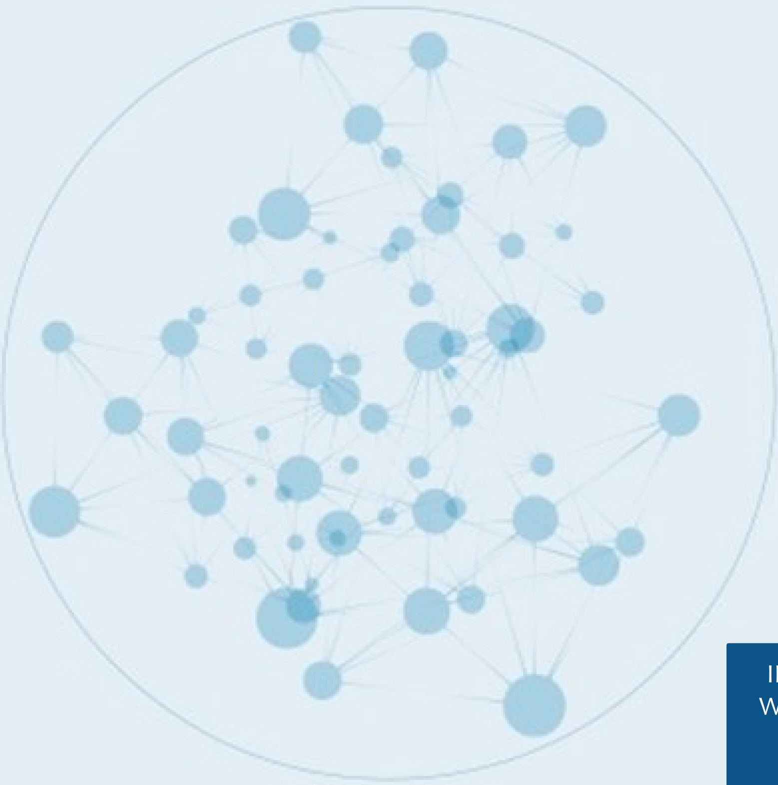
**Inquiry**: Design of a Sustainable Financial System

UNEP

# TOWARDS A THEORY OF SUSTAINABLE FINANCE



INQUIRY WORKING PAPER

15/08

October 2015

**The UNEP Inquiry**

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

**The Centre for International Governance Innovation (CIGI)**

CIGI is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

For more information, please visit *www.cigionline.org.details*.

**About this report**

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

**Comments are welcome and should be sent to** *simon.zadek@unep.org*.

**Author(s):** Joakim Sandberg, University of Gothenburg (Wallenberg Academy Fellow and Associate Professor of Philosophy) and Stockholm School of Economics (Research Manager at the Mistra Center for Sustainable Markets)

## Contents

## Introduction

Recent years have displayed a growing discontent in society regarding the functioning of financial agents and markets. This is leading to an emerging consensus that the financial system is in need of reform. The crisis of 2008 and onwards has demonstrated how misaligned incentives and poor regulations impose extreme and detrimental risks on both the financial system itself and society at large. But a more general problem is the seemingly inability of financial markets to address the more pressing sustainability challenges of our time, such as global poverty and the threat of climate change. These systemic flaws do not only pose a practical challenge for the world's leaders, but they also pose a theoretical challenge for contemporary researchers; to rethink the role of financial markets in society. If this role can no longer be defined solely in terms of profits and economic efficiency, then how should it be defined?

In his acclaimed book on the financial crisis, Joseph Stiglitz (2010) stresses the need for a new vision for the financial system. Rather than just "muddling through" – that is, putting out the most immediate fires but not addressing the root of the problem – we should seize the opportunity to rethink the system from the ground up. This paper is an attempt to do just that; to "think outside the box". The paper presents a theoretical model of a different and more sustainable role for financial agents and markets that is justified by systematic philosophical arguments and reasoning. My main locus of interest is to reflect on the aims and activities of financial agents themselves and how they may become a more positive part of society. However, the paper also reflects on the place and content of financial regulations and public policy. The aim of the model is to stake out a middle ground between the dominant view of finance, focusing only on profits, and contemporary calls for either more regulation by the authorities or greater social responsibility by agents themselves. In doing so, the aim is to present a vision that is both desirable and achievable.

A first a note on the methodology: The paper is normative rather than descriptive. It does not review how the financial system currently functions, but rather how it ought to function in the future. For this reason, I draw upon concepts, theories and arguments from the literature in both theoretical economics and normative philosophy. Some readers may feel that the models and suggestions under discussion are rather detached and abstract. But I should stress that this is not a good reason for dismissing them. Instead the suggestions should be evaluated for how robustly and effectively they provide a sustainable and plausible alternative to the current regime. The goal is to identify a new direction for finance which the majority of commentators will recognize as both desirable and achievable. It should thus come as no surprise if, despite the abstractness of the models and reasoning, the end result is a fairly straightforward idea about how the financial system can be improved.

