The South and Carbon Dioxide: Every Cloud Has a Silver Lining

Money makes the world go round. The growth of the now 370 trillion dollar derivatives market, according to a Bank of International Settlements estimate for the first half of 2006, serves to remind us that the financial sector is the compass from which both companies and countries take their direction. Yet as news about climate chaos, persistent poverty and intensifying inequality continues to percolate our pleasant lives in the West, we have to ask whether money is now causing the downfall of the world. In recent years more people have been choosing to engage in global finance to solve problems of the environment and international development. Their efforts herald a new paradigm for ethical finance, which no longer focuses on personal ethical dilemmas within existing professional frameworks but on how to use opportunities as a financial services professional to transform those frameworks so the world’s most powerful motor - money - makes the world work around barriers to a more sustainable, just and healthy future.

Our paper outlines how this is happening both in professions and in academia. It identifies urgent inter-connected challenges of climate change, unemployment, local enterprise and poverty reduction, and suggests that a new approach to socially responsible investing is required to create new frameworks for the innovative financing of sustainable enterprise in the global South. Investors can make money while contributing to low-carbon high-employment societies, if they help support the development of appropriate risk adjusting mechanisms. This focus on creating new financial frameworks is one of the highest embodiments of a commitment to our common humanity and ecology, which is the ground of all subsequent ethical discourse and philosophy.

Emerging trends in business ethics

To a large extent the question and practice of ethics in finance is influenced by the broader category of ethics in business. Both because financial firms are companies and because questions of ethics cut across various types of business, and also as business ethics is an established discipline within management schools around the world. Therefore reflecting on the situation in business ethics
academe can help us to see emerging trends of interest, hence what the future of ethics in finance might entail, both practically and intellectually.

The traditional academic approach to business ethics has been largely focused on esteemed philosophers, such as Aristotle, Kant, and Mill, and typically engages in an unending debate about whether certain business practices are either right or wrong. However, since 2003 there has been evidence of a changing paradigm. That year saw the main association for business ethics scholars in Europe, the European Business Ethics Network (EBEN), hold its conference titled ‘Building Ethical Institutions for Business’ and allowed the participants to reflect and debate on the role of institutions in the transformation of business toward a more human and ethical form.

This was not the focus on individual manager’s ethical dilemmas and problems that have characterised much business ethics work in the past, but rather a discussion of ‘stakeholder activism, global governance structures, corporate social responsibility, corporate governance, corporate citizenship, ethical investment, stakeholder society, Internet-enabled corporations, environmental regimes, human rights, future generations, and ethical institutions for corporate accountability’.

Another illustration of this trend is the best-selling textbook, Business Ethics: A European Perspective (Crane and Matten, 2003). The subtitle ‘Managing Corporate Citizenship and Sustainability in the Age of Globalization’ indicates that this is not a traditional business ethics tome. The book still discusses ethical theories and ethical dilemmas, but it frames all this within the broader debates conjured up by the subtitle.

**Ethics as a post-business creation**

The problem with business ethics has been that ethics is a post-business creation, both literally and conceptually. The context was nearly always assumed and managers asked to respond to a consequent dilemma. Today many managers and students of business are asking for something different - for ethics to be the starting point for their work.

This is partially due to a growing awareness of the power of business and finance, and the responsibility this brings. Of the world’s 100 largest economic entities, according to an Institute for Policy Studies report, 51 are now corporations and 49 are countries. With daily stories of private equity and hedge funds demanding dramatic changes in corporate structure, and ratings agencies able to influence the value of a national currency with their assessments of credit risk, no one can ignore the financial sector’s cumulative effect as a compass steering both companies and countries.

Consequently, people who are concerned about social and envi-
environmental issues have been turning to the financial sector. This is highlighted by the growing interest and activity of non-governmental organisations (NGOs).

The pressure of civil society

In the UK a variety of campaigning organisations including Amnesty International, Greenpeace, People & Planet, and WWF joined together to launch FairPensions, a campaign to mobilise UK pension fund owners to put pressure on their trustees, fund managers and ultimately the companies they invest in, to behave in a responsible and sustainable manner. An international coalition of NGOs also formed Banktrack, and agreed a common declaration of what they want to see from responsible banks.

