



# FINANCIAL INSTITUTIONS, SUPPLY CHAINS & CORPORATE SOCIAL RESPONSIBILITY

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**Clothing retailers** once freely sourced products from companies employing horrid sweatshop conditions. When initially confronted, retailers claimed it was not their fault that somewhere deep in a supply chain children were abused and labor exploited.

The sub-prime mortgage fiasco in the US is nothing but more of the same: a failure on the part of financial institutions to recognize and be responsible for the social impacts of their supply chain.

Many pundits have spoken loudly about the sub-prime mortgage debacle as a failure of risk management - which, of course, it is.

But the risk underlying the loans were not generated by mortgage holders, but mainly by mortgage brokers who up-sold and under explained complicated mortgages to financially

unsophisticated people who, more often than not, couldn't afford a mortgage in the first place. This is not to forget the minority of overextended amateur house flipping property developers who admittedly deserve less sympathy, but at the end of the day leveraging them to ruin is equally irresponsible. An inevitable conclusion is that real estate brokers walked away with hefty commissions for selling a faulty product. Less generously, they engaged in ingenious financial fraud. If these mortgages were toy trains made in China, a recall would be demanded.

Trade in money is rarely viewed from a supply chain perspective however. But it is not hard to now say that financial supply chains like many others -- inadvertently or not -- exploit a vulnerable class of people - the poor particularly -- by placing profit before socially acceptable business practice.



### Risk Management Prevention?

Some say improved credit risk management would have prevented all this and that is likely true. Common human decency imbedded in sound corporate social responsibility (CSR) would have too - morals and risk are often not mutually exclusive analytics (think of any get rich quick scheme over time).

Does anyone recall the story of the 93 year old woman taking a \$500,000 mortgage based on a \$2,000 monthly salary for caring for a 100 year old woman? This is neither sound lending nor is it serving the interest of any corporate stakeholders from the institution selling the mortgage, the investors purchasing collateralized debt obligations (CDOs), or, most importantly the client or primary stakeholder. In the end, everyone loses but most of all a poor, woman.

Financial institutions have never faced the CSR scrutiny felt, for example, by the consumer retail, mining, or forestry sectors. This is partly because financial institutions don't sell things we can touch. They buy, sell and borrow money. Their products and supply chains are sufficiently nebulous and their intermediation role in the economy is so complex that serious efforts to hold Financials accountable for the social and environmental impacts of their decisions have been sparse indeed.

Bankers are complicit in avoiding broader social responsibility: money, they say, doesn't destroy rivers or pollute air; it's the people who use it that do. The only systemic advance of a "public good" in finance has been to improve environmental risk assessments.

This is a great start but it evinces the logical

corollary of the sub-prime mess: risk and responsibility do actually lie *up and down* the financial supply chain. If a clothing retailer can be held accountable for ensuring supply chains are not dependent on 10 year olds paid 10 cents an hour – why shouldn't financiers be held accountable for their part in a supply chain that exploited millions of families, investors, and innocent economic bystanders the world round? Given their importance and influence, Financials -- more than other firms - - should be responsible and held accountable.

### Was Henry Ford prescient when he said:

*"Business must be run at a profit, else it will die. But when anyone tries to run a business solely for profit... then also the business must die, for it no longer has a reason for existence."*

### Where are the Social Investors?

Social investors have long braved conventional opinion by judging the social and environmental performance of companies but have largely failed in the task of judging Financial by their lending record, preferring, instead to assess them on their operating CSR impact instead.

Even the social investment community's commendable work on predatory lending has been ultimately and obviously ineffective as both a measure to protect people from poor



lending practice and from a financial system supply chain perspective. The overall result has been that Financials have had a fairly free ride into social investment portfolios and an artificially strong *Corporate Social Responsibility brand*.

Financials are not all bad and indeed lead in many CSR issues. CitiGroup is rightly held as a model for its pioneering work in microfinance for the poor around the world. Many financial institutions ascribe to the social and environmental principles of the Equator Principles' and Global Compact's efforts to increase social and environmental performance of private business. Some, though too few, have innovative green and community development financial products.

But when all is said and done, the trivial amounts dedicated to these efforts is just so much window dressing on the trillions of dollars of transactions which have social and environmental impacts ranging from unintended to outright venal -- evidence that CDO issuers were shorting the very products they were bringing to market makes anyone thinking otherwise complicit with the whole mess.

### **Know thy Stakeholder**

Failing to responsibly meet the needs of one stakeholder – the client – the Financials got good and pasted as they ignored the *First Law of Corporate Social Responsibility*: Know Thy Stakeholder and understand their needs as they were your own. The acid test for selling a mortgage to poor person should be simple as a

bank asking itself if it would take a single loan of 5 to 6 times its annual income (not profits) and accepts a leverage ratio of 50 times? None would and not only by choice, but by law. Another test is more simple and ironically is a guiding maxim in finance: know thy client.