The paper proceeds as follows: It first outlines the dominant view of finance and notes some of its strengths and weaknesses. Thereafter it introduces and evaluates contemporary calls for either more regulation by the authorities or greater social responsibility by agents themselves. In light of current evidence with both of these suggestions, a new theory is presented which I tentatively call the two-level model of sustainable finance. Finally, the paper closes with a discussion on what the theory implies in terms of both adequate behaviour by financial agents themselves and effective regulation by the authorities. The main results are summarized at the end of the paper.

# 1 The dominant view

Contemporary textbooks on finance typically give a simple yet consistent view of the purpose or role of financial agents and markets, which we may call the dominant or neoclassical view (Brigham and Ehrhardt, 2014; Kidwell et al., 2012). According to this view, financial agents should always adopt the practices which further their economic bottom line as effectively as possible – that is, they should strive to maximize shareholder wealth. For example, the best investment strategy is the one that leads to the highest risk-adjusted returns on the portfolio, and a pertinent lending strategy is one which maximizes the gains due to interest payments on the loans (minus losses due to borrowers' default). In a similar way, the appropriate level of complexity in financial products is whatever maximizes the agent's income while controlling for costs, and the appropriate level of capital reserves is whatever minimizes the agent's costs over the long run.

The dominant view is rooted in neoclassical economic theory, a school of economics developed in the early 20th century that sees markets as the result of rational behaviour by self-interested agents maximizing their utility. As such, some interpret the view as purely descriptive or predictive – as a model designed merely to approximate reality (Helgesson, 2002). However, it is clear that the neoclassical tradition has normative undertones and was used, for example, to underpin the large-scale deregulations of financial markets under Margaret Thatcher and Ronald Reagan in the 1980s. Some of the most visible defenders of the normative aspects of neoclassicism have been Milton Friedman (1962, 1970) and Michael Jensen (2000).

I cannot here review all of the arguments proposed in favour of the dominant view. I simply wish to highlight what I think is the best of these arguments, namely an idea of a division of societal labour. The idea is that a society works best – or, to put it differently, we as a society best fulfil our common aspirations if it consists of several parts with differentiated tasks. More specifically, it is argued that the task of the financial market, or private enterprise in general, should be to create wealth (to put it roughly), while it may be the task of the state or civil society to redistribute this wealth. The result is thought to be suboptimal if these tasks are intermingled; for example, if financial agents take on more substantive social responsibilities (Friedman, 1970; Jensen, 2000). One may visualize the argument in the form of a body (society) with at least two arms (the financial market and the state), and the point is that the body as a whole will do best if the two arms do different things.

The argument is obviously inspired by classical work on the division of industrial labour. Early economists like Adam Smith (1776) observed that allowing factory workers to specialize in very specific tasks led to increased economic efficiency, since they became more productive in their special tasks yet required less training and therefore less pay. In a similar manner, proponents of the neoclassical view of finance suggest that societal specialization leads to increased economic efficiency. This is because the two arms of society can focus on what they do best: financial agents can focus on making money which is their expertise, while civil servants can focus on social responsibility which is their expertise (Friedman, 1970). According to Jensen (2000), the very idea of one agent having two different goals (such as making money and accepting a social responsibility) is just irrational and precludes an efficient outcome.

## 2 Flaws of the dominant view

There is now a growing discontent with the dominant view of finance (e.g. Krugman, 2013; Malloch and Mamorsky, 2013; Santoro and Strauss, 2013; Stiglitz, 2010). Much of this is due to the financial crisis of 2008 and onwards, which has been described as the worst since the Great Depression in the 1930s. The crisis resulted in the threat of total collapse of some of the world's largest – and presumably most economically rational – banks, and a global economic recession we have yet to see the end of. While some of its causes can be traced to relatively "natural" macroeconomic events, such as a housing bubble in the US, the apparent carelessness of financial agents and markets also played a major role. Most importantly, the crisis was due to excessive lending to subprime borrowers, massive trade with obscure financial innovations such as CDOs, and a general lack of adequate capital reserves to cover the very high levels of systemic risk (Barth, 2009; Kolb, 2010; Stiglitz, 2010). All of these practices may have been rational on the individual level – they may have been justified from the standpoint of the dominant view that focuses on profit-maximization by individual agents – but they have had catastrophic effects on the collective level.

We may better understand this flaw of the dominant view if we return to the visualization outlined above. Proponents argued that a hand of finance that is left to function on its own accord will create a better society for all, in harmony with a hand of the state that does its job but refrains from interfering with finance. In reality, however, it seems that unregulated financial markets and behaviours have imposed enormous costs and risks on society. This is so because there is often a disconnect, or even a direct conflict, between what maximizes the profits of financial agents and what is best for society (more on this below). The aims of the hand thus become detrimental to the interests of the body. For example, sellers of subprime loans must have been aware of the great risks that they imposed on low-income borrowers, but it was "worth it" for them in terms of profits and individual bonuses. Similarly, the big banks that employed them knew of the massive risks involved, but they simply counted on the government to bail them out if something happened (Kolb, 2010; Ritholtz, 2009; Shiller, 2008). The classical vision of a division of societal labour thus does not seem to work very well with the reality of unregulated markets.