Many people with an NGO background have gone into the City, in order to effect change from there, including people like Rob Lake (formerly at Traidcraft now Head of Governance at Hendersons Global Investors), Nick Robins (formerly of International Institute for Environment and Development now Head of SRI at Hendersons) and Steve Waygood (formerly of WWF-UK now Chair of UK Social Investment Forum).

This indicates an approach to finance whereby a person’s ethical interests are the starting point for engaging in a career in finance. Consequently ethical issues are not seen so much as questions of how one should behave within a given office context, but rather how one wishes to contribute to the wider world by choosing a career within the financial sector. The new trend in the ‘business ethics’ academy reflects this, no longer just treating managers as victims of circumstance but helping them become masters of destiny, to change the circumstances for the better. If this is our starting point and if we consider finance to be, collectively, the most powerful driving force in the world, then we must be clear about the greatest challenges of our time, and the areas where finance could do a lot more to help.

Key challenges of our time

With global consumption levels five times what they were just 50 years ago, the natural world is buckling under the weight of demand. The impact tolls of all this are clear: climate instability, ecosystem pressures (already leading to complete collapse in some instances), soil loss and degradation, ground water depletion, loss of productive land, and toxic accumulation are some of the key issues. The global scientific consensus on climate change, as exemplified in the 2007 Report of the UN Intergovernmental Panel on Climate Change, proves beyond doubt that there are limits to what our atmosphere can take, and what changes in our atmosphere our nature, agriculture, water supplies and cities can cope with. The UK Stern Review on the Economics of Climate Change
Le boom actuel dans l’investissement cible principalement les grandes sociétés et les centres urbains. C’est ainsi que les 200 entreprises les plus importantes du monde représentent plus du quart de l’activité économique mondiale pour moins de 1% des emplois. Il est nécessaire de stimuler les petites et moyennes entreprises (PME) qui donnent du travail à plus de gens. De plus, ce sont justement ces PME qu’il faut toucher si l’on veut relever le défi climatique.

2007 predicts a 20% reduction in Global GDP, which is equivalent to two world wars combined. Already, people are losing their lives and livelihoods due to climate change. The scientific imperative is to control greenhouse gas emissions so that climate change can be kept within two degrees of pre-industrial levels. This implies a global halving of such emissions by 2050 at the very least.

Pollution and inefficient consumption is everyone’s problem and responsibility. The over half a billion middle-class Asians are consuming significant and growing amounts of resources with negative impacts on their own rural and urban environments as well as abroad. For example, the Indian middle class have higher carbon lifestyles than the UK average. We urgently need to focus on how to help the global South to develop, using low-carbon technologies and business activities.

In such countries there are very real concerns about poverty. The current boom in investment, which we discuss below, is mainly focused on large companies and urban centres. Yet the world’s top 200 corporations account for over a quarter of global economic activity, while employing less than 1% of its workforce. There is a need to stimulate small and medium sized enterprises (SMEs) that employ more people. In addition, it is these SMEs that need to be targeted if we are to meet the challenge of climate change. Promoting low-carbon high-employment societies is possible. The European Trade Union Confederation recently concluded that ‘less dependence on natural resources can be coupled with more intensive use of labour’ and predicted that ‘by 2010, it is estimated that the global market for environmentally friendly products and services will be worth around 700 billion’.

Thus we believe that the dual climate-employment challenge, particularly in emerging markets, is crucial, and one with which financial services need to engage. It is essential if we are to promote the sustainable economic development in the global South that can raise people out of poverty, without destroying the basis for human life on Earth. Consequently, within a new paradigm of ethical finance, we turn to the question of how to facilitate investments in sustainable SMEs in emerging markets.

