

Financial Regulation

Worldwide regulatory developments and their implications
for the financial services industry *international*

The Banking Sector and CSR: an unholy alliance?

I Introduction

The aim of the paper is to consider whether banks are already fulfilling their social obligations through their ethical policies or whether they could do more to incorporate those who are without financial products. The question arises of whether banks actually need to be socially and ethically obligated given that banks are simply organisations. This paper will argue that rather than banks being simply corporate entities they have, in fact, due to the growth of industrial society, become part of everyday life to such a degree that they have developed into utility entities thereby justifying calls for corporate social responsibility to be embedded in their actions. If as utilities, their services are not available to all, it is difficult to see how they can claim to be acting in accordance with their own policies. As Wittingdale states, 'It is self-evident that business cannot simply rule out the exercise of moral judgements in its activities. The question must instead be how corporate social responsibility is defined and managed' (Wittingdale 2001)

The paper reviews the origins of and the arguments for CSR before focussing on the role of banks in society and the ethical expectations of society especially in the area of financial exclusion. Finally it is argued that although there is not necessarily any tension between banks' CSR and their profitability, nevertheless given the current economic situation other priorities are present and it is accepted that until economic conditions change widespread efforts to tackle financial exclusion are not to be expected.

II Origins, Development and Motivation for Implementing CSR

Lord Holme and Richard Watts defined CSR thus; 'corporate social responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving

the quality of life of the workforce and their families as well as of the local community and society at large'. (Mallenbaker 2008) CSR has become an important and integral feature of modern society. The origins of CSR appear in several different arenas. Philanthropic ideals of the 19th century could be described as one of the earliest manifestations although limited to a few companies without a call for this to be spread to the majority. It was however in the twentieth century that ideas became more widespread. In the 1930's President Roosevelt was quoted as saying that 'we have always known that heedless self-interest was bad morals, we now know it is bad economics'. Some decades later theories of stakeholding arose in the 1950's and it is argued here that recognition and responses to stakeholders is synonymous with CSR. The origin of stakeholding is often felt to be work by the Stamford Research Institute (Plender 1997) and yet they may have been merely formalising thoughts expressed in business rhetoric. The Chairman of Standard Oil is quoted as saying 'The job of management is to maintain an equitable and working balance among the claims of the various directly interested groups – stockholders, employees, customers and the public at large' (Plender 1997). Along with stakeholder theory, matters of organisational legitimacy have also been debated with links between the two strands identified by Dowling and Pfeffer (1975). Other writers Black and Hartnell (2004) claim that legitimacy can only take place when the values of society and those of stakeholders are highly correlated. The answer lies within the developing belief that business and society co-exist; as Cannon (1992) states incorporating elements of both stakeholder and legitimacy theories, 'The enterprise, its proprietors and other stakeholders depend on their community in which they operate for their existence and prosperity.'

However, a contrary view is provided by Friedman (1962), Hayek (1969) and others who believe that the

role of a business in society is an economic one, stating 'There is only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, engages in open and free competition, without deception and fraud'. Furthermore, Friedman states that; If businessmen do have a social responsibility other than making maximum profits for their shareholders, how are they to know what it is? (Friedman 1962) Can selected private individuals decide what the social interest is?

Despite these arguments, massive economic growth during the 20th Century has focussed attention on environmental and social issues within companies, with calls for better ethical actions to be both addressed and formally disclosed. The United Kingdom Government accepts the importance of CSR and the implications for both behaving responsibly in business and in complying with European law. This it has implemented in two ways using both voluntary initiatives and the law. In 2004 The DTI (Department of Trade and Industry) set up the CSR academy as a resource for organisations of any size and sector wanting to develop their corporate social responsibility skills¹ to encourage and guide businesses in their strategic and operational activities. Furthermore in the 2006 Companies Act it became compulsory for companies to report on social and environmental matters in the context of the development of their businesses. Other legal initiatives include the Pensions Act of 2000 which required trustees of pension funds to provide a statement of their principles with regards to social and environmental matters in their investment decisions. In several European countries similar rules are to be found in the law relating to pension funds.

