The American College in 2006 as a doctoral fellow. She received an MA degree in social and political philosophy from Marquette University and is pursuing her PhD in philosophy at Temple University. Ms. Ragatz has taught courses in ethical theory and business ethics at universities including Marquette University, Villanova University, and Saint Joseph's University. She has published numerous articles on ethical theory and business ethics. Her second book, *Accounting Ethics*, written with Ronald Duska and Brenda Shay Duska, will be published by Wiley-Blackwell Press in 2010.

Ronald F. Duska is the Charles Lamont Post Chair of Ethics and the Professions at The American College as well as the director of the American College Center for Ethics in the Financial Services. He is the author, co-author, or editor of numerous books and articles. His most recent books are *Ethics for the Financial Services Professional* (The American College Press, 2008), *Contemporary Reflections on Business Ethics* (Springer Netherlands, 2009), and *Accounting Ethics* (Wiley-Blackwell, 2003). He served as the executive director of the Society for Business Ethics and editor of the society newsletter, and is currently serving on the board of directors of the society.

We would like to thank Sara Taylor for her insights and helpful comments on this chapter.

CHAPTER 21

Responsible Investing

CÉLINE LOUCHE
Assistant Professor of Corporate Social Responsibility, Vlerick Leuven Gent Management School

STEVEN LYDENBERG
Chief Investment Officer, Domini Social Investments LLC

INTRODUCTION

Responsible investment is both a product and a practice (Gond and Boxenbaum 2004). Responsible investment (RI) is an investment *product* in the sense that in addition to financial factors, investors acquire, hold, or dispose of companies' shares on the basis of environmental, social, and governance (ESG) factors as well as ethical factors. It is a *practice* in the sense that RI is a way to identify companies with strong sustainability records and to engage with companies to encourage improved ESG performance.

Responsible investment goes by many names—it is variously referred to as socially responsible investing, ethical investing, sustainable investing, triple-bottom-line investing, green investing, best-of-class investing, or most simply as responsible investing. It has evolved over the years from the concerns of religious organizations; environmental, labor, and human rights activists; community groups; and shareholders in the corporations themselves.

Underlying these varied names and approaches is a common theme: *long-term value creation*. Practitioners of RI seek to generate both financial and societal value; to stimulate change toward sustainability within corporations; to steer investments toward the productive and socially beneficial use of capital; and to initiate debate on the proper role of corporations in society. *Value creation* in this context refers not only to economic value, but to the wider impact of companies on society and the natural environment, both today and in the future (World Economic Forum 2005). The RI community implicitly recognizes and acknowledges that investment as an activity impacts society and influences business's behavior and actions. In addition, ESG information helps investors better manage risk and make better informed investment decisions (Lydenberg 2007).

Among the key characteristics of RI are the following:

- Responsible investment encourages a long-term perspective in investing. It does so because (1) environmental, social, governance, and ethical issues

cannot always be captured by the market, which tends to be short-term in its perspective; (2) RI seeks to establish trust between stakeholders (employees, communities, customers, suppliers) and corporations, a trust that results from ongoing dialogue and persists over time; and (3) RI encourages corporate managers themselves to adopt a perspective that encompasses corporate social responsibility goals with long-term financial benefits.

- Responsible investment has a broad definition of materiality, which it conceives as relevant to all stakeholders (not just stockowners) and as striking a balance between that relevance (what matters to whom) and significance (how much it matters). This means that RI takes into account in its decision-making issues that have both short-term and long-term implications for investors, other stakeholders, and society in general (AccountAbility 2006).
- Responsible investment adopts a stakeholder perspective. At the core of the conception and practice of RI is the belief that all stakeholders in the corporation matter and that a productive and profitable company will invest in its full range of stakeholders, receive a return from all its stakeholders, and consequently be able to provide a long-term return to its investors (Post et al. 2002).

The objective of this chapter is to provide insights into the activity of responsible investment and to highlight some of its key challenges. The first section presents the history of responsible investment from its roots in the eighteenth century to 2009. The second section maps the different tools and strategies used by responsible investors. The third section focuses on the major players including asset owners, providers of support services, and related organizations. Lastly, the fourth section examines four major challenges the RI field is currently facing.

HISTORY OF RESPONSIBLE INVESTMENT

The concept and practice of responsible investment have evolved over the years in what can be classified as five primary periods. Each phase of this evolution is characterized by its own particular practices and concerns. Each new phase of RI tends to incorporate previous forms that persist and coexist with the new ones.

Although precise figures are difficult to come by, there has been a significant growth of assets under RI management and the number of RI funds over the years, a growth that, it is not an overstatement to say, has been explosive since the late 1990s. In the United States, RI assets under management were at $2.71 trillion in 2007, representing 11 percent of the $25.1 trillion in total assets under management (U.S. SIF 2008). RI assets have increased by 324 percent since 1995, a faster growth than the broader universe of all investment assets under professional management. In Europe between 2002 and 2007, the number of RI funds increased by 150 percent to 447 in 2007 (Lipper FERI 2008). Eurosif has placed the value of the RI market at €2.665 trillion as of December 31, 2007, an increase by 102 percent between 2005 and 2007 (Eurosif 2008). According to Eurosif's figures, RI accounts for 17.6 percent of total European funds under management. Exhibits 21.1 and 21.2 depict the growth in RI funds in the United States between 1995 and 2007. Exhibit 21.3 shows the growth in RI funds in Europe during the period 2002–2007, while Exhibit 21.4

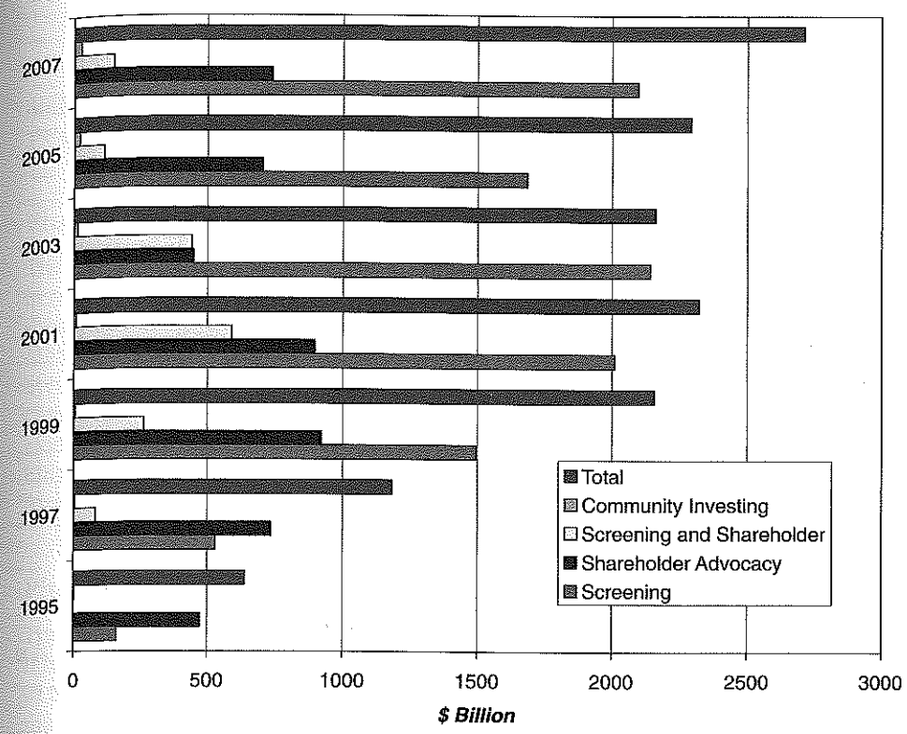


Exhibit 21.1 Responsible Investment in the United States, 1995–2007
Source: U.S. Social Investment Forum, 2008 report.

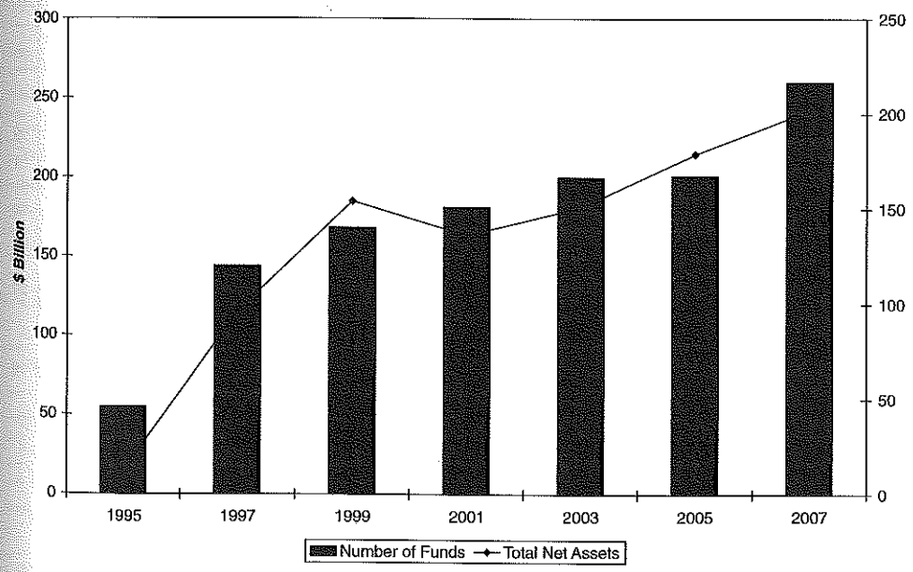


Exhibit 21.2 Responsible Investment Assets and Funds in the United States, 1995–2007
Source: U.S. Social Investment Forum, 2008 report.

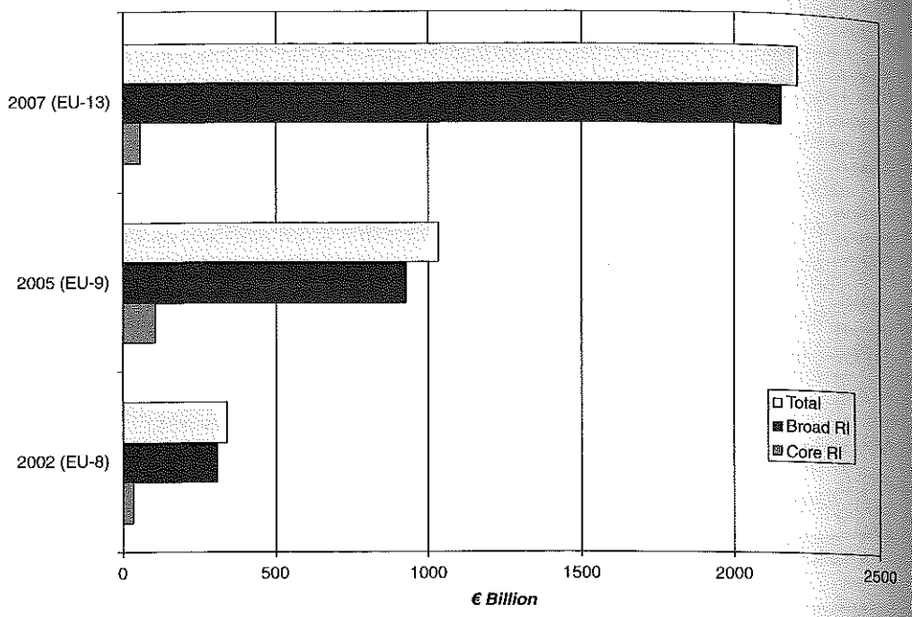


Exhibit 21.3 Broad and Core Responsible Investment in Europe, 2002–2007
Source: SIRI Group, 2007.

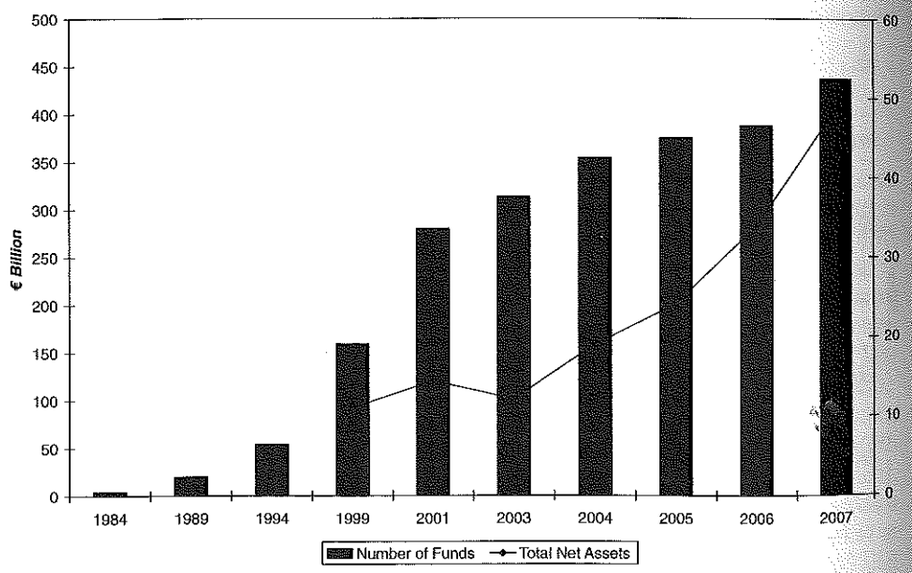


Exhibit 21.4 Responsible Investment Assets and Funds in Europe
Source: SIRI Group, 2007.

outlines the growth in number of European RI funds and their total assets from 1984 to 2007.