It's unfair to blame financial institutions entirely for their sub prime appetite. The 21<sup>st</sup> century of hyper short-return expectations built on a credit funded consumption economy is at root the cause. Exotic financial instruments don't help as they have a tendency to dangerously "decouple" money from ownership and hence responsibility for impact. This makes it hard for anyone to be held accountable to inevitable social or environmental externalities. The financial corollary to these CSR observations are, as we are finding out, is as damning as it is similar. Financial institutions, wrote the *Economist* "ploughed gleefully" into CDOs which are so poorly understood (even by their creators, it seems)...."

A responsible stakeholder driven strategy would have balanced short-term profit needs with a longer term view to providing sustainable financial services to lower income people. Serving the clients' needs by funding affordable mortgages serves numerous benefits but above all the goal of home ownership and all the good things that come with it – intergenerational equity, financial security, stronger communities, healthier families etc. It would have also better served the financial sector goals of building strong client relations which invariably translates into valuable long-term economic relationships (in an industry where every new client costs over \$300 to obtain this is not an incidental consideration).



## Two Hundred Billion Dollars and Counting Can't be Wrong.

A stakeholder strategy would have also served the Financials best short-term interest as well. We may never be privy to the full details, but it is clearly safe to say that the total profit on sub-prime mortgages after write offs will be exponentially less than which the Financials may have profited if they had only written "socially responsible" mortgages. Meeting what might be considered an average long-term "value stock" return of 10 percent or so would have been a *fait accompli*.

These observations are consistent with the *Second Law of Corporate Social Responsibility* which says the crisis a *company averts* by paying attention to stakeholders is always less painful than the costs, uncertainties and legislation that certainly follows the crisis they don't avoid. New legislation may be slow in coming but we can be assured it will be more painfully constricting than the Financials would like. We can only imagine a world where financial security is the norm as opposed to a beacon far across a vast, dark and stormy economic waterscape.

It is surprisingly inexpensive to sort out and manage stakeholder interests and claims on company. What is more, simple stakeholder engagement processes not only find risk amongst stakeholders, but almost always unearth grand opportunities as well. Mathew Kiernen of Innovest, a corporate social investment rating agency employing leading edge environment and social governance analytics, has argued and demonstrated for some time that companies that

can anticipate and manage environmental and social governance issues consistently outperform those that can not. Some of the world's largest pension funds using Innovest's products, naturally, agree.

### Profit and Society

By virtue of a century old social compact companies have unavoidable social responsibilities and no matter what later day "Milton Friedmanites" like to claim, making a profit has never been the sole term this contract. The internet, rising consumer affluence, social investors, super sensitive global brands, and increasingly savvy advocacy groups amongst other forces, are increasingly holding company, large or small, directly, or as part of a supply chain, over the fire of social and environmental accountability.

***"Price does not rule the Web;  
trust does."***

From the Harvard Business Review  
Cited in Profit Brand by Nick Wrenden

Banks and other financials deserve their trillion dollars spanking for not observing their social contract and the resulting Laws of Corporate Social Responsibility. Unfortunately the pain which will be disproportionately shared by the poor and middle class will continue long after the last bail out check is written. As the human face of the economic melt down precipitated by the sub



prime mess emerges, we can only hope the Financials will recognize the erosion of their CSR Brand.

Some, neigh, many will scoff, but CSR Brand Value is real and particularly so in an age where consumer relationships and hence profitability is built more on trust than any other factor in business. Just ask British Petroleum or Royal Dutch Shell about their CSR Brand value after their respective environmental and social misadventures (e.g., Brent Spar and Nigerian oil fields etc.). Some fifteen years after the fact, for example, Shell is still paying hefty court fees and related public relations damage surrounding its alleged complicity in the murder of Kenule "Ken" Beeson Saro-Wiwa in Nigeria. In finance, the CSR Brand Value cost to the sub prime mess will be much, much higher even incalculable given that in finance confidence and integrity is very a highly valuable commodity.

This can not be otherwise in the information age, where the internet is the *Auto de Fe* of corporate social and environmental accountability. Increasingly well informed and more often than not cynical "internet citizens" will determine the fate of a company's CSR Brand Value often without *even* having a direct stake in the company or ever having bought its product. Corporate counter propaganda will do no good as it is only so much gasoline on the fire the public's already poor view of business.

**27%**

Is the average public level of trust for big business between 1970 and 2000

And just as the Gap and Nike learned pre-Internet, companies in the are finding quite quickly their responsibilities inescapably lie both up and down the supply chain. Only through the magnitude of the financial crisis can we now see the potential negative effects of letting money dealers off without the same type of scrutiny placed on those companies producing more tangible things. It turns out that the *Third Law of Corporate Social Responsibility*, which holds social responsibility and profitability are *not* inversely correlated, applies quite dramatically. What is more, the benefits of CSR are not only long term. If the Financials has paid attention in late 2005 to market signals – unprecedentedly low savings rates, credit cards in the mail, mortgages without proof of income, the rise of informal lenders -- urging them scrutinize irresponsible loan originations more closely, their shareholder's short term profits interests would have been much better served.

This fiesta of corporate *irresponsibility* demonstrates, once again, the immense systemic economic risk of failing to adhere to a basic level of *responsibility*. Taking this lesson to heart may just help us avert more rapidly -- and profitably -- the current global warming crisis, the negative outcome of which will certainly make the cost of sub prime crisis look small indeed.



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