

Socially Responsible Credit

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Why has Social Banking been a financial success? What have Traditional Banks not taken into account? The purpose of this proposal is to shed light on this new form of banking and to understand the economic and social fundamentals that drive their performance. Whether or not social banking can be universalized or mainstreamed remains to be determined. By conducting in depth interviews and merging multiple financial databases, this proposal aims at investigating the real status, the potential and the future of social banking.

1 Introduction

The benefits and consequences of finance have stirred heated debate among politicians and the general public. The crisis of 2008 set a defining catalyst on the discussion, highlighted by the fact that currently, nearly half of adult Americans believe that **finance hurts** the US economy. As a result, financial economists have been urged to further figure out what works and what does not (Zingales, 2015). **Therefore, what have we done wrong and how can we improve Finance?**

The financial world often argues that an individual's utility is a function of their wealth and therefore, it should be maximized. However, this traditional way of thinking has been challenged by both researchers and the private sector. Leading researchers in experimental economics have tackled this issue and have shown that there is much more to incentives and utility than just monetary factors. Uri and Gneezy (2000) famously examined a group of high-school students who were collecting donations for charity. They found that students who were **not** monetarily incentivized (i.e. were not given money for their effort) performed far better than those who did. This showed us that intrinsic motivators such as selflessness are far better motivators than pure monetary ones. Further examples on the limits of finance are plentiful. Blood donations suffer once they are monetarily incentivized (WHO, 2010) and other inherent behaviours such as social pressure and peer comparisons have significant effects on individual actions and incentives (DellaVigna, List & Malmendier, 2012; Nolan et. Al, 2008). **What are we missing then?** What can finance do to maximize long term profit, and subjective wellbeing, while at the same time addressing global issues such as global warming and inequality? Finance has often received the blame for causing these problems and very often, for good reasons. Finance is becoming a balancing act of incentives, commitment and long-term thinking. Today, it is important for us to ask, **what makes finance work and what can make it better?**

Social Banking is a new phenomenon where banks have taken a triple bottom line approach (people, planet and prosperity) to their business and lending strategies. Social banks (such as Triodos) do not just avoid doing harm, but they actively use finance to do good. Collectively these banks have more than 100\$ billion in combined assets globally. The industry has experienced tremendous growth and surprising profitability. During the financial crisis of 2008, these banks reported positive profits and continued to employ more people, a statement that would not easily hold for other financial institutions (Weber and Remer, 2011). In addition, their Return on Equity and Return on Assets are

just as high (or higher) than that of larger traditional commercial banks. **Apart from this, very little is known about these banks and how they differ from traditional commercial banks.**

On the other side of the financial world, socially responsible investment (SRI) funds have increased in size over the past years and companies (non-financial) are increasingly investing their time and resources on socially responsible activities. This has heightened the interest of many researchers of which many have found a positive and significant link between corporate social responsibility and financial performance (Wang et al, 2015). Even though we have witnessed tremendous changes in how we perceive socially responsible behaviour, we still know very little about real effects of social investments on financials and hence, much remains to be explored.

By studying Social Banks, we do not suffer from similar CSR (corporate social responsibility) related problems as in previous literature. These studies are always forced to compile odd and ambiguous "good guy" measures from traditional ESG (environmental, social and governance) databases such as *KLD* and *Sustainalytics*. Aggregate measures force us to assume the meaning of these numbers and therefore, provide very little practical economic advice (especially since these firms are always large, public and operate everywhere). In addition, these studies often evaluate the impact of CSR on stock prices (among other things). This is not wrong, however, it has its drawbacks. Returns on stock will (at least in the short term) often measure the degree in which investors currently value ESG dimensions. The real financial and economic fundamentals that matter the most in ESG are not immediately incorporated in stock prices for they are difficult to value (short term costs often overshadow the not easily perceivable long term benefits). By just looking at stock prices, we always miss a big part of the story. **By analysing Social Banks, we would not face these traditional analytical problems.** Social Banks undertake the "social" screening themselves and banks are the ones that create the economic opportunity. We do not face issues of "greenwashing", because being "social" is a mandatory requirement of these banks for the firms and the banks make sure it holds. Managers at social banks have said; "*there is no way we are providing a loan to this farm (or agricultural institution) unless they make at least half of their production bio, if this is not met, we will not even talk to them*". This quotation might be an exaggeration, but nonetheless, it depicts the loan screening process mentality. With these fundamentals in mind, we can "reliably" compare firms that are "legitimately" social (or fulfil some basic requirements) versus firms that are not necessarily so. **Overall, the largest benefits of this study, is that it allows us to examine the real economy. We are not evaluating the success of financial speculation, but real economic opportunities, created by Social Banks.** This is where this research would contribute the most. In addition, this analysis would concentrate on SMEs and to my knowledge, there are no good legitimate studies on CSR and SMEs. These are private institutions seeking real economic opportunities and creating real value to the economy.