Phase 1: Roots

The earliest stage of responsible investment, before it was known as responsible investment, dates back to the eighteenth century (Domini 2001). For several hundred years religious institutions—such as the Society of Friends (Quakers) and the Methodists—were precursors to the modern form of RI in that they believed that investing was not a neutral activity, but implied values. They shunned "sinful" companies whose products conflicted with their basic beliefs. These so-called sin stocks were for the most part those of companies involved in alcohol, tobacco, gambling, and, in certain cases, weapons. One of the emblematic and first RI mutual funds of this first phase was the Pioneer Fund, launched in the United States in 1928.

Phase 2: Development

The second phase dates from approximately 1970 and runs through the late 1980s. It marks the beginnings of RI in the contemporary sense of the term and is typified in the United States by the Pax World Fund, launched in 1971, and in Europe by the Friends Provident Stewardship Unit Trust in 1984.

In the United States, this incarnation of RI originated in part in the political and protest movements of the day. The Vietnam War and apartheid in South Africa were two issues that in particular drove the RI movement of that time. Other citizen movements such as civil rights, women's liberation, and the environment raised issues of crucial concern to the RI movement and became a part of its lobbying of corporations on issues seen as unethical (Louche and Lydenberg 2006). At that time, Ralph Nader and Saul Alinsky, two U.S. consumer and community activists, started to use the shareholder right to appear at corporate annual meetings and to file shareholder resolutions to raise social and environmental issues directly with corporate management. Nader's General Motors campaign leading to the submission of two socially based resolutions on the annual meeting proxy ballot remains an historical moment. These tactics were soon adopted by the RI movement and became an important second tool for the responsible investor.

In the 1980s, RI also took root in Europe. The Friends Provident Stewardship Unit Trust was among the first ethical investment funds in the United Kingdom and a precursor to many similar funds. A number of eco-banks such as Triodos Bank in the Netherlands were also founded during that time.

Simultaneously, a number of RI support organizations were created, such as the Interfaith Center on Corporate Responsibility (ICCR) in 1971, the first two Social Investment Forums in the United States (1980) and the United Kingdom (1983), as well as the first professional RI rating agencies, such as KLD Research & Analytics (United States, 1988) and EIRIS (United Kingdom, 1983).

During this second period, RI developed in a political climate of social protest and was transformed from a faith-based activity (using ethical principles in the construction of investment portfolios) into an activity promoting a public awareness of the social responsibility of corporations and of investing (the self-conscious

phenomenon of RI) (Sparkes 2001). This was the period in which RI was first used to lobby corporations to adopt responsible and ethical practices.

Phase 3: Transition

During the early 1990s, RI began a gradual transition to a less confrontational approach with a strong growth in environmental concerns. The Brundtland Report, which highlighted and defined the concept of sustainability, was published in 1987. The Kyoto Protocol on climate change was ratified in 1997. For RI, this meant the emergence of so-called *green* funds, especially in Europe, less concerned with avoidance and stressing identification of specific positive sectors or activities linked to the environment, such as renewable energy and clean technologies.

During this period the number of social rating agencies grew significantly; the first RI index, the Domini 400 Social Index, was launched (1990); and corporate social responsibility (CSR) consultancy organizations such as SustainAbility began to thrive. These developments were typical of the new, more systematic and analytical aspects of this third phase with its emerging emphasis on sustainability and cooperation.

Phase 4: Expansion

The beginning of the twenty-first century heralded a turning point for RI in both its approach and its growth. This fourth period is characterized by the professionalization of the field and a growing worldwide interest in its practice. RI began to find acceptance in the mainstream investment community, leaving behind its more activist image and becoming a more commercially viable endeavor (Déjean, Gond, and Leca 2004; Louche 2004). This evolution was closely linked to the growing importance of corporate social responsibility and the increasing accessibility of CSR reports issued by corporations. The Global Reporting Initiative, launched in 2000, played a crucial role in this growing acceptance of CSR reporting by corporations and the increasing thoroughness and sophistication of these reports.

In the early 2000s, institutional investors started to become broadly involved in RI.[1] This growing interest on the part of institutional investors was partially stimulated by governments in Europe at both the continental and national levels. In several European countries, legislation and regulations required pension funds to publicly state the degree (if any) to which they took into account social, environmental, and governance considerations in their investment decisions. In the United Kingdom, RI pensions disclosure regulation was enacted in 2000, followed shortly thereafter by many other European countries. In addition, in 2001 the Norway Petroleum Fund adopted several RI policies, initiating a movement among major European pension funds toward the incorporation of RI practices. The interest of institutional investors in RI explains the substantial growth of the assets under RI management in Europe during the first decade of the twenty-first century.

With the increasing involvement of institutional investors, a best-in-class approach to stock selection found growing acceptance. This approach stresses broad diversification (no elimination of industries entirely), positive rankings (only the best companies in each industry are included), and quantitative measurements (all companies are scored on sustainability indicators). Companies are evaluated

on their performance relative to their peers, rather than in absolute terms. By stressing best practices, the approach promotes societal and financial values and at the same time encourages competition among corporations to achieve social and environmental goals.

Phase 5: Mainstreaming

As the first decade of the twenty-first century drew to a close, RI stood at a crossroads. Its increasing acceptance by institutional investors was marked by such events as the launch of the Principles for Responsible Investment (PRI) in 2006. Subsequently, the PRI grew into a coalition of more than 400 of the largest institutional investors and asset managers worldwide, representing some $15 trillion under management (Hobbs 2008). In many senses RI appeared to be poised to become a mainstream investment practice applied across various asset classes. A number of the members of the PRI, including the French national pension fund (Fonds de Réserve pour les Retraites) and the California Public Employees Retirement System (CalPERS), were extending the concepts of RI to asset classes beyond public equities.

At the same time, however, daily investment practices within the mainstream were apparently increasingly short-term in their time horizon and risky in their approach, as could be seen by the dramatic growth of hedge funds and large private equity firms and the increasing use of exotic financial instruments such as collateralized debt obligations and credit default swaps.

These five phases of the development of RI are summarized in Exhibit 21.5. The challenges faced by RI and its advocates as the financial world entered into a crisis of confidence in 2008, of a scope not seen since the Great Depression of the 1930s, are discussed in more detail in the last section of this chapter.

Responsible Investment and Financial Performance

Throughout the various phases of its development, the question of whether responsible investment imposes costs on financial returns has been the object of ongoing debate and extensive academic study. Advocates of socially responsible investing (SRI) have argued that social and environmental screens can help investors avoid risks unrecognized by traditional stock analysts, help identify high-quality corporate management, and highlight companies that are attuned to emerging issues—all of which should help boost performance (Camejo 2002). Critics have argued that, according to modern theories of portfolio management, any restriction on a universe of potential investments will increase undiversified risks and reduce risk-adjusted returns. Some have asserted that assets managed under such screens are insufficient to move stock prices. Others argue that social and environmental performance affects a company's overall reputation and that companies with stronger reputations can command higher price-to-earnings ratios in the stock markets and borrow at lower rates in the bond markets.[2]

Although this debate is likely to continue, considerable research indicates that, in general, social and environmental screening as recently practiced does not hurt a fund's financial performance. For example, a review of 31 socially screened mutual funds from 1990 to 1998 found that on average they outperformed their

Exhibit 21.5 The Five Phases of Responsible Investment

	Before 1970s Roots	1970s–1980s Development	1990s Transition	2000–2006 Expansion	2006 and Beyond Mainstreaming
Designation	Ethical investment	Socially responsible investment	Green funds: Socially responsible investment Sustainability/ environmentalism Retail investors	Sustainable investment; best-of-class investing; triple-bottom-line investing Professionalization Institutional investors	Responsible investment Mainstreaming Mainstream investors
Dominant logic	Moral and ethical grounds	Political grounds			
Dominant actor(s)	Faith-based institutions	Individual shareholder activists			
Dominant practice(s)	Avoidance	Shareholder activism	Inclusion	Best in class	Integration
Geographical spread	Essentially the United States	United States; Europe (mainly the United Kingdom)	North America; Europe; Asia; South Africa; Australia and New Zealand; Middle East		

unscreened peers, but not by a statistically significant margin (Statman 2000). Similarly, a 2001 academic review of 80 studies on the links between CSR and financial performance found that 58 percent of the studies observed a positive relationship to performance, 24 percent found no relationship, 19 percent found a mixed relationship, and only 5 percent found a negative relationship (Margolis and Walsh 2001).

As responsible investment finds application in asset classes beyond publicly traded stocks—such as fixed income, microlending, real estate, and private equity—this debate as well as an ongoing stream of studies examining RI's financial implications in practice will almost certainly continue (Lydenberg 2005).

TOOLS AND STRATEGIES USED BY RESPONSIBLE INVESTORS

Responsible investors vary in their motives and approaches to the discipline, although their underlying concerns may be the same. Four basic elements determine the final form that RI takes for these investors: (1) the degree of commitment, (2) the strategy adopted, (3) the tools used, and (4) the organizational approach taken. The investors' decisions about each of these elements shape their investment approach, the actions they take, and the types of outcomes they seek.

Degree of Commitment

In their stock selection, responsible investors may apply standards or screens either to the totality or to only part of their portfolio. Most stand-alone RI mutual funds in the United States, such as those run by Calvert, Domini, and Pax World, apply a set of RI screens to all the stocks in their equity funds. By contrast, in the early 2000s, several large European pension funds, such as the Dutch funds ABP and PGGM, allocated a limited portion of their equities to sustainability funds with environmental screens to test the effects of applying RI practices.

A second, alternative approach consists not in screening, but in applying a *responsible engagement overlay* to a part or all of one's assets. For example, this approach was promoted in the early 2000s by F&C Investments in the United Kingdom under the brand name *reo* and involved dialogue and engagement with the managers of the corporations in which investments were made. This approach does not require forgoing investment opportunities due to screening, while still allowing for dialogue and discussion with management on sustainability issues.

Strategies

Four strategies for implementation of RI screening coexist within the RI community. They can be used independently or, as often happens, in combination.

1. *Avoidance.* This approach seeks to avoid investing in companies engaged in businesses or practices regarded as unacceptable or generally harmful to society. It can be based on the exclusion of certain sectors or of certain activities.

2. *Inclusion.* This approach seeks to invest in companies engaged in business areas or practices that are exceptionally beneficial to society, particularly those encouraging a sustainable environment and economic development among the historically underserved.
3. *Relative selection.* This approach aims at selecting sector leaders on environmental, social, and governance (ESG) criteria. It invests across all industries and sectors, selecting the best-performing companies in each.
4. *Engagement.* This approach seeks either to supplement standard setting with contact with companies or to avoid screening altogether and concentrate instead on engaging with companies to voice shareholders' concerns on ESG and ethical issues.

According to surveys conducted in 2008, as much as 70 percent of the American and European RI industry may employ some kind of avoidance strategy, making it the dominant RI strategy (Eurosif 2008; U.S. SIF 2008), while inclusion strategies are employed by less than 10 percent of the European RI industry (Eurosif 2008). The avoidance strategy has been criticized as limited in impact and scope and as conveying a negative message that fails to encourage companies to improve their CSR commitments (Cowton 1999). The first decade of the twenty-first century has seen an increasing emphasis on the inclusion and relative-selection approaches, particularly among institutional investors.

Tools

For each of these four general strategies, a variety of specific tactics have been developed within the RI community since the 1970s.

The *avoidance* strategy has led to the development of a set of negative or exclusionary screening tools. A number of standards or screening tools have been developed that serve to exclude companies or sectors from the investment universe based on criteria relating to their products, services, policies, or actions. These screening tools include the following:

- Screens on products viewed as harmful by faith-based organizations and others concerned with ethical issues. These products include tobacco, alcohol, and gambling. In addition, a substantial Islamic finance practice has grown up in recent years that applies standards based on the teachings of the Koran. Among these is one on usury, which in effect excludes most companies in the financial sector.
- Screens on companies involved in products viewed as more generally harmful to society or the environment, such as land mines, nuclear weapons, nuclear power, ozone-depleting chemicals, pesticides, infant formula, and animal testing.
- Screens on companies doing business in countries generally regarded as contravening international human rights standards, such as Sudan and Burma.
- Screens based on international treaties and standards signed by governments but applicable in general to companies. These screens can relate to weapons of mass destruction or antipersonnel weapons, human rights, labor practices, environmental degradation, and similar issues.