However, even before the 2006 Companies Act, it had become the norm for large companies to report on actions beyond the maximisation of profits. Many companies make substantial donations to charities on a voluntary basis either in money or resource terms. Even where there exists a legal obligation to carry out social actions (e.g. in the area of disability) in many instances these obligations were exceeded by companies. (Woodward & Day 2006). There are also economic arguments for organisations to implement CSR. The growth of ethical investment (also known as socially responsible investment) is highly significant in most countries with a developed capital market. In the US \$2.71trn of funds are currently invested in socially screened investments and one out of each \$9 invested now has some form of

screening (Social Investment Forum, 2009). Many studies have demonstrated that socially responsible funds perform competitive over time with the market, with certain indices (such as the Domini index) even showing that these funds outperform the market. (Social Investment Forum)

III Financial exclusion

The case for banks in particular to have a corporate social responsibility to the community, links to the Government's 10-year initiative to stop financial exclusion. (Social Exclusion Unit).

Research (Chambers 2004) has demonstrated that there is a link between the banks behaviour towards its customers and the financial exclusion of individuals. There is a gap in expectation between what the banks deliver and what the customers expect the banks to deliver. This expectation gap can lead to financial exclusion because of the disengagement of the customer from the bank. (Chambers 2004) Thus there is a tension in the case of banks between the social responsibility of including the excluded by bridging the expectation gap, and the general economic business model of profit maximisation. The current economic crisis maintains the focus on the issue, as the banking industry blamed by many as the originator of this crisis could be seen as pursuing too vigorously the policy of profit maximisation.

There has been a plethora of research conducted, by both academics (Kempson & Whyley 1998-2001) and government (PAT 14) into the question of financial exclusion. These have generally concluded that there are different types and variations of social exclusion. It can be seen from such work that a person who is financially excluded is also often socially excluded thus demonstrating the dynamic relationship between the two. (Mckillip and Wilson 2007) The Social Exclusion Unit defines social exclusion as:

A shorthand term for what can happen when people or areas suffer from a combination of linked problems such as unemployment, poor skills, low incomes, poor housing, high crime, bad health and family breakdown.

Many definitions of financial exclusion have been offered by different commentators; Richard Vaughen of the Office of Fair Trading believes that such exclusion is a two-fold concept. Vaughen states that exclusion can either be caused by price or income. (OFT 1999) Price exclusion occurs where an individual at any given

income freely chooses not to purchase goods or services because the market price is above the maximum he or she is willing to pay.(OFT 1999.19) This willingness will be partly determined by individual preferences. Secondly people can be excluded due to income exclusion. Income exclusion refers to the non-consumption of goods or services arising from low incomes.(OFT 1999 p19).

Banks have taken the issue of financial exclusion seriously, with many of them having distinct departments for the integration of the excluded or help to assist people in difficulty. (Co-operative Bank). This brief overview of financial exclusion allows us to see that financial exclusion should be part of the banks' CSR agendas. Therefore they may achieve part of their CSR goals by helping the financially excluded.

IV Banks and CSR

It has been demonstrated that banks are businesses. Yet they also take interest in the social wellbeing of their customers and some banks have enacted financial inclusion programmes. By doing this banks are acknowledging that they are more than just a business. Furthermore by acknowledging and accepting that they have responsibility to society they have demonstrated their more human and philanthropic side.

The importance of CSR is now globally recognised with nearly every large UK company including within its' annual report and accounts information about its social and environmental activities, often in the form of a substantial standalone report. The main UK banks are no exception to this. Although banks have recognised financial exclusion being high on their agendas, there still remain 1.3 million people suffering financial exclusion. (Financial Inclusion Task Force) The self-regulatory approach taken by the banks, does not achieve its end goal i.e. to greatly reduce financial exclusion. In the current climate it is expected that more people will become excluded. (BBC News 11 Feb 2009) If the self-regulatory approach is not working the alternative is to legislate.