2 Data & Challenges

At the moment, this project has a lot of potential, but lacks a perfect identification strategy. Our biggest challenges remain in finding an appropriate benchmark or comparison group. Overall, the data for this analysis would come from multiple sources and databases. First of all, we need to collect firm level information. This information will be collected from the *Orbis* database. If we were provided with a full list of firms from Triodos or Global Alliance for Banking on Values (GABV), this would allow the collection of firms effectively characterized as "social". In addition to collecting the information on social firms, we would collect all other firms from *Orbis* as well. This would allow us

to establish a control group or matched firm sample (i.e. compare companies of similar size, location, industry, etc.) in order to make some preliminary comparisons. This is a fairly standard approach in literature (Dimson and Karakaş, 2015) and would provide breadth to our analysis. What is also important to keep in mind; the data would be across countries. Even by just examining the loans from Triodos Bank alone, would allow us to extend the empirical results to a multicounty context.

To further extend the analysis, we would collect bank level information from the *BankScope* database. Many of the social banks that are members of GABV can be found from this database. There are some banks that are not in *BankScope* and would require manual collection. In addition, we would collect all other bank level information (i.e. the traditional commercial banks). This information will serve as supplementary information for our analysis.

Furthermore, *Orbis* provides information on firm-bank relationships. The firm-bank relationships are not accurate, but would give additional information and would allow merging the matched/control firm samples with their respective banks. Ideally speaking, we would need information on the loans of the comparable firms (i.e. non-social firms). This would be necessary in order to accurately compare the loan-firm performance differences between social and non-social banks. There is no easy way to gather this information and would require further investigation. Potential solutions would be to find credit registry data and shift this portion of the analysis to a single country study.

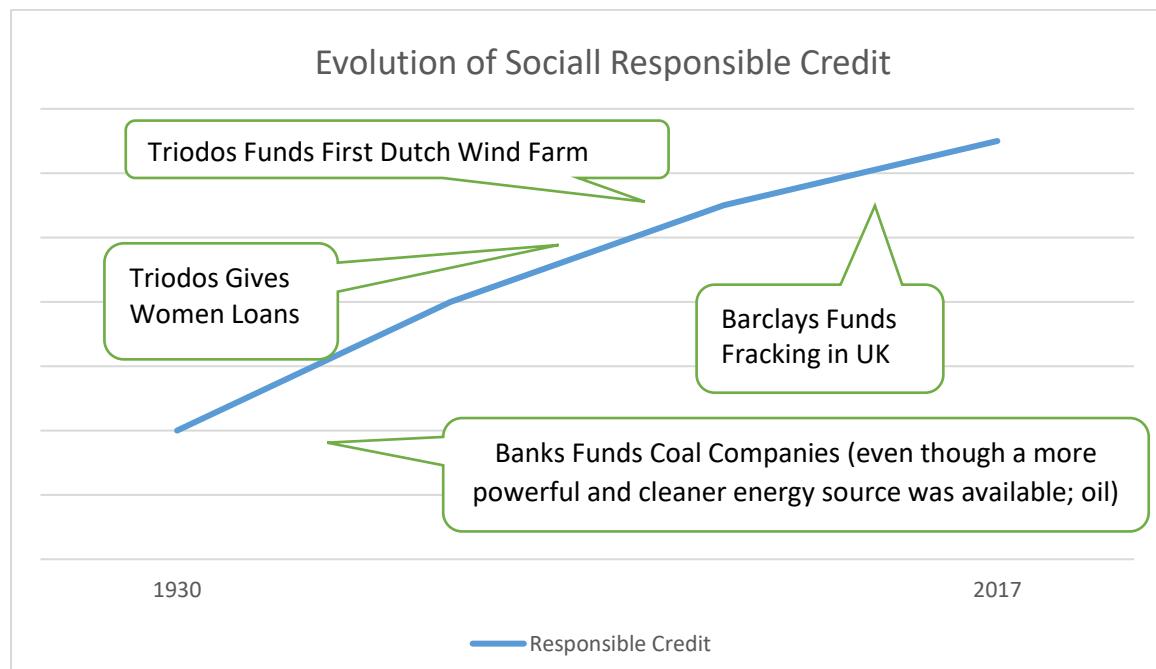
What is important to remind now, is that we still lack an appropriate identification strategy as well as comparison group. Unless we do not get access to a unique alternative set of data, we still face the problem of investigating a one-sided story. Since we do not have information on loans or firm relationships from traditional banks, we will always miss a part of the story. This will be the main issue that needs to be tackled before we begin this investigation. In the next few paragraphs, I clarify a few potential venues of investigation. Please note, these are suggestive and still require a further and deeper level of analysis.