Within this range of screening techniques, the specific exclusions applied are usually tailored to the values of individual and institutional investors and can vary considerably.

The *inclusion* strategy has led to the development of a set of positive screening tools. Tools that have been developed for these positive screens seek out companies or sectors particularly beneficial to society:

- Screens identifying companies promoting environmental sustainability through the development of energy efficiency, renewable and alternative energy technologies, pollution control and prevention, public transportation, and similar initiatives.
- Screens identifying companies promoting economic development and health among the historically underserved, such as mobile telephones, microfinance and microinsurance, vaccines, clean water, and related initiatives.

The *relative-selection* strategy has led to the development of a best-in-class screening tool. Best-in-class generally employs a substantial number of ESG criteria to score and rank companies. It then selects the best-performing (for example, top 10 percent) companies in each industry and excludes the rest. The number of ESG criteria used varies greatly. For example, SAM Group, a longtime proponent of best-of-class screening, uses some 130 criteria, while Asset 4 has developed a methodology that employs approximately 250 key performance indicators that it uses to rate and rank 2,300 companies worldwide.

Exhibit 21.6 provides examples of ESG criteria that are widely used in the RI world and often serve as the basis for best-in-class screening. In constructing scores for ratings, a weighting system is often applied to the different criteria in each sector to reflect the varying degree of importance of ESG issues for different industries. For example, environmental issues may be given a substantial weight in the chemical sector while human resource issues may be overweighted in the computer software industry.

Exhibit 21.6 Examples of Environmental, Social, and Governance Issues

Environmental (E)	Social (S)	Governance (G)
• Emissions • Environmental policies • Environmental management systems • Toxic chemicals • Genetic engineering • Pollution • Water • Energy efficiency • Hazardous and solid waste	• Stakeholder relations • Working conditions • Respect for human rights • Diversity • Workplace health and safety • HIV/AIDS • Product safety • Treatment of customers • Labor relations	• Board structure • Independent directors • Independent leadership • Separation of chairman and CEO • Remuneration • Shareholder rights • Accounting quality • Audit quality • Board skills

The *engagement* strategy has led to the development of a set of engagement tools. Over the past 30 years, shareholder activism and dialogue have become widely used strategies for those seeking to influence corporate behavior on a broad range of issues. Three primary modes of RI engagement have emerged: proxy voting, filing of shareholder resolutions, and dialogue with corporations.

Voting on the shareholder resolutions that appear on corporate proxy statements for annual general meetings is not only the right of all stockholders but the fiduciary obligation of institutional shareholders. Most resolutions appearing on proxy statements relate to corporate governance: election of board members, selection of auditors, approval of compensation packages for corporate executives, and related issues. In addition, resolutions relating to social and environmental matters also appear, particularly at U.S and Canadian companies. Adopting RI voting policies and communicating these policies to corporate management is therefore the most common form of engagement and is essentially applicable to all investors.

Filing shareholder resolutions is a more direct means of engagement with management, used particularly by the RI community in the United States and Canada where filing such resolutions is simpler than elsewhere. Since the early 1970s in the United States, members of the Interfaith Center on Corporate Responsibility have filed well over 100 such resolutions on social and environmental issues each year. Increasingly, unions are also using this tactic to raise corporate governance concerns. Although few proposals on social issues receive majority votes, these resolutions are an important tool in reaching management and initiating dialogue (Forum for the Future 2002).

Dialogue with corporate management is the third widely used form of engagement. RI institutional investors often enter into dialogue with managers on social and environmental issues such as human rights, labor standards, the environment, and diversity, as well as corporate governance matters. Increasingly dialogue is conducted through coalitions of RI investors, such as those participating in the Carbon Disclosure Project (CDP). The CDP is a coalition of institutional investors urging the largest corporations in the world to measure and disclose their carbon emissions.

Between 30 and 40 percent of the U.S. and European RI industries currently engage in some kind of shareholder activism or dialogue (Eurosif 2008; U.S. SIF 2008). While the U.S. RI industry is active in filing shareholder resolutions and public engagement, Europe is notably active in direct private engagement (Louche and Lydenberg 2006).

Organizational Approach

The organizational approaches that asset owners and money managers—be they pension funds or foundations, banks, private money managers, or mutual funds and unit trusts—choose to implement their RI strategies vary depending on whether they choose to conduct these activities internally or outsource them to vendors. Activities that can be outsourced include research, screening, and engagement.

On the research side, responsible investors have the option of either building their own in-house research team to evaluate the social and environmental

records of publicly traded companies, or purchasing such services from specialized vendors. The advantage of having an in-house team is that RI investors can focus their research on the specific CSR issues of greatest importance to themselves; or, in the case of the managers of RI funds, they can perform their research on behalf of others and tailor separate portfolios to the concerns of a variety of clients. Examples of asset managers with in-house RI research capabilities—sometimes referred to as *green teams*—include F&C Investments and Morley Asset Management in the United Kingdom; Société Générale in France; Dexia Asset Management in Belgium/France; and Calvert Asset Management, Domini Social Investments, and Pax World Mutual Funds in the United States. These teams typically range in size from 5 to 15 researchers and are charged with developing the RI standards for in-house funds, conducting CSR research on specific companies, and maintaining lists of approved and excluded companies. In most cases, firms with in-house research teams combine their own research with the research provided by one or multiple outside research vendors.

Money managers or asset owners may also decide to rely primarily on outside RI research vendors for their RI research and screening. In this case, the firm typically maintains an internal staff of one to three persons responsible for overseeing research obtained from vendors and creating approved or excluded lists from that research. (See the next section for a listing and description of research providers often used by RI investors.) By using an outside vendor, the manager or asset owner relies on research criteria and screening methodologies developed by what are generally regarded as independent and high-quality parties, thereby avoiding the internal decision making and expense of customized research and screening. This approach is often adopted by money managers wishing to serve an RI clientele along with their other conventional clients, but choosing not to make RI a primary focus.

On the engagement side, similar options for the developing of in-house expertise or the outsourcing of services exist. (See the next section for a description of organizations providing outsourced engagement services.) An additional consideration for RI investors taking up the engagement tactic is whether to act alone or in coalitions with others as they approach corporations on social and environmental issues. As RI becomes an increasingly accepted practice, the trend is toward engagement in broad-based coalitions. One of the largest and most successful of these currently is the Carbon Disclosure Project, which as of 2009 included some 475 institutional investors with combined assets of approximately $55 trillion, seeking disclosure from the largest corporations in the world regarding their carbon emissions. In the United States, since the early 1970s, the Interfaith Center on Corporate Responsibility, a coalition of some 300 institutional investors, mainly religious organizations with combined portfolios worth an estimated $45 billion, has served as a coordinating organization for those engaging with corporations on a wide variety of CSR issues. In the Netherlands, VBDO, the Dutch Association of Investors for Sustainable Development, provides voting services and engages with companies in order to direct corporate policies and behavior toward sustainable performance. It has provided voting advice since 2005 to its clients and engages in dialogue with publicly traded Dutch companies on their behalf.

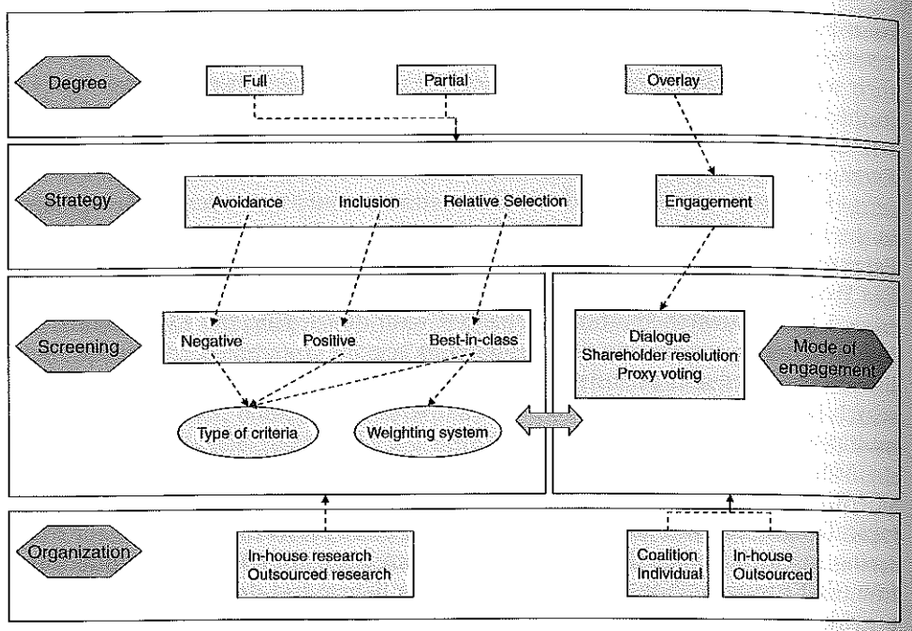


Exhibit 21.7 Map of Approaches to Responsible Investment

Coalitions have the advantages of pooled resources and coordinated action in approaching companies, increasing the chances for a successful engagement. In particular, they raise the level of seriousness of dialogue by assuring corporations of a breadth of concern for specific issues.

The approaches to RI outlined in this section are summarized in Exhibit 21.7.

MAJOR PLAYERS IN THE RESPONSIBLE INVESTING FIELD

As RI has evolved, the number and variety of players in the field has increased. Since the late 1990s RI investors have come to encompass individuals, small institutions, and, increasingly, large government and private pension funds. A growing number of specialized RI research firms and rating agencies, as well as in-house green teams within mainstream money management firms, have also emerged. These in-house teams and outside research firms play a crucial role in supporting the engagement between the financial community and corporate management on social and environmental issues and are important intermediaries between companies and fund managers as they have gained legitimacy in their assessments of companies (Louche, Gond, and Ventresca 2005).

The major players in the RI community today can be divided into three basic categories: asset owners, providers of support services to the RI field, and related organizations.

Asset Owners

The asset owners category refers to retail and institutional investors investing their funds according to RI principles.

Retail Investors

Retail RI investors are individuals wishing to invest in corporations that have positive social and environmental records and to avoid those with more questionable records. They usually invest in RI mutual funds (unit trusts) or, if they are particularly wealthy, through separate accounts managed by private banks or trust offices. They are typically driven by a desire to use their investments as part of a commitment to lives that improve the world.

The retail market for RI products is notably strong in the United States and Japan. In the United States, retail investors, along with religious organizations, were historically one of the driving forces of the RI movement as it evolved during the 1970s and 1980s (Louche and Lydenberg 2006).

According to the U.S. Social Investment Forum, as of 2007 in the United States there were 260 RI mutual funds with $202 billion in assets. These funds primarily serve retail RI investors and retirement savings plans (defined contribution pension plans) for individuals. In Europe, the number of RI retail funds in 2008 was 437, representing €49 billion in assets.

Retail investors may participate in the RI market individually or through retirement savings plans offered by institutional investors. For example, TIAA-CREF, the retirement plan for many college and university professors in the United States, offers its Social Choice Account, which as of year-end 2008 had assets of approximately $6.5 billion.[3]

In Japan, social investing began in the mid-1990s with the launch of a number of retail funds with environmental and sustainability themes (ASrIA 2003; Sakuma and Louche 2008; Solomon, Solomon, and Suto 2004). As of 2007, there were some 34 RI funds in Japan with combined assets of approximately ¥58 billion, or approximately US$3 billion (Sakuma and Louche 2008). Institutional investors currently play a relatively minor role in the Japanese RI market.

Institutional Investors

Since the late 1990s, institutional investors, particularly in Europe, have become a major factor in the responsible investment movement (Albareda and Balaguer 2009). In the 1970s and 1980s in the United States, a substantial number of state and municipal pension funds participated in the South Africa divestment movement to protest the apartheid legal system there. At its peak, many of the major pension funds in the United States, including those of the states of California, New York, New Jersey, Massachusetts, and Wisconsin, with hundreds of billions of dollars in assets, had policies limiting investments in companies doing business in that country (Massie 1997). With the dismantling of apartheid in 1994, these American pension funds pulled back from RI activities.