**Only backing the big guns?**

With the liberalization of financial markets in Asia, Africa, and Latin America, emerging markets have emerged as an important asset class for investors in developed countries. Further, recent macro-economic trends such as strengthened banking sectors, increased use of Generally Accepted Accounting Principles, increased focus on Return on Investment (ROI), and decreasing information inefficiencies have made this asset class an increasingly popular one with the investment community in Europe, North America and Japan.

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The prevailing argument in the international investment arena suggests that although emerging markets are more volatile than their developed market counterparts, the inclusion of an emerging market asset in a balanced investment portfolio can actually reduce volatility of the entire portfolio, while simultaneously increasing the global return. Needless to say, the fundamental principle of ‘profit maximization’ underpins most of the investment activity in relation to emerging markets. Profit maximization, in itself, could be a fair goal to pursue, and it could be said that most investment activity relative to Emerging Markets Enterprises (EMEs) takes place within ‘ethical’ norms or book-balancing ethics; but given the complexity and interconnected nature of the present-day world, such a judgment would be partial at best.

For a meaningful discussion on the role of ethics within the world of finance and its interaction with the EMEs, it is crucial to look at the broader sociological, economic and cultural contexts within which these new market economies are emerging. It is also important to acknowledge that such economies exist within countries, mostly low to middle income and developing, that are characterized by numerous development challenges including endemic corruption, ineffective public institutions weak regulatory systems, and wide-spread environmental degradation. Seemingly benign investment decisions that are made in London, New York, and Tokyo with the simple intention of maximizing profits could have far-reaching implications on the development of countries with emerging economies. Particularly, when such investing decisions embed a bias towards large firms that are subject to the short-term expectations of the stock markets, they could have serious negative impacts on the development and growth of such economies.

**Socially Responsible Investing and Emerging Markets**

Social investors have been using three basic strategies to protect financial returns while pursuing a social agenda. Screening (and divestment) excludes certain securities from investment consideration based on social and/or environmental criteria. For example, many investors screen out arms company investments, or divest when they make a decision no longer to hold such assets. Shareholder activism and engagement involve efforts to positively influence corporate behaviour by initiating conversations with corporate management or submitting and voting proxy resolutions.

Positive investing involves investment in activities and companies believed to have a positive contribution to society. Positive investing activities can target underserved communities, or clean technologies.

Socially Responsible Investing (SRI) is not a new phenomenon.
Over the past thirty years, it has evolved from what was initially a limited movement advocating morally informed investment decisions, to become an international industry worth over $2.7 trillion in assets. The current approach to SRI, while having clearly delivered tremendous benefits, creates a traditional dichotomy of the ‘good versus bad’ in the investment community at large.

This not only limits the growth of SRI to a mainstream investment trend, but also hinders its application in emerging markets. As a result, it remains largely a developed-country phenomenon. Only an estimated $2.7 billion, or 0.1% of all SRI fund assets worldwide are currently held in emerging market securities. Complexity of the application of ethics in investing in general, and in emerging markets in particular, needs to be acknowledged. While it is the ‘socially responsible’ investment community and the development community at large that is interested in the sustainable development of EME countries, it is the mainstream investment community that is primarily concerned with maximization of ROI.

**Guiding money to where it is needed**

What is required, therefore, is for financial professionals to embark on an innovative approach to SRI, and focus on creating new frameworks and incentives to guiding money to where it is most needed. Two examples of this ‘transforming framework’ approach have taken place in London. The first is the Enhanced Analytics Initiative (EAI), where asset managers and asset owners with over 380 billion assets under management are actively supporting better sell-side research on extra-financial issues concerning society, the environment and corporate governance. They are committed to the individual allocation of a minimum of 5% of their respective brokerage commission to sell-side researchers who are effective at analyzing material extra-financial issues and intangibles. The second example is the Institutional Investors Group on Climate Change (IIGCC) who are helping investors to promote appropriate change in public policy to help address the climate challenge. This resonates with the new paradigm of ethical finance as described above: the domain of business and finance ethics has shifted from legal concerns, to exploring what can be done over and above the law, to shape legal frameworks and incentives.