However, any form of special legislation to ensure that they encompass the financially excluded does not govern the UK banks. This is not the case in the United States of America, where legislation has been passed to ensure this outcome. The Community Reinvestment Act 1977 was passed in America some three decades ago. Its main role is the reinvestment of money from banks and lending institutions back into the community and is an integral part of wealth creation in

the United States of America. Could this be a model that the UK could adopt? Certainly academics such as Mayo have voiced this opinion in the past. (Mayo et al 1998).

The US tackled financial exclusion in a completely different manner to the UK; however this is not to say that the US does not have financial exclusion as an issue any more, far from it. As far back as 1977 the Americans were aware of red lining (where banks and other financial institutions would not lend to a post code area because there was an assumption that all people in such area were a bad risk) and the associated problems of financial exclusion. As such they enacted a Bill, which can be said to be one of the best comprehensive pieces of legislation aiming to tackle financial exclusion. The Community Reinvestment Act 1977 12 USC 2901(a) (CRA 1977) was introduced as a means of dealing with the heavy criticism that banks were red lining and were creating financial exclusion among a significant proportion of US citizens. (Bernanke, 2007)

The aims of the legislation were to encourage financial institutions to reinvest in the areas they serve. (Henry 2006). The CRA 1977 states:

'(1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;

(2) the convenience and needs of communities include the need for credit services as well as deposit services; and

(3) regulated financial institution have continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.

(b) It is the purpose of this title to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions'. (12 USC 2901 (a)).

It has been stated that the CRA 1977 has 'revolutionised social equity' (Maria 2002). This is mainly because of the requirement that financial institutions should support and fulfil the credit needs of the community that they are chartered to serve. There is also an incentive for financial institutions to contribute to the local community.

The CRA 1977 was amended as it was rather a 'vague' piece of legislation (Maria 2002), where the results were 'modest' (Barr 2005). Other commentators noted that the results were 'little more than a vague statement of principle without much real world effect', (Macey et al 1993) which maintained a 'low profile' after its enactment. (Bernanke 2007)

The first amendment came in 1989 whereby there were indicators added to the legislation to measure the compliance with the legislation. (Macey 1993). In 1995 the CRA was amended once again to introduce objective performance measures of lending practices. The CRA was further amended in 1999 by the Financial Modernisation Act, (Gramm-Leach Bliley Act). This Act required financial institutions to have a satisfactory CRA rating when they applied to regulators to change their authorised activities.

Although the CRA 1977 does purport to increase the social responsibility of financial institutions by ensuring fair and equitable lending, it does not recognise the other aspects associated with social irresponsibility nor financial exclusion. Social responsibility goes further than just ensuring fair lending to all customers. It goes further than just not red lining customers because of their geographical location or ethnicity. However what the regulators have missed is the manner in which customers are treated, whether customers know what they are actually doing with their finances, and whether the customer is able to manage their finances in a responsible manner themselves. This is dubious as to whether this should in fact be a social aim of the financial institutions.

Social responsibility should however, in the researchers' opinion, be more than just allowing people access to financial products, it should also take into consideration the manner in which the customers manage and deal with their finances. However, it is acknowledged that without access to financial products the manner in which the customers use the products would be obsolete. The CRA 1977 would therefore, in the researchers' opinion, not be a solution for the UK's financial exclusion problem. However, lessons can be learnt in relation to fair and responsible lending, something that the Government and regulators are examining in the current economic climate.