With the growth of interest in sustainability in Europe starting in the mid-1990s, and the simultaneous privatization of many industries previously in state hands, governments and institutional investors became increasingly interested in responsible investment. Governments, including the European Union, began

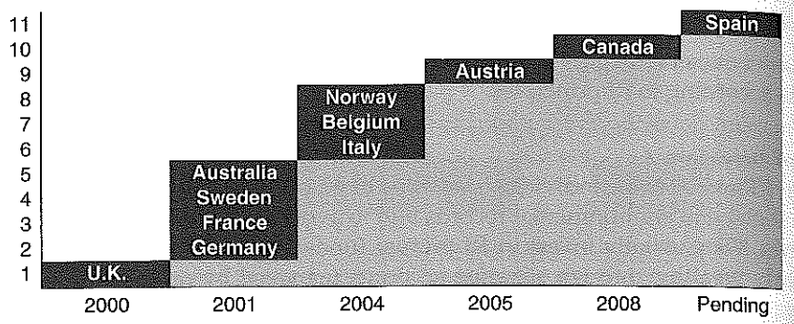


Exhibit 21.8 The Adoption of Disclosure Regulations for Pension Funds

promoting the concept of corporate social responsibility, and various national and local pension funds began adopting aspects of RI. One early move in the promoting of RI among institutional investors came in the late 1990s and early 2000s when the governments of the United Kingdom, Germany, and Sweden, among others, adopted policies requiring pension funds to state whether they took social and environmental considerations into account in their investment practices (see Exhibit 21.8). At the EU level, discussions around increased transparency by institutional investors on their RI practices were underway as of early 2009 (Eurosif 2009).

As a result of these RI disclosure requirements, a number of large European pension plans have increasingly adopted specific RI practices. The Norwegian national pension fund has established specific screens on weapons, human rights, bribery, and the environment.[4] The Swedish national pension plans have varying policies, including several with weapons and human rights screens.[5] The French Fonds de Réserve pour les Retraites (Retirement Reserve Fund) is planning to apply sustainability criteria across all asset classes.[6]

One of the most significant developments in the institutional investor field, however, has been the creation of the Principles for Responsible Investment (PRI),[7] under the aegis of the United Nations Global Compact. Launched in 2006, the PRI had been endorsed by approximately 150 pension funds and other large institutional investors as of early 2009, including major pension funds from throughout the world.

By signing the PRI, they agree to implement six basic practices in their investing:

1. Incorporate ESG issues into their investment analysis and decision making.
2. Incorporate ESG issues into their ownership policies and practices.
3. Seek ESG disclosure.
4. Promote the PRI principles within the financial industry.
5. Work cooperatively to implement the PRI principles.
6. Report on progress in implementing the PRI principles.

The PRI is particularly significant because it provides a forum to institutional investors for consensus building on best practices, collaborative action, engagement, and the promotion of academic work in the field.

Support Services

This second category consists of actors that provide support services to the RI. It consists of money managers, financial consultants, research providers, and those offering engagement services.

Money Managers and Financial Consultants

As the market for RI has grown, the financial community has also responded. Having treated RI with suspicion as it emerged in the 1970s and 1980s, many, if not most, large financial institutions now offer RI services.

A number of mainstream money managers and financial institutions in the United Kingdom have committed to applying responsible investment principles to all of their assets. These include:

- *F&C Investments.* F&C describes its commitment to responsible investment as "fundamental to our global investment philosophy across all our funds." In addition to managing some £3.4 billion in funds with RI screens, it engages with corporate management on behalf of all its own funds, as well as providing an engagement service to others.[8]
- *Hermes Asset Management.* Owned by its largest client, the BT Pension Scheme, Hermes describes itself as "completely committed to responsible investment and the long-term approach that it entails." Hermes manages some £27 billion in funds for a variety of clients, including BT, with an interest in responsible investment.[9]
- *Co-operative Bank.* A part of the Co-operative Group, a large UK consumer cooperative organization, the bank had £18 billion in unit trust assets under management as of September 2008 and analyzes "social, ethical, environmental and other company management issues (e.g., 'fat cat' pay) across all the funds we manage."[10]

RI money managers serve a variety of clients with a variety of social and environmental considerations. One fast-growing segment of the RI market is Islamic investing. Investors in Islamic countries have become increasingly interested in developing and applying approaches based on the teachings of the Koran. As interpreted by most Sharia committees (local committees of clerics charged with applying the Koran's principles to daily life), the Islamic approach resembles traditional Christian RI screening in that, for example, it avoids companies producing alcohol. However, its interpretation of the Koran's condemnation of usury can require the screening out of financial services companies. According to a report by the Oliver Wyman consulting firm, Islamic finance will reach $1.6 trillion in assets by 2012, and as of year-end 2007 had $660 billion under management (Zaywa Finance 2009).

As interest in RI has grown, financial consultants—who serve as gatekeepers for institutional investors, advising them on management practices and helping them implement their financial objectives—are increasingly recognizing responsible investment as a legitimate discipline and advising interested clients on how best to enter the field. Among the major financial consulting firms with RI teams in place as of 2009 were Mercer and Cambridge Associates.

Research Providers

To serve the growing need for data to implement RI strategies and tactics, a number of RI research organizations have sprung up. These organizations provide background data on the social and environmental records of publicly traded companies, rating and ranking their performance. The information they provide is used primarily by institutional investors for investment decisions or shareholder engagement.

In 2007, the French consultancy Observatoire sur la Responsabilité Sociétale des Entreprises (ORSE), in an update of a study originally published in 2001, surveyed the methodologies and services of 30 RI research and rating organizations (ORSE 2007). Among the major firms are EIRIS (United Kingdom), GES Investment Services (Scandinavia), Jantzi-Sustainalytics (Canada and the Netherlands), PIRC (United Kingdom), RiskMetrics Group (including KLD Research & Analytics, United States), SIRIS (Australia), and Vigeo (France).

Engagement Services

Engagement with corporations to encourage positive change has been an important feature of RI since its inception. During the 1970s, engagement was in many senses the primary focus of RI in the United States. Since 2000 it has become increasingly an important part of the sustainable investment movement. Among organizations with a strong focus on engagement as of 2009:

- F&C Investments, which has an engagement protocol called Responsible Engagement Overlay (reo) that it applies to all its assets plus an additional £63 billion of funds managed by other investment institutions.[11]
- Principles for Responsible Investment Engagement Clearinghouse, which provides its institutional investors with a platform for sharing information on engagement activities and encourages collaborative engagement efforts.[12]
- GES Investment Services Engagement Forum, which facilitates collaborative actions among Northern European institutional investors, with a particular focus on encouraging companies to meet international norms on social, environmental, and governance issues.[13]

In addition, proxy voting advisory services, such as RiskMetrics Group and Glass Lewis in North America and PIRC in the United Kingdom, provide recommendations on how to vote on the numerous shareholder resolutions filed each year on corporate governance, social, and environmental issues.

Related Initiatives

The last category of actors covers all other organizations and initiatives that are involved and active in the field of responsible investment. It consists of trade organizations, think tanks, national stock exchanges, and national governments.

RI Associations and Think Tanks

With the growth of RI, a number of associations facilitating networking, meetings, and the promotion of best practices have evolved. These initiatives bring together professional practitioners, researchers, and academics.

The most widespread model for these associations is the *social investment forum*, or SIF. As of 2009, the European Social Investment Forum (Eurosif) served as an umbrella for seven European national SIFs—Belgium, France, Germany, Italy, the Netherlands, Sweden, and the United Kingdom—and was affiliated with four other SIFs in Asia, Australia, Canada, and the United States.[14]

In addition to the Principles for Responsible Investment, other coalitions of investors organized around particular issues, such as the Carbon Disclosure Project and the Investors Network on Climate Risk, are also increasingly emerging and attracting widespread participation. In addition, organizations such as the Enhanced Analytics Initiative have been formed to influence money managers and fund owners to factor into their investment practices those negative and positive externalities relating to ESG that companies have created.

An increasing number of RI academic research initiatives are also underway, including the Moskowitz Research Program at the Center for Responsible Business at the University of California, Berkeley; the Sustainable Investment Research Platform, hosted by the Umeâ School of Business in Sweden and sponsored by the Mistra Research Program on Sustainable Investments; the European Center for Corporate Engagement, a joint initiative of Maastricht University and RSM Erasmus University in the Netherlands; and the Initiative for Responsible Investment at the Harvard University Kennedy School.

National Governments and Stock Exchanges

Also enhancing the growth of SRI around the world have been initiatives by governments and national stock exchanges to promote corporate social responsibility, along with the creation of socially responsible stock indexes by private parties.

To overcome one important barrier to the implementation of SRI in the equities market—the lack of data on the corporate social responsibility records of publicly traded companies—a number of national governments have taken steps, sometimes in conjunction with their national stock exchanges, to encourage and even mandate increased CSR disclosure (Investments 2008). Among countries engaged in these efforts are the following:

- The government of France in 2001 mandated disclosure in financial reports of some 40 key CSR data points by publicly traded companies.
- The government of Malaysia has required publicly traded companies to disclose CSR data in their annual reports since 2007 and imposed CSR requirements for companies listed on its national stock exchange.
- In South Africa, the JSE Limited (formerly the Johannesburg Stock Exchange) has published its SRI Index since 2004, listing companies with the best CSR records.
- The government of Sweden has mandated that companies with state ownership report on their CSR records by 2009, following the guidelines developed by the Global Reporting Initiative.

- The government of Denmark mandated in late 2008 that the 1,100 largest companies in that country begin disclosing CSR data or report on why they do not do so (Cooper 2009).

In addition, a number of RI research firms around the world have created indexes of their own, listing companies they believe fit various criteria for responsible investors. ORSE (2007) lists 12 groups of such indexes, including those maintained by KLD Research & Analytics; SAM Group and Dow Jones; and EIRIS and FTSE. These indexes serve as the basis for a number of financial products.

MAJOR CHALLENGES OF RI TODAY

Despite the growth in interest in RI over the past 30 years, RI remains a niche market within the traditional financial community and a number of important questions confront the field as it continues to evolve. Four of the major challenges are:

1. Can RI become mainstream?
2. Can RI be applied across all asset classes?
3. Can RI develop tools to measure sustainability risks and rewards?
4. Can RI address the issues raised by the financial crises of 2008–2009?

Can RI Become Mainstream?

The increasingly global reach of the RI industry has led some authors to conclude that RI is becoming mainstream (Friedman and Miles 2001; Sparkes and Cowton 2004; World Economic Forum 2005; Zadek, Merme, and Samans 2005). Investment managers, brokers, and fund managers are increasingly interested in RI or specific RI issues such as the environment (Ambachtsheer 2005; PLEON 2005; Taylor Nelson Sofres 2003). A 2007 survey showed that there is a common belief among investors that RI is expected to grow by 25 percent per annum over the next few years and become mainstream by 2015 at the latest (Robeco and Booz & Company 2007).

Money managers such as Generation Investment Management, where former U.S. Vice President Al Gore is a partner, view the practice of sustainable investment as a source of competitive advantage. In addition, regulatory pressures, collaborative initiatives such as the Principles for Responsible Investment, and the trend toward shareholder engagement are bringing RI into the mainstream.

However, a number of hurdles remain before RI will be fully accepted:

- Models quantifying ESG data in stock valuation need to be developed. A 2005 World Business Council for Sustainable Development Young Managers Team and the UN Environmental Program Financial Initiative survey found that young financial analysts felt unequipped to incorporate ESG issues into mainstream company analysis (Jaworski 2007; WBCSD and UNEP Finance Initiative 2005).
- Cross-fertilization between mainstream financial analysts and ESG specialists needs to be encouraged.

- The dominant single-dimensional assessment of companies only on financial dimensions needs to move toward multidimensional models that include ESG issues.
- The communications gap between companies and investors with regard to ESG issues and their relation to materiality needs to be overcome.
- The inherent short-termism of today's financial markets that undercuts the long-term orientation of RI needs to be addressed (Guyatt 2006; Juravle and Lewis 2008).

Can RI Be Applied across All Asset Classes?

Discussions about RI in academic literature and the general press often focus on its theory and practice in relationship to publicly traded corporations. Increasingly RI practices are also applied to other asset classes—most notably cash, fixed income, and real estate, but also private equity and hedge funds.

- The Institute for Responsible Investment (2007) has noted that although the underlying principles of RI remain the same for each asset class, the specific social and environmental issues that they are most naturally suited to address vary from one asset class to another. For example: Cash investments in banks, credit unions, and revolving loan funds are naturally suited for local community economic development, particularly serving the historically underserved. Microfinance is currently a prominent example of RI's integration into the asset class of cash.
- Fixed-income investments in the bonds issued by national and local governments are particularly well suited for the creation of large-scale public goods such as affordable housing, transportation infrastructure, and education. In the United States, Community Capital Management and RBC Global Asset Management's Capital Access Strategies are examples of the use of this asset class to support affordable housing and environmental infrastructure projects.
- Real estate investments are naturally suited to promote environmentally sustainable communities emphasizing proximity to public transportation, walkability, and energy-efficient properties. The UN Environmental Program's Financial Initiative Real Estate Property Working Group, for example, is currently promoting best practices in sustainable real estate development among institutional investors.

A major question for RI is whether it can develop a theory that applies RI to all asset classes.

Can RI Develop Tools to Measure Sustainability Risks and Rewards?

Contemporary investment practice is dominated by the measurement of risk and reward in relation to price-based benchmarks. Risk (usually defined as volatility or *beta*) and rewards (usually defined as excess risk-adjusted returns or *alpha*) do not account for the social and environmental risks and rewards of investments.