This new paradigm and new framework-changing approach to SRI needs to be applied to the challenge of increasing investments in sustainable SMEs in emerging markets to create more low-carbon high-employment societies around the world. And this ethics-first approach to deciding which ethical-financial issues to address is both the approach of the future and the most laudable one, because it truly embraces the responsibility that comes with the power of finance.

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The role of small and medium enterprises in emerging economies is now widely recognized. For instance in Africa, SMEs form the backbone of the private sector at all levels of development, and make a significant contribution to economic development in general and industrial development in particular.

**Size matters: the role of emerging market SMEs**

SMEs and the informal sector represent over 90% of businesses in Africa, contribute to over 50% of GDP, and account for about 63% of employment. Being labour intensive, SMEs absorb labour and other productive resources at all levels of the economy and flourish in villages, towns, and cities helping to develop technical and business skills while reducing the rural-urban income gap. In addition, the following characteristics of SMEs make them particularly valuable for development goals (Luetkenhorst, 2004):

- **SMEs are more labour-intensive.** SMEs play an important role in generating employment and thus alleviating poverty, often providing employment opportunities at reasonable rates of remuneration to workers from poor households, and to women;

- **SMEs contribute to a more efficient allocation of resources in developing countries.** SMEs tend to adopt labour-intensive production methods and thus more accurately reflect the resource endowment in many countries where labour is plentiful and capital is scarce;

- **SMEs support the building of systemic productive capacities.** They help to absorb productive resources at all levels of the economy and contribute to the establishment of dynamic and resilient economic systems in which small and large firms are interlinked;

- **SMEs tend to lead to a more equitable distribution of income than larger enterprises.** There is evidence that countries with a high share of small industrial enterprises have succeeded in making the income distribution more equitable. This, in turn, is a key contribution to ensuring long-term social stability by alleviation of economic disparities between urban and rural areas;

- **SMEs are a seedbed for entrepreneurship development, innovation, and risk-taking behaviour** and provide the foundation for long-term growth dynamics and a transition to larger enterprises. With the advent of globalization, such linkages are of increasing importance whereby trans-national corporations (TNCs) seek reliable domestic suppliers for their supply chains.

The above-mentioned non-exhaustive list emphasizes not only the importance of SMEs to emerging economies but also their tremendous relevance to the socio-economic and cultural context of many developing countries. Many researchers conclude that SMEs, more locally anchored than large corporations, are...
more likely to have ties of dependence and familiarity to their communities, which will ensure they protect their reputation and relationships among neighbours and customers. It is essentially through the promotion of SMEs that individual developing countries and the international community at large can make progress towards reaching the Millennium Development Goals of halving poverty levels by 2015.

**The trouble with being small**

Despite the widely acknowledged importance of the SME sector, SMEs in emerging market economies face many obstacles, including corrupt governance structures, an unfavourable macro-economic environment, poor physical infrastructure, and a multitude of administrative challenges. However, inadequate access to financing continues to be one of the most significant impediments to creation, survival, and growth of SMEs. The most important factor here is risk: credit risk, currency risk and country risk. These are all higher for SMEs in developing countries and thus make the risk profile of emerging market SME funds too high for most ordinary investors.

As a result, private sector activity in many emerging market countries is hindered by a ‘missing middle’. While investors primarily focus on large firms (with over 500 employees), the development and micro-finance communities are largely focused on very small businesses or micro-enterprises (5 or less employees). Furthermore, large enterprises and multinational corporations can exercise their influence in emerging markets to gain easy access to financing, whereas development and aid agencies primarily concentrate on the promotion of micro-enterprises. SMEs (employing 10 to 100 people) find themselves caught between these two extremes. In many African countries, banks remain highly liquid and are reluctant to extend credit to other than the most credit-worthy borrowers. While microfinance institutions have expanded vigorously, their limited scale remains largely insufficient for meeting the needs of many SMEs seeking start-up or growth capital. This leaves SMEs with little choice other than to seek the long-term risk capital that is crucial for starting-up or scaling-up their businesses. Moreover, SMEs also suffer from an image problem, particularly in the eyes of foreign investors. SMEs are often seen as being too small to serve as significant drivers of economic growth.