While the financial crisis is a vivid example and a good point of discussion, the dominant view on finance also has more general flaws. It is increasingly argued that the dominant view is unable to address the great sustainability challenges of our time, such as global poverty and the threat of climate change. Financial agents that aim to maximize profits just have too little to gain from caring about such things, or so they tend to think (Juravle and Lewis, 2008, Hawley et al. 2014). Many commentators now challenge this belief and argue that there is money to be made also on, for example, green investments and microfinance ventures targeting poor communities (Calvello, 2010; Kiernan, 2009; Krosinsky, 2012). There may be some truth to this, and certainly more truth than contemporary agents have realized. However, there is no mistaking the conflict between financial and non-financial values. This conflict is perhaps best brought out by comparisons of the social effectiveness versus financial cost of various sustainability initiatives in industry: there are strong indications that the more effective initiatives are also more costly, and that "win-win" solutions – that should be good in both financial and social regards – have insignificant social effects (Sandberg, 2008; Richardson and Cragg, 2010).

The conflict between financial and non-financial values is not only a practical conflict for financial agents, but it is also a more fundamental conflict inherent in the dominant view. As noted, the view only measures societal welfare in terms of economic efficiency and market production. However, arguably, the society we want is not only economically efficient but also socially and environmentally sustainable, among other things. There are then important societal values that the dominant view fails to take into account.

## 3 Is more regulation the solution?

In response to the problems outlined above, many commentators argue we need more and/or better regulation of financial markets (e.g. Admati and Hellwig, 2013; Barth, 2009; Kaufman, 2009; Shiller, 2008). Exactly what kind of regulation? There are many ideas in the literature, and indeed many countries have imposed new regulations in the aftermath of the crisis. Some of the most popular policies related to the crisis are:

(1) regulations to better contain financial risks, such as mandatory "stress tests" and increased capital reserve requirements;
(2) regulations of management incentives, such as limits on stock options and bonus programs; and
(3) increased taxation of financial agents, such as financial stability contributions (a "bank tax") or a financial transaction tax.

The point of many of these regulations is to move some of the risks or costs that financial activities have imposed on society back onto the financial agents.

A number of regulations have also been proposed related to sustainability and social responsibility (Dupré and Chenet, 2012; Hawley et al., 2014; Liebreich, 2013; Richardson, 2008). Examples include:

(1) reformed formulations of the fiduciary duties of financial institutions towards their beneficiaries and society;
(2) requirements that financial agents disclose and report on their work with "ESG" (environmental, social and governance) issues; and
(3) requirements that specific policies or governance structures are put in place to facilitate the consideration of ESG concerns.

The point of many of these regulations is to make financial markets pay closer attention to sustainability issues, beyond what their bottom line requires or allows.

While it is impossible to review all of these suggestions in the present context, I will simply make some general comments. The proposed regulations of course have progressive ambitions and make a lot of sense in that way. However, as Stiglitz (2010) notes, very few proponents have developed their suggestions into a comprehensive alternative view of the role of financial markets in society. Indeed, it seems as the majority of the suggestions – with the exception of the reformation of fiduciary duty and perhaps some other ideas – work within the worldview of the dominant theory of finance. Looking at the visualization above, one can see the point of the regulations as an attempt to give the hand of the state more power over the hand of finance. Financial agents retain the same ambitions and purpose – roughly to make as much money as possible – but the state now gains power to ensure that such financial incentives lead to socially beneficial outcomes. The hand of the state basically holds the hand of finance on a leash.

While this definitely can improve the situation, it seems that the underlying problem remains; namely that the hand of finance has no regard for broader society. It is not difficult to forecast that financial agents will do their best to try to evade the regulations, either through withholding crucial information, finding loopholes in the regulations, or indeed by actively lobbying against them. Since the financial industry controls such vast resources in society, it seems that their power to withstand or even push back an empowered state should not be underestimated. Indeed, there are reasons to think that such lobbying by financial agents played a major role in the previous round of deregulations that lead up to the crisis (Igan et al., 2009). For this reason, it seems that few regulatory solutions are likely to be effective and sustainable over the longer term.

One may also note that at least some of the benefits of the division of societal labour are lost with heavy regulation of financial markets. While financial agents are left to focus on their own activities, regulators will have to focus on the very same activities and are likely to have a hard time trying to keep up with the industry: the hand of the state will be quite busy with following the moves of the hand of finance, leading to lots of bureaucracy and wasted resources (Goodhart et al., 1998).

But as noted, there are some more optimistic exceptions. At least some of the suggested regulations challenge the core idea that finance is just about profits. I will return to this below.