Pioneering work has been done by RI research firms such as Trucost in quantifying environmental risk—in Trucost's case, quantifying the carbon footprint of companies and the implied financial risk.[15] The RI research firm Innovest (acquired by RiskMetrics Group in 2009) has produced "intangible value assessments" that capture the social and environmental capital created by firms.[16]

In 2005, Freshfields Bruckhaus Deringer, a prominent international law firm, concluded that investment managers' fiduciary duties should not necessarily preclude or overly hamper RI (Freshfields Bruckhaus Deringer 2005). According to this report ESG information should be taken into account whenever it is relevant to the investment strategy. Where the link between ESG factors and financial performance is recognized, the integration of ESG is not only permissible but even advisable.

How best to report on the full range of social and environmental risks and rewards of investments is a question the RI community needs to address.

Can RI Address Issues Raised by the Financial Crises of 2008–2009?

The worldwide financial crises of 2008–2009 have raised questions about the wisdom of many of the practices of contemporary investing driven by the application of modern portfolio theory (MPT). Whether RI can construct a theoretical framework that justifies its approach as an alternative to certain aspects of MPT remains an unresolved question. Without such a theoretical framework, however, it is unlikely that RI will be able to replace or modify in a meaningful way the investment practices that led to these crises (Lydenberg and Sinclair 2009).

NOTES

1. From the 1970s through 1994 many pension funds and other institutional investors, particularly in the United States, had adopted South African divestment policies, but in general they withdrew from the RI field with the dismantling of apartheid in 1994.
2. For those interested in an extensive annotated bibliography of academic studies on this topic, see the web site maintained by the Center for Responsible Business, sristudies.org.
3. See TIAA-CREF's web site at http://www.tiaa-cref.org/ (accessed April 8, 2009).
4. See Norges Bank Investment Management's web site at http://www.norges-bank.no (accessed April 8, 2009).
5. See http://www.ipe.com/news/Swedish_buffer_funds_exclude_cluster_bomb_investment_29115.php (accessed April 8, 2009).
6. See FRR's web site at http://www.fondsdereserve.fr/ (accessed April 8, 2009).
7. See PRI's web site at http://www.unpri.org/ (accessed April 8, 2009).
8. See F&C's web site at http://www.fandc.com/new/aboutus/Default.aspx?id=82810 (accessed April 8, 2009).
9. See Hermes Investment's web site at http://www.hermes.co.uk/abt_our_philosophy.aspx (accessed April 8, 2009).
10. See Cooperative Bank's web site at http://www.co-operativeinvestments.co.uk/servlet/Satellite/1204616032483,CFSweb/Page/Investments-UnitTrustsAndISAs (accessed April 8, 2009).

11. See F&C web site at http://www.fandc.com/new/institutional/Default.aspx?ID=80961 (accessed April 9, 2009).
12. See the PRI web site at http://www.unpri.org/workstreams/#1 (accessed April 9, 2009).
13. See the GES web site at http://www.ges-invest.com/pages/?ID=70 (accessed April 9, 2009).
14. See the EuroSIF web site at http://www.eurosif.org/about_eurosif/sifs/other_sif_s_around_the_world (accessed April 9, 2009).
15. See Trucost's web site at www.trucost.com (accessed April 9, 2009).
16. See RiskMetrics web site at http://www.riskmetrics.com/sustainability (accessed April 9, 2009).

REFERENCES

AccountAbility. 2006. The materiality report: Aligning strategy, performance and reporting. London: AccountAbility.

Albareda, L., and F. M. R. Balaguer. 2009. The challenges of socially responsible investment among institutional investors: Exploring the links between corporate pension funds and corporate governance. *Business & Society Review* 114:31–57.

Ambachtsheer, J. 2005. SRI: What do investment managers think? Mercer Investment Consulting. www.mercer.com.

ASrIA. 2003. SRI in Asia. www.asria.org.

Camejo, P. 2002. *The SRI advantage: Why socially responsible investing has outperformed financially*. Gabriealla Island, British Columbia: New Society Publishers.

Cooper, B. 2009. Danish reporting rules. *Ethical Corporation*, March: 26–29.

Cowton, C. J. 1999. Playing by the rules: Ethical criteria at an ethical investment fund. *Business Ethics: A European Review* 8:60–69.

Déjean, F., J.-P. Gond, and B. Leca. 2004. Measuring the unmeasured: An institutional entrepreneur's strategy in an emerging industry. *Human Relations* 57:741–764.

Domini, A. L. 2001. *Socially responsible investing: Making a difference in making money*. Chicago: Dearborn Trade.

European Sustainable Investment Forum (Eurosif). 2008. European SRI study. www.eurosif.org/publications/sri_studies.

———. 2009. www.eurosif.org.

Forum for the Future. 2002. Sustainability pays, http://www.cis.co.uk/socacc2002/pdf/SusPays.pdf: Co-operative Insurance Society in association with Forum for the Future.

Freshfields Bruckhaus Deringer. 2005. A legal framework for the integration of environmental, social and governance issues into institutional investment: UNEP FI. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

Friedman, A. L., and S. Miles. 2001. Socially responsible investment and corporate social and environmental reporting in the UK: An explorative study. *British Accounting Review* 33:523–548.

Gond, J. P., and E. Boxenbaum. 2004. Importing "socially responsible investment" in France and Quebec: Work of contextualization across varieties of capitalism. Paper presented at the EGOS, Ljubljana.

Guyatt, D. J. 2006. *Identifying and overcoming behavioural impediments to long-term responsible investments—a focus on UK institutional investors*. Unpublished PhD dissertation, University of Bath.

Hobbs, M. 2008. UN PRI enlists 400 firms. *Financial Standard* 28 (July). http://www.financialstandard.com.au/news/view/23618/.

Institute for Responsible Investment. 2007. Handbook on responsible investment across asset classes.
Jaworski, W. 2007. Use of extra-financial information by research analysts and investment managers. European Center for Corporate Engagement (ECCE).
Juravle, C., and A. Lewis. 2008. Identifying impediments to SRI in Europe: A review of the practitioner and academic literature. *Business Ethics: A European Review* 17:285–310.
Lipper FERI. 2008. From niche to mainstream. *Hot Topics*. http://www.lipperfmi.com/FERIFMI/Information/Files/Hot%20Topics%20SRI%200807.pdf
Louche, C. 2004. *Ethical investment: Processes and mechanisms of institutionalisation in the Netherlands, 1990–2002*. PhD dissertation, Erasmus University Rotterdam. Rotterdam: Optima Grafische Communicatie. https://ep.eur.nl/retrieve/3259/ESM-dissertation-3003.pdf.
Louche, C., J.-P. Gond, and M. Ventresca. 2005. Legitimating social rating organisations: on the role of objects in the micro-processes of SRI legitimacy-building in Europe. Paper presented at the IABS, Sonoma, California.
Louche, C., and S. Lydenberg. 2006. Socially responsible investment: Difference between Europe and United States. Working Paper. Vlerick Leuven Gent Management School.
Lydenberg, S. 2005. *Corporations and the public interest: Guiding the invisible hand*. San Francisco, CA: Berrett-Koehler Publishers, Inc.
———. 2007. Long term investing. Paper presented at the 2007 summit on the future of the corporation, Paper No. 5.
Lydenberg, S., and G. Sinclair. 2009. Mainstream or daydream? *Journal of Corporate Citizenship*, June.
Margolis, J. D., and J. P. Walsh. 2001. *People and profits? The search for a link between a company's social and financial performance*. Mahwah, NJ: Lawrence Erlbaum and Associates.
Massie, R. 1997. *Loosing the bonds*. New York: Nan A. Talese.
ORSE. 2007. Guide to sustainability analysis organisations. Paris: EDEME, EPE, ORSE.
PLEON. 2005. Accounting for good: The Global Stakeholder Report 2005: Pleon Kohtes Klewes GmbH / Pleon b.v.
Post, J., L. E. Preston, and S. Sachs. 2002. *Redefining the corporation: Stakeholder management and organizational wealth*. Stanford, CA: Stanford University Press.
Robeco and Booz & Company. 2007. Responsible investing: A paradigm shift from niche to mainstream. http://www.booz.com/media/uploads/Responsible-Investing-Paradigm-Shift.pdf
Sakuma, K., and C. Louche. 2008. Socially responsible investment in Japan: Its mechanism and drivers. *Journal of Business Ethics* 82:425–448.
SIRI Group. 2007. Green, social and ethical funds in Europe—2007 review. Milan: SiRi Group/Avanzi.
Solomon, A., J. Solomon, and M. Suto. 2004. Can the UK experience provide lessons for the evolution of SRI in Japan? *Corporate Governance: An International Review* 12:552–566.
Sparkes, R. 2001. Ethical investment: Whose ethics, which investment? *Business Ethics: A European Review* 10:194–205.
Sparkes, R., and C. J. Cowton. 2004. The maturing of socially responsible investment: A review of the developing link with corporate social responsibility. *Journal of Business Ethics*, 52:45–57.
Statman, M. 2000. Socially responsible mutual funds. *Financial Analysts Journal* 56:30–39.
Taylor Nelson Sofres. 2003. Investing in responsible business—the 2003 survey of European fund managers, financial analysts and investor relations officers: CSR Europe, Deloitte, Euronext.
U.S. Social Investment Forum (SIF). 2008. 2007 report on socially responsible investing trends in US—executive summary. Washington, DC: US Social Investment Forum.
WBCSD Young Managers Team, and UNEP Finance Initiative. 2005. Generation lost: young financial analysts and environmental, social and governance issues. http:// www.wbcsd.org/web/publications/ymt-perspectives.pdf

World Economic Forum. 2005. Mainstreaming responsible investment. Cologny/Geneva, Switzerland.
Zadek, S., M. Merme, and R. Samans. 2005. Mainstreaming responsible investment. Geneva: Accountability and World Economic Forum.
Zaywa Finance. 2009. Islamic asset to reach $1.6 billion with revenues of $120 billion despite short-term market volatility. April 10. http://www.zawya.com/printstory.cfm?storyid=ZAWYA20090406075859&l=075800090406.

ABOUT THE AUTHORS

Céline Louche is assistant professor at Vlerick Leuven Gent Management School (Belgium). She teaches and researches on corporate social responsibility and sustainability. In her work, she explores the way processes of change take place with a special focus on CSR as a factor of innovation and value creation, socially responsible investment, and stakeholders' processes. Before joining Vlerick, Céline worked five years as a sustainability analyst for SRI at the Dutch Sustainability Research institute. She is member of the Academic Board of EABIS, the scientific committee of the RIODD, and the SRI advisory committee of Dexia Asset Management.

Steven Lydenberg is chief investment officer for Domini Social Investments LLC. He has been active in social investing for 35 years as director of corporate accountability research with the Council on Economic Priorities, investment associate with what is now Trillium Asset Management, and director of research with KLD Research & Analytics. Mr. Lydenberg is the co-author of *Rating America's Corporate Conscience* (Addison-Wesley, 1985) and *Investing for Good* (HarperCollins, 1993), and co-editor of *The Social Investment Almanac* (Henry Holt, 1992). He is the author of *Corporations and the Public Interest: Guiding the Invisible Hand*, published by Berrett-Koehler in early 2005.

CHAPTER 22

Microfinance*

ANTONIO ARGANDOÑA
Professor of Economics, "la Caixa" Chair of Corporate Social Responsibility and Corporate Governance, IESE Business School, University of Navarra

INTRODUCTION

Although microfinance as a practice is probably very old, the term itself is very recent. It started to be used in the 1960s and 1970s when organizations such as ACCION International, Opportunity International, and Grameen Bank started to grant small loans (less than US$100) to microentrepreneurs, mostly women. These loans were backed by a group guarantee, thus overcoming the lack of collateral which was the main reason why commercial banks neglected the low-income segments of the population.

Since then, microfinance has experienced considerable growth. In 2006, Muhammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize "for their efforts to create economic and social development from below." In awarding the prize, the Nobel committee wrote, "From modest beginnings three decades ago, Yunus has, first and foremost through Grameen Bank, developed microcredit into an ever more important instrument in the struggle against poverty."[1] At present, microfinance is a standard tool in development and poverty reduction policies. It is estimated that in 2007 the volume of outstanding microcredits in the world stood at about US$25 billion, with about 125 to 150 million beneficiaries (*Financial Times* 2008, 1).[2]

The social goal pursued by the microcredit lending agencies gave them an aura of respectability that they have maintained over the decades. However, with the passing of time, critical voices have also emerged: Some of the features that made microfinance attractive have been lost or become blurred, such as the joint liability (see later section on microcredits, discussing group guarantees). Other questionable aspects, such as the high interest rates charged by the microcredits, have been maintained, and microfinancial institutions (MFIs) have placed increasing emphasis on their operations' economic sustainability, which has led some to think that they were not being true to their social function and ethical mission.