Furthermore, it is questionable whether creating an obligatory regulation ensuring financial institutions meet the needs of their consumers, actually meets the necessary social, ethical and moral issues. A bank

undoubtedly cannot refuse to lend to someone because of where they live or what race or colour they are. However this does not mean that customers are enabled to use the financial products available. No matter how much regulation is enacted, unless people are aware through their own financial literacy of the complex products offered by banks, then they (the banks) cannot be fully fulfilling their social responsibility. Financial education and literacy is the key to understanding and countering financial exclusion.

The question is therefore do banks have a CSR to ensure financial inclusion. And can this be achieved by the UK style of self regulation rather than through legislation, as in the US. Many writers agree that UK banks do have an obligation to fulfil their CSR. Chatterjee (1996) suggests that CSR is an aspect of general business which entails not only the maximisation of profit for the benefit of the shareholders in the company but the adoption of a socially responsible attitude in conducting business. Banks are institutions making decisions affecting much of society and as such would be expected to fulfil the widest CSR agenda. Chatterjee notes that although profit maximisation may be beneficial to part of society, it can have the opposite effect on another part by fostering financial exclusion.

In recent years societal uneasiness has become manifest particularly in respect of the issue of profit-maximisation, as opposed to profit-optimisation, by corporate bodies. But is profit-maximisation a source of harm, or a source of benefit to society? If profits are channelled appropriately for the welfare of society, then it may be difficult to condemn the profit maximisation policy that corporate bodies usually pursue; but the appropriate channelling of profits is a matter for the Government, not for the corporate bodies, unless the latter takes the initiative to do so. In the absence of any legislation in this regard, it may be unjust to condemn corporate bodies on this issue in mind that not all corporate investors may be persuaded by the concept of corporate social responsibility. For any organisations, there may well be a trade off between the application of CSR and profit maximisation, as UK law requires that directors act in such a way as to benefit shareholders but also adds the expectation of a certain set of behaviours in the area of CSR. The relationship between CSR and the UK banking sector can only be examined once the role of banking within the UK is examined. A bank is undoubtedly a corporate entity. It has shareholders,

directors, employees and customers. It is governed by company and banking legislation and as such is constituted as an entity to pursue the interests of the companies memorandum of association. The operation of a bank affects society.

Although banks are primarily businesses, there has been a lot of criticism from the media and amongst academics surrounding the manner in which banks have been conducting their business in recent years. Why does society pay such attention to profits being made, shareholder dividends, director's salaries and the returns (or lack of) being made on customer accounts? The stakeholders of other corporate entities do not tend to focus critically on so many areas of performance. Yet the banking sector has become a target for widespread criticism. The reason would seem to lie with the preconception that a bank plays a social role within society. A bank, it is believed, performs a service for society and is essential to everyday life. Through deposits, loans and banking facilities it enables people and corporate entities to participate in an economic society based on financial transactions. This has been greatly facilitated by the introduction of modern technology. Most individuals use banking facilities everyday. As such, a bank has progressively come to be seen as a utility and, as an important if not essential facet of life; it is considered difficult for people to participate in economic society without the benefit of a bank. (BBC New 14 Feb 2009). This coupled with the controversial activities of the banking industry in recent years has resulted in questions being asked over the banks' ethical and moral obligations as well as their business obligations.

A bank being a social utility was demonstrated in the economic turbulent times of the decline of Northern Rock. Government and regulators have treated the banks in manner more akin to a utility. The rescue package demonstrated that the Government did not want the bank to fail, nor did they want any other UK bank to fail. The House of Commons stated that they:

'Noted that similar special legal regimes exist in regard to other essential services, such as for the provision of energy, water and railways' (House of Commons 2008). In other words the rescue package was indeed similar to those that would be launched for a utility. 'Banks are special' (House of Commons 2008) or, as the Governor of the Bank of England has said, 'banks are not like other companies' (House of Commons 2008) The banks are treated differently than any other for profit organisation, excepting utilities. The manner of this is worrying, yet understandable, given the economic, social and political effects that would occur if the UK banking system should fail.