- i) **Economic Contribution:** By collecting all firm level information from the members of GABV, we could analyze the total economic contribution of Social Banks. If we can create a database with all the known social firms (i.e. firms who receive a loan from a Social Bank), we could effectively compare them to the full universe of firms. This would be a first step towards understanding the country & sectoral level composition of loans and businesses, which social banks contribute to. At the end, this would provide us with extensive information and summary statistics (but no regressions) and would be a great start to understanding the full economic impact of social banking.
- ii) **Firm Level Effects of Receiving a Social Loan:** How do firms with a loan from a social bank differ from comparable firms that have received a loan from a traditional bank? Apart from the social dimension, are they more profitable or perhaps less likely to default? The ideal setting would be to compare firms who receive loans from a Social Bank and firms who receive a loan from a Traditional Bank. With this, we could effectively value the benefits of receiving a social loan. Since Triodos Bank also provide loans to firms in cooperation with traditional banks, it would be great to make comparisons between the firm level effects of receiving a loan from i) a social bank ii) social bank & traditional bank and iii) a traditional bank. As mentioned earlier, we are still missing iii), but it is something to consider in case we could ever find the appropriate data to investigate this question.

iii) **Utilizing Economic Shocks:** Another potential venue for research would be to exploit an economic shock, such as the removal of renewable subsidies in Spain or the financial crisis of 2008. Understanding the real effects of economic shocks could provide a great opportunity for a natural ‘laboratory experiment’. For example, one could compare the firm level effects of the 2008 crisis and document how the shock affected social firms and social banks differently compared to traditional firms and banks. At this point, the stories here remain limited (driven by sectoral differences and other attributes), but this could serve as interesting supplementary evidence. We could further document changes in consumer deposits, by examining whether depositors switch to social banks during economic hardship.

5 Conclusion

The purpose of this research project is to understand the financial and economic fundamentals that drive the performance of social banks. Above all, we want to understand how they differ from that of traditional commercial banks. Social Banks have always been above the normal curve (see graph below) when it comes to prosocial investments and it is important for us to understand why traditional banks have not been able to tackle these positive NPV opportunities. Is it all about relationship banking? Perhaps sectoral cream skimming? Or perhaps the social dimensions have financial value that has yet to be identified or documented? The contribution of this study to financial literature would be enormous and the messages are clear. The problem still lies in finding a comparable benchmark or regression. As of now, we can begin with comprehensive summary statistics establishing the economic realm that Social Banks operate in. However, much more remains to be done.



6 References

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5 Appendix

Anecdotal Evidence and Misconceptions

There are common misconceptions about the costs and risks of social investments. I elaborate below on the key insights that I have acquired until this point. Some of these points have been gathered via formal interviews with environmental economists and policy institute representatives at the IBRD, IFC, EIB and EBRD. Some of this anecdotal evidence is not easy to verify, but will nonetheless serve as indicative evidence to guide our research.

- 1) **Risk Misconception** Policy institute investments have already demonstrated that the political risk associated with green and social investments is the same as with traditional NPV/growth based investments and projects. It seems, traditional banks have been unable to identify the benefits of the social dimension, perhaps due to universal banking approaches that do not incorporate such information. It seems, investing in social projects does not have any additional associated risks as some academics and practitioners might believe.
- 2) **Funding Misconception** Common intuition would imply that green and social related investments are mainly driven by donations and subsidies, while evidence has shown that this is very much the opposite. As a clear example, carbon based investments collect larger subsidies than renewable energy sources. Even with this obstacle, social institutions (social banks, green funds, etc.) are in many ways relatively and financially successful. Examples include the crisis of 2008 when social banks reported positive profits and continued to employ more people. This statement would not hold for any other commercial bank or financial institution. Multilateral development banks also bring in a lot of capital from private financial institutions further legitimizing the profitability of their projects (i.e. they are not dependent on subsidies or donors).
- 3) **Performance Misconception** On average, social investments (via project finance) have a much smaller default rate. The current estimates state that commercial banks have approximately 18% default rate on project finance, while social institutions have below 8%. This is anecdotal evidence and finding these figures for standard loans is important for future research (as opposed to project finance). We know that the ROA and ROE of social banks is just as high compared to other financial institutions, however, we do not know fully what drives this competitive performance and efficiency.
- 4) **Incentive Misconception** Social banks tend to have a stronger incentive alignment with their clients due to the altruistic incentives from both the bank employees as well as the loan applicants. It seems there is an additional commitment mechanism that drives bank loan relationship effectiveness other than pure financial performance. Testing this claim is not easy and would also be a fruitful venue for future research.
- 5) **Segmentation Misconception** It is important to keep in mind that big banks are taking part in social initiatives and loans as well. These investments are not solely driven by a niche segmentation strategy of Social Banks. For example, Barclays has launched a £50 million green loan scheme to small businesses and has invested over £1 billion in Green Bonds (as well as committed to invest a further £1 billion). The commercial bank investments are becoming bigger and bigger. Private equity funds have long played their part in this, but social banks are really the ones creating both the impact and financial opportunity. Observing that big banks are following suit, does not mean that they are doing this solely because of external or internal pressure. As a result, there are real economic