*This chapter forms part of the activities of the "la Caixa" Chair of Corporate Social Responsibility and Corporate Governance, IESE Business School.

This chapter offers an overview of microfinance and a detailed discussion of the ethical problems associated with it. There is a very extensive literature on microlending,[3] but the literature that is specifically concerned with its ethical dimension is very limited (Hudon 2006, 2007, 2009; Vakulabharanam and Motiram 2007; Vanroose 2007). The following sections discuss the concept and scope of microfinance and the features of the microcredits, after which the chapter turns to issues with a more substantial ethical content: microfinance's social responsibility, the debate over the MFIs' financial sustainability versus their social function, and the ethical issues raised by setting interest rates and the MFIs' right to earn a profit. The chapter closes with some conclusions.

MICROFINANCE

The shortest definition of *microfinance*, and perhaps the most comprehensive, is the provision of financial services to poor, low-income people who, in normal conditions, would not have access to them (the *unbankables*). The reasons for this exclusion may be their location (farmers who live far away from towns); their lack of income (which makes it difficult to repay the loan) or assets (which keeps them from providing any surety); their lack of a financial track record; or other reasons, which altogether mean that the potential client is not profitable for a traditional financial institution. Microfinancial services started with the microcredits, but they also include payment methods (cards, transfers, emigrant remittances), savings instruments (current and savings accounts and other assets), insurance, pension funds, financial leasing, and so on. This extension is based on the realization that microentrepreneurs' needs go much further than credit and may also include training, creation of social networks, education, health, access to land ownership, and information.

Microfinancial services are provided by a broad range of organizations, including commercial banks, nonbank financial companies, public and development banks, and credit unions, both nonprofit and for-profit. The institutional landscape is completed with (1) the providers of funds, which may be the clients themselves (through deposits) or other financial institutions, such as unit trusts, private equity, and public or private donors; (2) partner financial institutions that render services to foundations or NGOs; and (3) supranational organizations that create microlending networks, such as ACCION International, Women's World Banking (WWB), Kreditanstalt für Wiederaufbau (KfW), and the Small Enterprise Education and Promotion (SEEP) Network.

The goal of microfinance is to ameliorate poverty and underdevelopment. It is based on two basic assumptions: (1) The lack of access to financial services is a major (although not the only) cause of poverty, and (2) access to credit is key for the development of entrepreneurial projects that will provide borrowers with a stable income, assets, and the knowledge and skills that will enable them to lift themselves from poverty, thereby extending the impact to the local community (through the creation of jobs and income, the generation of new ideas) and to the country as a whole. This assumption implicitly holds another within it: There is a considerable supply of entrepreneurial ability, even among people without any financial resources or specific training.

MICROCREDITS

Based on the practices of the Grameen Bank, microcredits are usually identified as having the following 12 features (Armendáriz de Aghion and Morduch, 2005):

1. They are for small amounts.
2. The beneficiaries are poor or very poor families and, within them, particularly women.
3. Their goal is to help the beneficiaries put an end to a state of poverty by generating self-employment activities or entrepreneurial projects and, sometimes, enabling construction or purchase of a dwelling; but the microcredits do not cover day-to-day expenses.
4. They are not backed by physical collateral or a contract whose performance can be enforced by law but are founded instead on trust.
5. In order to obtain the credit, the beneficiary must belong to a group (group lending); considerable importance is given to the creation of social capital among the participants.
6. The guarantee is collective, with joint responsibility by the entire group.
7. The microcredit program develops a distinctive credit selection and management methodology and a personalized system for relations between the MFI's staff and its clients; it is the bank that goes to the client and not the client who goes to the bank.
8. Interest and capital are paid in regular installments at frequent periods (every week or fortnight) and in public.
9. The credits are granted in a continuous sequence. The quantity offered in each new credit increases and is conditional upon prior repayment of the previous loans by all of the group's members.
10. The lending program is complemented with compulsory or voluntary savings programs.
11. The interest rates stipulated do not seek to provide an attractive return for investors but to guarantee the program's sustainability. However, the sustainability goal is subordinated to providing a service to the poor.
12. The loans are usually granted through nonprofit organizations or institutions owned by the users themselves (cooperatives), although participation is also open to for-profit institutions.

However, microlending can take many and varied forms, such that, in practice, there is no unanimous—or even majority—agreement on each of these individual features. Let us examine each of these features more closely.

1. *Amount*. A microcredit is the act of lending a small amount, less than what is usually lent in commercial banking. Its amount depends on the borrowers' ability to use it effectively and, above all, on their ability to pay interest and return the capital in various installments.
2. *Beneficiaries*. Microcredits usually target people who are close to the poverty threshold (they live on slightly more than two dollars a day), "poor" people (who live on less than two dollars a day), and "destitute" people (who

live on less than one dollar a day). The ethical problems arising from the microloans' goals and beneficiaries are discussed later in this chapter.

3. *Women*. Preferential lending to women is based on three assumptions: (1) They are better administrators than men; (2) the money they receive will have a greater effect on the family's well-being, particularly on the children; and (3) in many countries, they are discriminated against in the development of their abilities and the roles they can perform, with the consequence that the microcredits may be a useful tool for increasing their empowerment and improving their status and opportunities. In fact, many microcredit programs target primarily women (97 percent, in the case of the Grameen Bank, for example [*Financial Times* 2008]).[4]
4. *Microenterprises*. The microcredit's purpose is not to solve occasional problems caused by lack of income but to start a self-employment program or create or expand a microenterprise. Borrowers may buy a business or farmland, operate a small industrial or craft business, engage in retail sale, street-selling, farming, and so on. The intention is that borrowers be able to generate future income that will enable them to pay interest and return the loan. This purpose of the microcredit is based on two assumptions: (1) that poor people have entrepreneurial abilities that they cannot put to good use due to lack of financial resources, so that providing these resources will enable them to change their lives; and (2) that self-help is much more effective than public or private aid targeting the low-income population.
5. *Other uses*. Rather than restricting the microcredit to an income-generating function, other authors suggest that the borrower be allowed to decide how the funds are used, which may also include covering extraordinary expenses (a wedding, a funeral, or a disease), a temporary fall in income (a bad harvest), the purchase of a trousseau or educational expenses, and so on (Nourse 2001).[5] However, if the microcredit is used for consumption, it may be harder for borrowers to repay it, and its economic impact may be more limited.
6. *Group guarantee*. Microcredits are usually not granted against a physical guarantee but on the basis of trust. Accordingly, credit applicants join groups that perform a variety of functions: share information, negotiate together, monitor other borrowers' compliance, and even share in their members' liability, undertaking to pay their debt if the borrower defaults.

   The most distinctive feature of microlending, at least in its early stages, is this group liability. Because the borrowers have no assets, individual guarantees are replaced by that of the group, whose formation is facilitated by the fact that the members already know each other. These members join the group voluntarily and usually live in the same place. The group's meetings with the MFI's representative are held in public, and at these meetings, each member makes her payment in the presence of all the others. The fact that it is a group enables members to monitor each other's compliance and bring pressure to bear on defaulters, appealing to incentives such as reputation loss, shame, or reprisals.

   However, many authors criticize joint liability. For example, it raises free-rider problems (Stiglitz and Weiss 1981); the fact that liability is accepted jointly may attract potential borrowers with a higher risk (adverse selection) and encourage higher-risk behaviors (moral hazard). And it may also have a domino effect, when nonpayment by one member of the group induces the others to also default if the liability they would incur is too burdensome (Schreiner 2003). Therefore, if social pressure is to effectively counteract these perverse incentives, it must be very strong, perhaps unjustly so.

7. *Individual guarantee*. In spite of the success achieved with the group credit,[6] many MFIs do not work with groups, and some of those that do are reducing the percentage of their portfolio made up of group loans (including Grameen Bank). This may be for efficiency reasons: Many of the advantages previously discussed (sharing information, peer pressure to abide by the contract, and mutual help) are the result of the group treatment of credit, without any need for joint liability. It may be appropriate in the program's early stages, but when the group and the MFI have obtained the necessary information on each member and the member in question has already acquired some real guarantees and a greater confidence in her project, the individual guarantee may offer more advantages (Drugov and Macchiavello 2008).[7]
8. *Repayment*. When the loan is granted, regular installments are specified for paying interest and returning the capital (the installment amount is constant during the loan period). The first installment is usually a few days (often one week) after the loan is granted, and the installments are also spaced closely together (weekly or fortnightly) during the loan's term (usually 6 to 12 months). Using this procedure, the amount of each installment is low, which facilitates regular payment and reduces monitoring costs.
9. *Bank-client relationship*. The public nature of the transactions and the unique relationship between clients and the MFI also play a major role, which starts with the formation of the group, the discussion of the microcredit's terms, and the provision of the money. It is not the client who goes to the bank but the bank that goes to the client. Meetings are usually held at the borrowers' village or town, often in a public place, such as the market square. The MFI's employee comes weekly or fortnightly, meets with each group of borrowers (attendance is compulsory) to discuss any problems that have arisen, and reviews the credit's status. At this meeting, each member of the group pays her installment in the presence of the other members; if a member cannot pay, she must say so at this time because the meeting is usually not concluded until the employee has received all the payments, either from the borrower or from the other members of the group. Under this system, the defaulter is under very strong pressure from the group, which explains, at least in part, the high repayment rates obtained with these loans.
10. *Credit scaling*. The incentive to repay the loan within the stipulated period is not just based on the social costs (reputation and shame) but also on the fact that honoring the loan's terms by all of the group's members is a necessary condition for entitlement by any one of them to future loans. These loans usually follow a progressive scale: The first loan is small, which makes it easy to return and reduces the group's monitoring costs. When this loan

has been fully repaid, clients may have access to other loans for higher amounts. This is in the interest of each member, because they can now ask for larger sums; in the interest of the group, because their monitoring costs are now lower; and in the interest of the MFI, because its costs are reduced by economies of scale. It is common for the first two or three loans to a client to provide very little return, because the administrative costs are very high compared with the quantity lent (Roodman and Qureshi 2006).

11. *Savings.* The MFIs usually encourage their clients to save voluntarily, or else they impose a compulsory savings amount that is included in the microcredit installments. By this means, the borrower shows her willingness to abide by the terms of the loan; it provides an additional guarantee for the credit and complements the repayment installments; it provides an additional source of income for the family; and it helps develop habits of austerity, good administration, and thinking about the future. Compulsory saving also provides an incentive for punctual performance of one's obligations, because noncompliance of the compulsory saving condition may entail loss of the quantity saved and exclusion from future credits. However, the savings increase the cost of the credit to the borrower and provides a surplus to the MFI, due to the differential between the interest rate paid on the loan and the interest received on the savings.
12. *Interest rates.* The microcredits' interest rates are usually high, often above 100 percent per annum. This raises efficiency and, above all, equity problems, which are discussed later in this chapter.

THE SOCIAL RESPONSIBILITY OF MICROFINANCE

Is microfinance ethical? The most common answer is yes: Microfinancial institutions' moral legitimacy is given by the goal they pursue. But what goal provides moral justification for MFIs? To help determine this, it is helpful to consider (1) how they perform their social responsibility and (2) what are the social results achieved.

The Social Function of Microfinance

In principle, the social function of any organization is justified by its internal and external mission (Pérez López 1993). The former is defined by its contribution to satisfying those needs that drive its members to pool their effort in a common task: how it rewards the labor and capital provided, and how it sustainably and efficiently offers satisfaction, knowledge, and skills to employees, while earning a profit in the case of a business enterprise. The external mission is defined by the needs of clients, suppliers, local community, and other groups that it tries to satisfy, including its actions' impact on outside stakeholders. This external mission is specific to each type of company. In the case of financial institutions, it will be the provision of brokerage services that facilitate the flow of savings toward investment (Argandoña 1995; Merton and Bodie 1995). Each MFI will adapt this generic social function to its nature (commercial bank, hedge fund, insurance company, and so on) and to the environment in which it operates (for example, whether it is a developed or emerging country).

Each MFI defines and implements its mission to a greater or lesser extent and expresses it in a series of voluntary policies: in the case of the MFIs, the provision of financial services (generic social function) to people who until now were excluded from the system (specific function arising from the nature of their activity and the environment they operate in). This is then implemented using different models. Some of them minimally fulfill their social function while trying to maximize profits; others give more weight to social results, although they also try to cover their costs; and, lastly, others emphasize helping the most needy, even if this entails incurring losses, which are covered by donations. We can therefore say that all MFIs fulfill, at least in principle, the generic social function of financial institutions, but the degree to which they assume their specific responsibilities varies in each case, depending on how they have voluntarily defined their external mission.

Social Results

It is not easy to measure the social results of microfinance, because these organizations usually pursue different goals that cannot be measured by applying uniform criteria for society as a whole (economic development, poverty reduction, women's empowerment), for their clients (improve the microentrepreneurs' standard of living), or for the lending institution (its sustainability). Which goal is used, or which goals are combined, is always a more or less arbitrary decision, and the measurement of these variables is also subject to discrepancies.