A sociological explanation stems from the notion that within the structure of an effective industrial society there exist both an infrastructure and a super-structure. An infrastructure constitutes the economic base, which predetermines the superstructure or the conceptions behind a society. Therefore if the infrastructure alters then so does the super-structure. (HM Treasury 2007).

By using this description it can be seen that the Banking industry is part of the infrastructure of the United Kingdom and what the banking industry does affects the rest of society on a number of levels. The banking industry by the very nature of the business it conducts, exists as an integral part of society and does not work in isolation from society. The role of the banking industry is difficult to conceptualise therefore without consideration of the social obligations that are expected of such a fundamentally important institution. It is here that the tensions between social and economic responsibilities arise.

One possibility could be that if banks do behave ethically and morally they may increase their customer base and therefore their profit. A less cynical argument may be that banks have an ethical consciousness, (Weiss 1994) which predetermines how they conduct their business affairs.

Table 1 Forge team involved in the development of guidelines			
FORGE Group	Trade Assoc.	Govn. Depts.	Advisors
Abbey	ABI	DEFRA	Amnesty International
AVIVA	BBA	DfID	British Quality Foundation
Barclays		DTI	Business in the Community
Lloyds TSB			Traidcraft
Legal & General			University SA Scheme
Royal & Sun Alliance			UNIFI
RBS			WWF – UK
Zurich			

* Source: Forge, 2002

V Ethical aspects of businesses – the banks' perspective

Ethical practice in business is not a new phenomenon but the relationship that has developed between the importance of ethics and the banking industry is relatively new. The Co-operative Bank was the first bank to give thought to the ethical implications of its operations although it was considered a pioneer in its field (Owen 2003) Banks have taken a great deal longer to approach the same standards as today when all main high street banks have ethical mission statements applicable to the conduct of their business. It is these ethical mission statements, which should shape and constrain business decisions. The constraints may include the possible risk of reputational damage (as in the case of Barclays Bank and their business interests in South Africa at the time of apartheid). A business decision by a bank may therefore consist of two elements:

1. Is this good for the bank in terms of profit maximisation;
2. Is this ethically sound?

The law however cannot provide a complete framework for ethical decisions but does play an integral part in the formation of the ethics, which affect the decisions. The values and beliefs of a society generally reflect belief in what is right and what is wrong. These same notions of right and wrong are also normally assimilated into law. There is, however a difference between that which is right and wrong and unregulated and that which is right and wrong and is regulated. This is where the question of moral obligations arises.

Where the law is silent and moral obligations come into play, issues rely on interpretations of ethics and the ability of the bank to self-regulate. Although the law by virtue of the Financial Services Authority (10 Oct 2002) is beginning to think about regulating the banks' ethical decision making process, it seems that the regulator's thinking does not go far enough to offer protection to those people who suffer from financial difficulties and financial. Regulation thus tends in this instance to prevent bad behaviour rather than to promote good behaviour.

VI CSR and Guidelines and Disclosure

Corporate social responsibility encompasses a large number of areas, some of which are company or industry specific and others of which are generic. Without some form of public reporting, accountability cannot really take place, as many of the actions of

organisations are effectively invisible. By looking at public reporting guidelines, these can be used as a surrogate for the underlying actions that are expected.

There exist a large number of guidelines produced for reporting (and carrying out) CSR. Many of these are generic such as UN Global Compact, AA1000 and OECD. Other organisations such as ILO tend to focus on a single aspect. It has been recognised that generic guidelines often limit clear action and reporting and industry specific guidelines have been drawn up. One such set are the FORGE guidelines, which were drawn up by the financial services industry as a response to this shortcoming.