opportunities that traditional banks have not been able to identify earlier in their loan screening process and now, they are catching on. Why they have not found them, remains an important question for further research.

Further Material - Implications for Theory

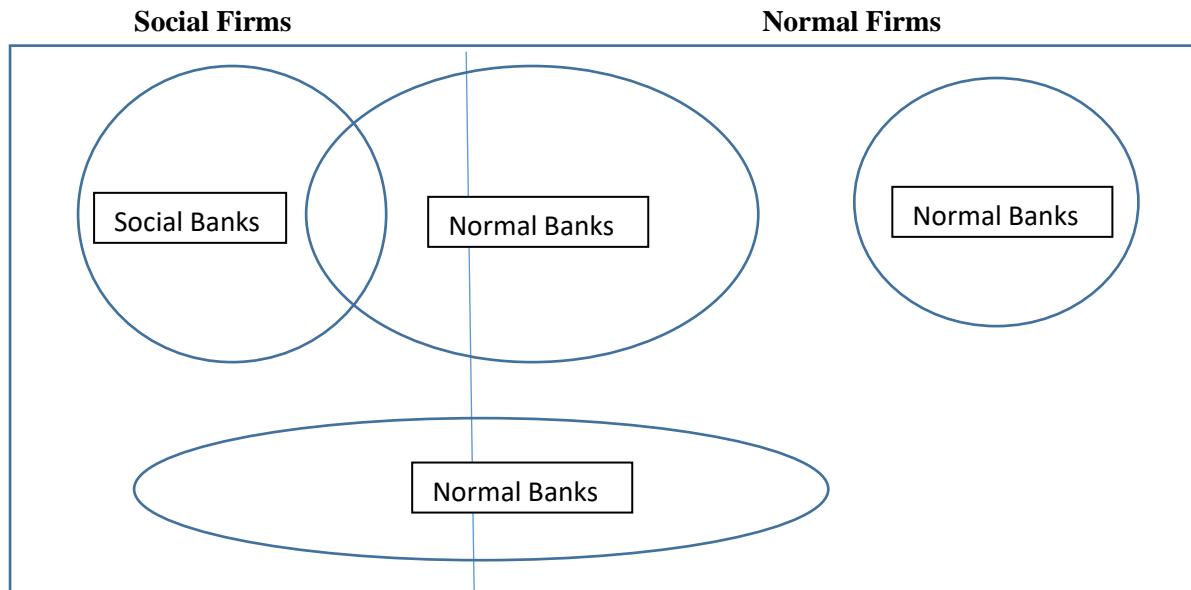
For this research, it would be interesting to develop a theoretical foundation. The pool of firms that banks are facing are not just "Good" and "Bad" anymore, as traditional academics would put it. There is an extra dimension that aligns the utilities of the bank and the firm. Both agents care about maximizing their income stream and having at least some societal impact. Whether it is just a stronger incentive alignment mechanism, something is making these institutions work. Growth, profitability and other things in mind, these firms are indeed relatively more successful. If they are more successful, then why have traditional banks not found them? I do not believe that the lack of soft information processing skills is the final answer here. Work by experimental economists have shown that altruism incentivises. Blood donations suffer when they are financially incentivised (UK vs US) and same goes for door to door charity among children (kids who received financial compensation for their effort on collecting money for charity perform worse than kids who are not monetarily incentivised). Financial incentives alone do not motivate everyone (factors like selflessness and Jones' effect are big drivers that we tend to ignore in our traditional way of thinking in Finance). These things are no new hype either, history has shown that more equal societies thrive (Piketty, Acemoglu's "Why Nations Fail", etc.), firm social responsibility has been discussed since 1916 (at least) and became "big" in 1953 with Bowen's book "Responsibilities of a Business Man". The same commonalities exist when we discuss why Quakers were historically so successful via their strong trust based financial relationships and why extractive financial practices were banned such as usury (thus creating a long chapter in time for the Bible, Quran, etc.). Even the first IPO wave in Dutch history around 1750 mandated that a certain proportion of IPO proceeds had to be donated to local Poor Houses. With these thoughts, I emphasize the long-term nature of economic social fundamentals and motivation. Therefore, the incentive alignment is one part of the story and I believe these banks are also better at screening these financial opportunities from social projects and investments. Traditional banks do not see these "intrinsic" opportunities as they do not show up on the firm financials (or at least they did not see them before). A paper by Eccles, Ioannou, Serafeim (2014) also showed that firms who chose CSR strategies in 1993 (i.e. far before the CSR issue became a hype) performed far better than any other firm in the long run. Investors have realized the benefits of these strategies much later. This also explains partly why we are finding more results on CSR and performance, because there is a broader understanding that, one way or another, CSR is good for business.