The empirical studies of the measurement of social results do not show any agreement on the results achieved, not even on one of these variables, and the methods used in most of these studies are subject to serious criticism. Even so, the best empirical studies support the microcredit programs' effectiveness in reducing poverty and empowering women.[8] Dunford (2006) concludes his review of several of these studies by saying that "in sum, the evidence seems sufficient to say that [microfinance]—particularly when provided to relatively poorer women—increases income and savings, improves nutrition and health, and empowers women" (12), and that "many microfinance programs are reaching large numbers of very poor while fully covering their costs" (13). In regard to the effects on the direct beneficiaries (microentrepreneurs and their families), there are many, more or less anecdotal cases of very positive results, although it is not possible to generalize very far from these conclusions.

It would seem, therefore, that an ethical appraisal of microfinance would give a positive finding, at least in regard to its social function and results. But good intentions or positive social results are not sufficient in themselves. Like any human organization, the MFI must also observe ethical criteria in its decisions, which include fairness in granting the microloans, avoiding dependence and overborrowing, and managing with prudence.

SUSTAINABILITY AND THE FIGHT AGAINST POVERTY

The debate on the ethics of microfinance has focused recently on the compatibility between its economic (cost coverage) and social dimensions (outreach). In this

section, two issues are discussed: (1) whether the MFIs can and/or should be financially sustainable,[9] and (2) whether they can and/or should try to earn a profit like the commercial banks—that is, whether for-profit organizations should take part in microfinancing.

Microfinance has an economic dimension, and, as such, it is reasonable that it be required to show efficiency in its management, which will manifest in coverage of its costs and production of a surplus. However, microfinance is also an instrument for social policies, and on the one hand, some (the so-called *welfarists*) argue that it should subordinate its strategies and policies to its social function by providing the best possible service at a price that can be afforded by the greatest possible number of people, particularly the poorer people, even if this means that it will always be dependent on donations and subsidies. On the other hand, the *institutionalists*, while acknowledging the social function (outreach), add that financial self-sufficiency is a necessary condition for the MFI's survival and for the expansion of its activity to more potential clients, as its social function requires, without having to resort to a continuous injection of donations. Institutionalists also hold that both goals should be compatible with each other, at least in the medium term.

The debate between these positions has given rise to what Morduch (2000) calls the microfinance *schism*. This debate can be analysed on two levels: historic development and principles.

The Development of Microfinance

From the historic viewpoint, the discussion is a consequence of the organizations' evolution. They started off as subsidized institutions in which the product was new, the clients were not the conventional clients served by commercial banking, and the risk was very high, so that cheap funds provided by subsidies were required to cover start-up expenses. At that time, few people thought that MFIs would ever be self-sufficient.

Over time the MFIs learned to manage their businesses. They improved their procedures, increased their scale, and reduced their costs. Sustainability was no longer a utopia, and, for some of them, it became a necessity because the growth of their businesses forced them to look for broader sources of finance,[10] while the continuity of donations was no longer assured since it was affected by the appearance of other needs requiring the help of agencies and private donors. According to one writer, "The challenge is not to find a willing lender and endow it with sufficient loanable funds but, rather, to find a production function (a technology) that makes it possible to produce quality financial services at reasonable costs for the micro-client and in a profitable manner for the MFO [microfinance organization]" (González Vega 1998, 7). At the same time, commercial banking had also entered the microcredit business, and some nonprofit MFIs have now become for-profit organizations.[11]

In order to be sustainable, microfinance requires a mix of yield and risk that gives it appeal. This may be feasible for some organizations but not for all of them. Hence the danger that some may relinquish their social function for the sake of sustainability—for example, by charging very high interest to increase their profitability, or cutting back on their portfolio of very poor borrowers to reduce their risk (Conning 1999).

Microfinance and Profit

The debate on principles has focused on criticizing those people who seek to earn a profit by doing business with a country's poorest people. However, I feel that this view is mistaken. If someone intends to supply goods and services to those who have nothing (such as severely disabled people or children in a state of complete destitution), it is not reasonable to obtain anything from them because they have no possessions. However, if they can give something, it is reasonable to ask them for a little (such as asking people who go to charity-run community canteens to help clean up afterward), not to obtain a personal profit at their cost but to help them appreciate what they receive, to reduce costs (so that more people can benefit from the service), and to restore their human dignity. Such an argument would be even more justified if beneficiaries are provided with resources that enable them to improve their situation, as is the case with MFIs. Therefore, it seems reasonable for an MFI to require something in exchange from the microcredit's beneficiaries, including return of the capital and payment of interest. To say that these institutions earn profits at the cost of the poor, and not by helping the poor, is to ignore the very nature of business activity, portraying it as predatory.

However, this response does not give a final answer to the question of the compatibility of sustainability and outreach. As Morduch explains, "Much of the enthusiasm [about microfinance] rests on an enticing 'win-win' proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty" (2000, 617). Obviously, this is true for some organizations, but it is not necessarily true for all of them. Many MFIs have not achieved a win-win solution nor is it likely that they ever will,[12] either because that is not their chosen strategy or because they are prevented from doing so by such factors as the regulatory framework, government attitudes, competition from other financial institutions, and the impossibility of gaining access to cheap sources of finance.[13]

In any case, a growing number of organizations are trying to make their social function compatible with operational sustainability. This can also mean a rapprochement to the traditional banking model, either as a result of a deliberate decision by the MFIs themselves or because they are forced to do so by the environment in which they operate. It is not known what effects this may have in the long run on the extent, depth, and nature of the microcredits.

THE ETHICAL PROBLEMS ASSOCIATED WITH INTEREST RATES

A large part of the debate between institutionalists and welfarists is concerned with the interest rates charged by the MFIs, which are often very high.[14] This matter raises three economic and ethical issues:

1. Are these high rates justified?
2. What should be the interest rate stipulated for each operation?
3. If, as seems logical, a high interest rate discourages the poorest clients, does this effect give rise to a moral duty for the MFI?

Why Are the Interest Rates So High?

The following arguments are usually given to justify the high interest rates (Goodwin-Groen 2004):

- The alternatives available to microcredit clients also charge very high interest rates. For example, informal lenders and pawnshops may charge up to 20 percent per day (Lewis 2008, 57).
- The profitability of microenterprises in developing countries is probably very high, particularly in the informal economy.[15]
- The real interest rate is high because it includes a risk premium. The lender takes into account the likelihood of a loan not being repaid and increases the interest rate charged on all loans to cover the expected loss. And although the microcredit repayment rate is usually very high (close to 97 percent in many cases), as a group, the borrowers continue to be high risk, particularly because of their vulnerability to external factors, such as poor harvests, epidemics, and recessions.
- The MFIs need capital, which they obtain from private investors, and their cost of capital is high because the MFIs' risk is also high, because it includes their clients' risk premium.
- The interest rates must cover operational and transaction costs, which are usually very high: The clients often live at a considerable distance from towns, they are visited frequently, and the meetings are lengthy. In addition, the administration costs (study and decision making, monitoring, enforcement, and accounting costs) are not less than those of a traditional financial institution, but because the amount of the loans is very small they are unlikely to cover the organization's overhead. (It is just as expensive to process a microcredit for $50 as it is to process a loan for $10,000.)

The conclusion to be drawn from all this is that the high interest rates of MFIs may be justified by the lenders' cost structure and the borrowers' risk. However, the fact still remains that the interest rates are very high—and other costs must be added that are borne by the borrowers, such as the monitoring costs by members of their group (including the time spent in meetings) and compulsory saving.

The Fair Interest Rate

The issue of what interest rate should be charged in a specific operation corresponds to *commutative* justice (Pieper 1966).[16] In a competitive market, in which the prospective borrower has access to several credit providers with similar terms, the resulting interest rate will tend to be equal to the minimum amount needed to cover the provider's costs, and, as a result, there will be no ethical problem at all. However, in the microcredit market, competition is usually limited, so the resulting interest rate will depend on the two parties' relative bargaining power. Because the clients usually have little power, the interest rate imposed will be high (Hudon 2006).

In this case, fair price theory does not recommend what should be the fair interest rate. It cannot be said on the basis of fair price theory that the high rate

is unfair, but the MFI should remember that this extraordinary profit is not the outcome of its greater efficiency, but because of the MFI's market power. Then, corporate social responsibility policies should address the best use that could be made of this profit, which might include reducing the interest rate for all or some clients and allocating the extraordinary earnings to social activities.[17]

Exclusion of the Most Needy

If the interest rate is high, it is likely that some potential clients, mainly those with less income, will be excluded from the microcredit system. What are the MFI's moral obligations in this case? This is a problem of *distributive* justice, which addresses the distribution of costs and profits between people in a community (Pieper 1966). There are a number of possible solutions. A lower interest rate could be specified for lower-income borrowers, financed by higher interest rates for those who have more resources (a cross-subsidy), by public or private subsidies from outside organizations,[18] or by waiving part of the institution's profits (provided that this does not endanger its sustainability). As I said earlier, the MFI's external mission should be to establish the needs of the people it seeks to satisfy, and this determination will define its social responsibility on this point.

In any case, the issue of distributive justice goes beyond microfinance's social responsibility in that it also has a political element. The microfinance sector of the economy absorbs indeed a not insignificant volume of subsidies; it generates competition between organizations with very different profiles; it receives different treatments from the authorities; and, in short, it gives rise to vested interests, which often come into conflict, particularly when it must answer the question asked here.

CONCLUSION

Microfinance has undergone considerable growth in recent years and, in general, has enjoyed a very favorable public opinion—which is well deserved, at least in many cases. This chapter has discussed its economic-financial, social, and ethical features—and all of them must be taken into account when judging this reality, which is, at one and the same time, an instrument integrated in development policies, a business opportunity, and a service provided for needy people.

Microfinance rests on certain basic assumptions, such as the role of capital and the importance of access to financial services for economic development; the existence of a large supply of entrepreneurial ability among people without any financial resources or prior training; the importance of social networks as guarantors of the borrowers' conduct; the need for economic efficiency (sustainability) as a condition for the MFIs' survival and growth; and the possibility and effectiveness of a development strategy devised by private institutions, without requiring any direct public involvement (but with the appropriate legal, regulatory, and institutional framework). If any of these assumptions is rejected or challenged, the appraisal made of microfinance might be different.

Microfinance is important for the institutions that offer it, as well as for its clients, the local communities, and society in general. It is based on an ethically correct motivation, and its actions are morally good. Consequently, if it is applied with prudence, honesty, and reasonableness, it deserves a positive ethical

appraisal. It also seems to be morally good when judged by its personal, social, and economic effects, although there are reasons for being unsatisfied with the results, either because they have unwanted indirect effects or because they are insufficient in some of their dimensions. In addition, success or failure depends on many factors that are outside an MFI's control, including protection of property rights, adequate incentives, infrastructures and basic services, absence of corruption, adequate regulation of MFIs, and a public policy that fosters it or, at least, does not interfere with microfinance.

Microfinance organizations are not a panacea in the fight against poverty, and microcredit will not render other development policies unnecessary. MFIs have a lot to learn and room to improve—and, in fact, they are learning and changing, both in the technical-financial area (sustainability) and in the ethical area (outreach). As Morduch observes, "There appears to be ample room . . . for a diversity of programs, with competing methods and financial arrangements" (2000, 626), and an extensive variety of MFIs, each one of which will leverage its comparative advantages, as explained by Hudon (2008, 41):

> *For-profit institutions have important financial know-how and are able to mobilize important sums. The state-owned institutions understand the local markets and benefit from a strong reputation among the poor. Their social knowledge could become essential to complement the financial knowledge of the for-profit institutions. Cooperatives have the deepest penetration in the market for small deposits. NGOs can play a key role by helping to create experiments with new frameworks to develop the microfinance schemes. They also provide training and management capacity building in order to stabilize and sustain the growth in this field.*

This ultimately implies that there is no point in opposing sustainability to outreach, and even less in defending a fundamentalist attitude about what a microfinance program is and should be (Vanroose 2007). In any case, every MFI should be responsible for its decisions on the balance between sustainability and outreach, since it will have to consider its mission and goals, its limiting factors, the intentions of its fund providers (owners, donors, financial markets) and clients, its competitors' strategies, and the constraints of the legal and institutional environments in which it operates.

NOTES

1. See nobelprize.org/nobel_prizes/peace/laureates/2006/press.html.
2. The differences in the figures between the various sources are substantial. Stephens (2008) reports information on almost 900 microfinancial institutions in 2007, with 366,000 employees and more than 40,000 branches throughout the world, more than 64,000 borrowers, and almost $32 billion in credits.
3. See summaries in Armendáriz de Aghion and Morduch (2005), Ghatak and Guinnane (1999), Morduch (1999), and Sengupta and Aubuchon (2008), among many others.
4. Khandker (2005) and Smith (2002) provide empirical evidence to support the efficacy of microcredits targeting women; for evidence against this, see Goetz and Gupta (1996). See also Brau and Woller (2004) for a summary of papers on this subject.