The purpose of these guidelines was to:

1. Improve understanding of the relevance of Corporate Social Responsibility to the sector and the role and challenges of the sector in responding to CSR.
2. Increase engagement of financial services companies in responding to CSR, recognising that many financial service companies are already addressing some aspects of CSR.
3. Build on the initiatives that companies are already taking to help develop a systematic and structured approach to CSR.
4. Provide a basis for achieving increased levels of consistency across the sector.
5. Provide a practical 'step-by step' toolkit for identifying and prioritising issues, designing and implementing CSR management processes both in central functions/departments and in relation to financial products and services.
6. Improve sharing of the sector's knowledge relating to CSR management and reporting.

Furthermore the guidelines recognised four categories of CSR, workplace, environment, marketplace and community. Again within these categories a list of issues is give. For the purposes of this paper, it is interesting to note that in 2 above it implied that not all aspects of CSR were being addressed by the sector. In the disclosures made by the largest UK banks at the time of the research (2006) all of the then nine largest UK banks addressed the issue of 'access to products and services', and despite many of the disclosures being general rather than specific, it did however indicate that this item was at least on the agenda. (Day and Woodward 2009).

VII Conclusion

The aim of the paper was to assess the interrelation

between banks, corporate social responsibility and financial exclusion. By examining these three concepts, it is clear to see that a large proportion of society are still financially excluded, even through the Labour Government have since 1997 worked towards eradication. Banks show a higher awareness for corporate social responsibility and are working with partners, such as credit unions and debt awareness organisation to counter the problems of financial exclusion. However, it is debateable whether they are doing enough or indeed whether they can ever reduce financial exclusion.

The paper also comments on the current economic crisis being experienced in the UK as well as the US. The crisis has thrown the banking industry into turmoil and with an increase in personal financial crisis being experienced in both countries, the authors are dubious as to whether banks are able, given the current economic climate, to be in a position to act on encompassing the excluded. Indeed whether it would be prudent to take action in the present climate is under question. At the moment it is too soon to tell. Banks are acting and reacting to the crisis that is unfolding day by day and the regulators are doing the same. By imposing more regulations, similar to that of the US CRA 1977, may not be the best possible route for the industry. Certainly some regulation on monitoring, supervising and disclosing information about financial institutions would undoubtedly be beneficial but to ensure that banks fulfil their social responsibility functions may not be wise under the current economic crisis. As with any new regulation, there are costs associated, and at this time the financial services industry does not have the time, resources or finances to tackle new regulations of this sort.

What the researchers are proposing, that realistically, once the economic situation has settled the CSR of banks in terms of financial inclusion should be tackled head on. The researchers are not saying that providing access to financial services is

not a beneficial thing to concentrate on, but at this time it may not pose a universal benefit to society. At the time of economic recovery it is then that the banks should act on improving their social responsibility. They should have plans in place ready to go when the market once again become buoyant, as it will do. Economic patterns are cyclical and will, in time, recover and we can take stock of the financial situation. The fear though in the meantime is that the financially excluded will be forgotten and CSR of banks will go by the wayside. But who can blame Government or the financial sector, as pragmatic solutions to the current crisis must take precedence.

The credit crisis may be a reprieve for the banks from onerous regulation to bank the unbanked, but for the section of society who are financially excluded, these turbulent times are even more testing and promulgate their perceptions of the troubled and irresponsible banking sector. Corporate social responsibility is often far from the banks conscious thought at the best of times but now it is left firmly off the agenda.

*Dr Clare Chambers, University of West of England. Email: Clare.Chambers@uwe.ac.uk
Robert Day, Bournemouth University. Email: rday@bournemouth.ac.uk*

For the complete paper with bibliography, please contact the authors.

Endnotes

1. The CSR Academy developed a CSR Competency Framework, a template designed to help managers integrate CSR within their organisation. The Academy worked with a number of founding Programme Partners and Contracted Agents to establish the Competency Framework and disseminate its key messages. These included: Accountability, Association of Business Schools, British Chambers of Commerce, BSI, Business in the Community and the Chartered Institute of Personnel Development.

www.i-law.com/financialcrime
For more information call Leyla Utman
on +44 (0) 20 7017 4192