In a theoretical model, a bank would be bounded by a financial constraint as well as a social constraint. For traditional banks, only the first one will hold and that is where they gain a pool of firms that look financially better, but operate worse on the social axis that will harm them in the long run (social firms are better in the long run, therefore a time component might need to be included depending on the results from the study). Social banks operate under the social constraint as well as the financial constraint and this is what allows them to avoid any opaque firms that look good on paper, but are in fact more extractive/non-social in nature. As emphasized earlier, social investments are not more risky and this would not be an assumption of the model (as many academics might still believe). Traditional thinking would imply that social firms are more risky due to inherent political preferences, green subsidies, etc. However, this is far beyond reality as demonstrated by the

statements from multilateral development banks (even during the "current oil/energy crisis", I have been told that the CEOs of solar and wind power companies stating that the "crisis" had barely any impact on their operations, i.e. no energy substitution). This also means that external factors are not the sole drivers of loan performance. Something that might make these investments more costly, could be the search costs, expertise costs or costs associated with soft information. This is a rational thought of course. However, expertise alone is no argument, every loan officer needs to have some idea of some industry and if soft information plays a role in this, to me, and under plausible assumptions, it surely is not the main driver taking place here. Another thing to consider is that these are deposit driven institutions and they provide fair interest for depositors on their savings. If depositors are choosing to lose on interest by switching to these banks, the effects are marginal at best from a depositor's viewpoint. There is no income loss on the depositor's side (the governments often provide tax breaks on the interest gained from these institutions) and they are not "investing" in these banks at the expense of other financial opportunities.

This is the Spectrum of Information

	<i>Social Firm</i>	<i>Normal Firm</i>
<i>Social Bank</i>	YES	MAYBE
<i>Normal Bank</i>	MAYBE	NO (or Maybe)



Additional questions via Interviews

- (i) Is social banking better for firms? Do firms receive loans that would not have been administered to them via standard banks? If firms can choose between banks, why do they choose a social bank? Lower interest rates, customer satisfaction, or alignment of ideals (is it efficient that these loans are given out)?
- (ii) Is social banking better for banks? Do Social Banks find investment opportunities that were not identified by other standard banks? If yes, are the clients/firms better, less risky, or more long term in nature (i.e. lower defaults)?
- (iii) Is social banking better for the economy? What is the added value of these institutions? – servicing financially constrained firms or lowering aggregate financial risk. Is the allocation more efficient, do they close a real gap in the economy or is it crowding out / inefficiently lending to companies that should not be lend to?
- (iv) Is profitability at specific points in the cycle as opposed to across the cycle?
- (v) Are social banks more profitable because they operate in narrowly defined niche markets (i.e. would they be as successful if mainstreamed)? How does the loan portfolio of social banks differ from traditional banks? Are there sectoral differences that could explain a proportion of the results?
- (vi) Do costs and benefits of social vis-à-vis pure profit-oriented banking cancel out or does one dominate? Are there any specific channels?
- (vii) Is there a different incentive alignment mechanism associated with social banking? How does employee wages (i.e. lower wage ratio gaps) affect performance of Social Banks? How does their talent pool differ from traditional banks? People with same ideals, same schools, is there more in-house employee training?
- (viii) Why have traditional banks not issued loans to the clients of social banks? Does the universal banking model not reach this far, is this a niche loan segmentation strategy or do social banks utilize soft information to a much further extent than traditional banks?