5. In fact, "scattered research suggests that only half or less of loan proceeds are used in business purposes. The remainder supports a wide range of household cash management needs." From "What Is Microfinance" in www.microfinancegateway.org/section/faq percent23Q2, no. 5.
6. Empirical studies on the factors that determine high credit repayment rates include Ahlin and Townsend (2007), Cassar et al. (2007), Hermes et al. (2005), Karlan (2007), Sharma and Zeller (1997), Wenner (1995), Wydick (1999), and Zeller (1998).
7. As a general rule, the commercial banks that engage in microlending prefer individual liability, while the nonprofit institutions prefer group liability. See Cull et al. (2008).
8. For recent reviews of these studies, see Armendáriz de Aghion and Morduch (2005), Goldberg (2005), Morduch et al. (2003), and Watson and Dunford (2006). Khandker (2005) is a particularly careful paper, based on three large-scale programs in Bangladesh; his conclusions are clearly positive.
9. Here, *sustainability* refers to the economic aspect, the coverage of operating expenses and capital costs, not the environmental aspect.
10. In 2007, the 892 MFIs that provided information to Microfinance Information eXchange (MIX) obtained 72 percent of their funds from deposits or commercial debt and only 2.5 percent from subsidies (Stephens 2008, 29). The inability to gain access to sustainable sources of funds accounts for the high percentage of MFIs that do not manage to grow (73 percent of them never get beyond 2,500 clients, according to "Economies of Scale" in www.microfinanceinfo.com/economies-of-scale).
11. This is the case of Banco Compartamos, Mexico's largest MFI, which was created in 1990 as a nonprofit institution. Over the following years, it received $4.3 billion from international development agencies and private donors. In 2000, when it had 60,000 clients, it became a commercial bank; by 2006, it already had 616,000 clients, and it decided to go public in 2007. This operation aroused the interest of investors: 30 percent of its equity was placed for $450 billion, which gave an annual compound rate of return of 100 percent (Rosenberg 2007). Some institutions, such as ACCION International, saw a model in this operation that other MFIs should follow, but there was also strong criticism from those who interpreted it as a betrayal to the spirit of microlending, as Compartamos charged interest to its borrowers at an annual rate of 120 percent, compared with 31 percent charged by similar institutions (Lewis 2008; Yunus 2007).
12. Among the optimists, see González Vega et al. (1997) and Hulme and Mosley (1996). Among those who think that it is not possible to achieve both goals, at least as a general rule, is Morduch (2000).
13. The empirical studies on the effect of a greater sustainability on outreach are not conclusive; for recent summaries, see Goldberg (2005) and Weiss and Montgomery (2004). Hulme and Mosley (1996) and Copestake et al. (2005) show that the poorest people are the least benefited by microcredit, but Khandker (2005) and EDA Rural Systems (2004) come to the opposite conclusion.
14. Cull et al. (2008) calculate that the median interest rate charged by nonprofit, nongovernment MFIs is 25 percent per annum, while the interest rate charged by commercial banks on ordinary loan operations is 13 percent.
15. "For a microentrepreneur, the cost of a microcredit loan represents a small proportion of total business costs. Studies conducted in India, Kenya, and the Philippines found that the average annual return on investments by microbusinesses ranged from 117 percent to 847 percent." (From "International Year of Microcredit," United Nations, 2005; quoted in "What Is Microfinance," www.mcenterprises.org/studycenter/microfinance.) However, Dehejia et al. (2005) and Karlan and Zinman (2006) deny that the demand for microcredits is insensitive to the interest rate, at least for low-income clients.

16. This problem is a variant on the old fair price problem (Messner 1965). Commutative justice is the justice that regulates the relationship between two people: in this case, lender and borrower.
17. Sen (2006) is stricter when he discusses sharing the benefits of globalization. For him, it is not enough that the poor borrower does not come out worse off, in absolute terms. In fact, he argues that profit distribution between the two parties should be biased toward the borrower, and increasingly so the poorer the borrower is and the greater the MFI's market power is (cf. Hudon 2006).
18. Sustainability-driven MFIs are unwilling to accept government aid, which imposes constraints on their characteristic flexibility, innovativeness, and independence.

REFERENCES

Ahlin, C., and R. Townsend. 2007. Using repayment data to test across models of joint liability lending. *Economic Journal* 117:F11–F51.

Argandoña, A. 1995. The treatment of ethical problems in financial institutions and markets. In *The ethical dimension of financial institutions and markets*, ed. A. Argandoña. Berlin: Springer Verlag.

Armendáriz de Aghion, B., and J. Morduch. 2005. *The economics of microfinance*. Cambridge, MA: MIT Press.

Brau, J. C., and G. M. Woller. 2004. Microfinance: A comprehensive review of the existing literature. *Journal of Entrepreneurial Finance and Business Ventures* 9:1–26.

Cassar, A., L. Crowley, and B. Wyndick. 2007. The effect of social capital on loan group repayment: Evidence from field experiments. *Economic Journal* 117:F85–F106.

Conning, J. 1999. Outreach, sustainability and leverage in microlending: A contract design approach. *Journal of Development Economics* 60:51–77.

Copestake, J., P. Dawson, J. P. Fanning, A. McKay, and K. Wright-Revolledo. 2005. Monitoring the diversity of the poverty outreach and impact of microfinance: A comparison of methods using data from Peru. *Development Policy Review* 23:703–723.

Cull, R., A. Demirgüç-Kunt, and J. Morduch. 2008. Microfinance meets the market. Policy Research Working Paper 4630, World Bank.

Dehejia, R., H. Montgomery, and J. Morduch. 2005. Do interest rates matter? Credit demand in the Dhaka slums. Discussion Paper 37, ADB Institute.

Drugov, M., and R. Macchiavello. 2008. Learning and microlending. CEPR Discussion Paper 7011.

Dunford, C. 2006. Evidence from microfinance's contribution to achieving the Millennium Development Goals. Presented at the Global Microcredit Summit, Halifax, November 12–15.

EDA Rural Systems. 2004. *The maturing of Indian microfinance: A longitudinal study*. New Delhi: EDA Rural Systems.

Financial Times. 2008. Conflicts of interests. Life & Arts, December 6–7.

Ghatak, M., and T. Guinnane. 1999. The economics of lending with joint liability: Theory and practice. *Journal of Development Economics* 60:195–228.

Goetz, A. M., and R. S. Gupta. 1996. Who takes the credit? Gender, power, and control over loan use in rural credit programs in Bangladesh. *World Development* 24:45–63.

Goldberg, N. 2005. Measuring the impact of microfinance: Taking stock of what we know. Grameen Foundation USA. www.grameenfoundation.org.

González Vega, C. 1998. Microfinance: Broader achievements and new challenges. Occasional Paper 2518, Ohio State University Rural Finance Program.

González Vega, C., M. Schreiner, R. L. Meyer, S. Navajas, and J. Rodríguez. 1997. A primer on Bolivian experiences in microfinance: An Ohio State perspective. Working Paper, Ohio State University, Rural Finance Program.

Goodwin-Groen, R. P. 2004. Making sense of microcredit interest rates. *Donor Brief* 6 (January).

Hermes, N., R. Lensink, and H. T. Mehrteab. 2005. Peer monitoring, social ties and moral hazard in group lending programmes: Evidence from Eritrea. *World Development* 33:146–169.

Hulme, D., and P. Mosley. 1996. *Finance against poverty*. London: Routledge.

Hudon, M. 2006. Fair interest rates when lending to the poor: Are fair prices derived from basic principles of justice? Working Paper 06/015, Solvay Business School, Université Libre de Bruxelles.

———. 2007. Fair interest rates when lending to the poor. *Éthique et Économique/Ethics and Economics* 5:1–8.

———. 2008. Norms and values of the various MFIs. *International Journal of Social Economics* 35 (1–2):35–48.

———. 2009. Should access to credit be a right? *Journal of Business Ethics* 84:17–28.

Karlan, D. 2007. Social connections and group banking. *Economic Journal* 117:F52–F84.

Karlan, D. S., and J. Zinman. 2006. Credit elasticities in less-developed economies: implications for microfinance. *MIT Research in Action Working Paper*.

Khandker, S. R. 2005. Microfinance and poverty: Evidence using panel data from Bangladesh. *World Bank Economic Review* 19:263–286.

Lewis, J. C. 2008. Microloan sharks. *Stanford Social Innovation Review*, Summer:54–59.

Merton, R., and Z. Bodie. 1995. A conceptual framework for analyzing the financial environment. In *The global financial system: A functional perspective*, ed. D. Crane, K. Froot, F. Mason, A. Perold, R. Merton, Z. Bodie, E. Sirri, and P. Tufano. Boston: Harvard Business School Press.

Messner, J. 1965. *Social ethics: Natural law in the modern world*. Rev. ed. St. Louis, MO: B. Herder Book.

Morduch, J. 1999. The microfinance promise. *Journal of Economic Literature* 37:1569–1614.

———. 2000. The microfinance schism. *World Development* 28:617–629.

Morduch, J., S. Hashemi, and E. Littlefield. 2003. Is microfinance an effective strategy to reach the Millennium Development Goals? *CGAP* Focus Note 24.

Nourse, T. H. 2001. The missing part of microfinance: Services for consumption and insurance. *SAIS Review* 21:61–70.

Pérez López, J. A. 1993. *Fundamentos de la dirección de empresas*. Madrid: Rialp.

Pieper, J. 1966. *The four cardinal virtues: Prudence, justice, fortitude, temperance*. Notre Dame, IN: University of Notre Dame Press.

Roodman, D., and U. Qureshi. 2006. Microfinance as business. Center for Global Development, ABN-AMRO Bank.

Rosenberg, R. 2007. CGAP reflections on the Compartamos initial public offering: A case study in microfinance interest rates and profits. *CGAP* Focus Note 42, June.

Schreiner, M. 2003. A cost-effectiveness analysis of the Grameen Bank of Bangladesh. *Development Policy Review* 21.

Sen, A. 2006. *Identity and violence: The illusion of destiny*. Boston: Norton.

Sengupta, R., and C. P. Aubuchon. 2008. The microfinance revolution: An overview. *Federal Reserve Bank of St. Louis Review*, 90:9–30.

Sharma, M., and M. Zeller. 1997. Repayment performance in group-based credit programs in Bangladesh: An empirical analysis. *World Development* 25:1731–1742.

Smith, S. C. 2002. Village banking and maternal and child health: Evidence from Ecuador and Honduras. *World Development* 30:707–723.

Stephens, B. 2008. MFI benchmark analysis: An industry still expanding, despite challenges. *MicroBanking Bulletin* 17:25–32.

Stiglitz, J. E., and A. Weiss. 1981. Credit rationing in markets with imperfect information. *American Economic Review* 71:393–410.

Vakulabharanam, V., and S. Motiram. 2007. The ethics of microfinance and cooperation. *Éthique et économique/Ethics and Economics* 5.

Vanroose, A. 2007. Is microfinance an ethical way to provide financial services to the poor? Microfinance: Are its promises ethically justified? Working Paper 07/014, Solvay Business School, Université Libre de Bruxelles.
Watson, A. A., and C. Dunford. 2006. From microfinance to macro change: Integrating health, education and microfinance to empower women and reduce poverty. *United Nations Population Fund and Microcredit Summit Campaign.*
Weiss, J., and J. Montgomery. 2004. Great expectations: Microfinance and poverty reduction in Asia and Latin America. Discussion Paper 14, Asian Development Bank Institute.
Wenner, M. 1995. Group credit: A means to improve information transfer and loan repayment performance. *Journal of Development Studies* 32:263–281.
Wydick, B. 1999. Can social cohesion be harnessed to repair market failures? Evidence from group-based lending in Guatemala. *Economic Journal*, 109:463–475.
Yunus, M. 2007. Remarks by Muhammad Yunus, managing director, Grameen Bank. *Microcredit Summit E-News* 5.
Zeller, M. 1998. Determinants of repayment performance in credit groups: The role of program design, intra-group risk pooling and social cohesion. *Economic Development and Cultural Change* 46:599–620.

ABOUT THE AUTHOR

Antonio Argandoña is a member of the Royal Academy of Economics and Finance, chairperson of the Professional Ethics Committee of the Catalan Economics Association, and a member of the Anti-Corruption Committee of the International Chamber of Commerce (Paris). He has been the honorary treasurer and member of the Executive Committee of the European Business Ethics Network (EBEN), and co-founder and secretary general of EBEN-Spain. He is the editor and co-author of *The Ethical Dimension of Financial Institutions and Markets*, and the author of many articles on ethics, economics, and management issues.

PART V

Financial Management