The difficulties confronting SMEs to finance their development mean that they do not have the required support to plan for the future. Consequently investments in cleaner technologies and production processes, which only pay off after a period of use, are not affordable to many SMEs. This results in the SME sector in many countries not being as environmentally appropriate as it could be. With the anticipated growth in global carbon markets, with heavy
polluters being paid to reduce their carbon emissions by using new technologies, SMEs could miss out, due to the very high transaction costs involved in administering the carbon credit process. This presents an opportunity to address the SME financing issue linked to an effort to ‘green’ the sector, and thereby support more low-carbon jobs in emerging markets.

**Meeting the challenge**

Recognizing the relevance of the SME sector to the growth of emerging market economies, a few innovative mechanisms have emerged that target the financial needs of SMEs. Initiatives include the East Africa Fund by the Shell Foundation and the Africa Enterprise Challenge Fund by the UK Department for International Development (DFID). While these initiatives are steps in the right direction, their focus is on a handful of African countries. Success of such initiatives is yet to be critically reviewed. Furthermore, no matter how successful such initiatives are, if the SME sectors in emerging economies are to be given a true boost, ways will have to be found for scaling up existing successful models. New mechanisms will have to be developed to either provide direct finance or to create conditions that enable SMEs to gain more ready access to finance.

Charity won’t work. A systemic approach is required that changes the balance or risks and incentives for ordinary investors, not socially responsible ones, so that more money flows towards sustainable SMEs. The most important factor here is finding new ways of reducing credit, currency and country risk at the same time as both screening and engaging SMEs to ensure that their activities are contributing to a low-carbon development pathway. Exploring the potential for what we call ‘Risk Adjusting Philanthropy’ could solve this problem.

**The potential of ‘Risk Adjusting Philanthropy’**

In the light of recent donations to charities by large banks dedicated to more traditional charitable activities, e.g. HSBC’s US$ 18.4 million funding of the WWF, large banks with strategic interests in growing the SME economy could make million dollar philanthropic donations to a charitable organisation. The objective could be to set up a new foundation aimed at establishing criteria for sustainable enterprise, and certifying emerging market sustainable SME funds that meet specific criteria (there would be cascading criteria for the funds, the banks, and the SMEs themselves). This would drive improvements in SME practice as well as encourage entrepreneurship in areas such as clean technology and agro-ecology.

This new foundation would also:

- underwrite partial credit guarantees, in the form of a letter of credit, essentially guaranteeing reimbursement to investors of a certain per-
percentage of any losses on the certified funds. This would reduce the risk profile of the funds and their ability to raise funds at a lower cost of capital i.e. attracting normal capital rather than socially responsible capital. If the funds were carefully identified then this foundation would not incur high losses, and could maintain or grow its assets over time;

- spend some of the interest earned from investments on reducing the insurance premium payments for the certified funds. The premium cost of political risk insurance can often make SME investment targets funds untenable (if you’re expecting a 5% Return on Investment (ROI), you can’t afford risk coverage costing 4% of the investment). By reducing the cost of insurance this would make the funds more attractive to traditional investors;

- spend some of the interest earned from investments on supporting capacity-building in countries, through NGOs and local Chambers of Commerce, to promote the viability of sustainable SMEs. A key focus could be on helping to create credible carbon offset markets, so that SMEs could gain financially from investing in less carbon-intensive energy production processes.

A new initiative with resources and experts is needed to explore this hypothesis, and other relevant ideas for the innovative financing of sustainable SMEs, and the public policy innovations that may be required for implementation. This would apply the new domain of ethics in finance, and the newest approach of SRI, to a key interconnected challenge of our time - promoting low-carbon high-employment economies in the global South. It would be satisfying for more of the world’s investors to care about the future of our planet and our children, but we believe it would not be ethical to rely on this in order to deliver the urgent changes required. Instead, if we create frameworks that enable investors to do the right thing, whatever their motivations, we are using our influence in the most conscientious possible way. •

References


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