

CSR and finance: hype vs reality and what to do about it

Lecture at BI Oslo, 12 February 2009

Carlos Joly

Visiting Professor BI , investor, advisor

carlos.joly@gmail.com

Topics

1. **Why CSR? Problem CSR seeks to solve?**
2. **What is this crisis about?**
3. **How get out of the global recession/depression? Is more lending and more stuff the answer?**
4. **Regulatory proposals.**

Reality: U.S. banks cheat on taxes

Source, GAO and NYT, January 16, 2009

US BANKS hundreds of subsidiaries offshore to **evade their tax bills**

Citigroup has 427 subsidiaries in offshore havens like the Cayman Islands, British Virgin Islands and Switzerland. More than \$50 B in taxpayer bailout.

Bank of America has 115 subsidiaries in offshore havens, while Morgan Stanley has 273, the report said. Hundreds of Billion \$ toxic mortgages relief.

Etc Etc

Thank you Bill Clinton's Mr Rubin then Co Chair Citi.

Reality: unsustainable stuff...

[Obama's actions] will not cure **the post-bubble hangover of the over-extended consumer. That will take time...**

...until the rest of the world uncovers a new consumer – which is not likely during the next few years – a protracted global slowdown is distinctly possible.”

Steven Roach, Chairman, Morgan Stanley Asia

GOVERNMENTS WORLDWIDE SEEK TO RESTIMULATE DEMAND FOR STUFF AND THINGS, MOSTLY ENVIRONMENTALLY UNSUSTAINABLE STUFF... COMPANIES HOPE GOVERNMENT STIMULUS PLANS WILL BREATHE LIFE INTO EXHAUSTED CONSUMERISM



Reality: US companies have rights of persons but execs no liability of persons

US corporations have legal “personhood” allowing them constitutional rights intended for people:

- 1. broad advertising freedoms grounded on right of free speech
- 2. protection against search for pollution events unless inspector has a warrant and gives prior notification
- 3. right to financially support political candidates. Lobbying to rephrase regulatory controls or tilt to advantage.

35,000 lobbyists for 535 legislators. Hundreds million dollars spread around.

Reality: CSR does not act against externalization of \$ € or enviro risks

- Irresponsible risk off-loading: CDOs, MBSs, etc
- Lending to 50x overleveraged hedge funds.
- TARP funds not being lent on to good customers but kept for acquisitions, bonuses \$20B, private planes, office décor
- US money center banks are insolvent: \$1.8T losses vs \$1.4T capital (Roubini).
- Profits privatized, losses socialized, ie paid by the taxpaying public
- GHG emissions cost nothing or little, therefore emissions go on.

What is CSR a response to? What problem does it solve or whose interest does it further?

The problem to which CSR was posed as a practical solution

Crisis of trust in business in 80s, 90s due to dissatisfaction of employees, screwing customers, cheating investors, destroying the environment...Ciba Geigy, Enron, 3 Mile Island,

Business said “we can fix this ourselves. Regulation is overly detailed, misguided, inefficient.” WBCSD. UNEP FI. Global Compact. CSR avoids bureaucratic inefficiency and stupidity. Best and brightest are in business.

Trust is key for brand value. Brand value is essential to business, works by differentiation: GOOD BUSINESS vs THE BAD AND THE UGLY FEW ROTTEN APPLES.

But...

CSR based on a false antinomy: free market
vs imprisoning regulations

Does CSR really solve the problem
of market failures in capitalism?



It misses ethical values at the core

- Think of budget planning: how much profit to seek vs how much pay in salaries, in performance bonuses, invest in R&D, pay in taxes, use in office decor? US companies fired 1m in Jan
- Think of financing strategy: leverage risk of new large bank loans vs dilution of existing shareholders by new equity issue?
- Think of dividend policy: how much to reinvest in the company vs distribute to shareholders?
- Think of lobbying: how much to pay into political campaigns to influence legislation?

ETHICS GOES BEYOND CORRUPTION, FRAUD, AND SELF-DEALING
TO THE CORE OF BUSINESS DECISIONS; SHOULD BE IN CSR



What is a company?

Company= “compagnia”= “cum panis”

IX and X Century Amalfi, Venice, mediterranean towns: family firms: sons , brothers, close friends, relatives. Everything shared: work, risks, income, assets, debts. Total solidarity.

Next phase: *societas maris: socius stans* (in place, put the money) and *socius tractator* (went on ship, put the work)...early division of labor and capital. Marseilles. Hanseatic ports. Portuguese. Lasted until XVII Century.

Mills in Toulouse owned by shareholders/ *pariers*

First English share company 1555, Muscovy Co.

By 1673 *societes generales* in France= collective liability of the partners

Limited liability: 19 Century

Limited liability is the invention that allowed for capitalism as we know it. It allows risk-taking on a grand scale, with one's own or other peoples money.

The corollary: risk transfer onto others, or externalization of risk. I make the profit, you take the risk. I pollute , nature dilutes.



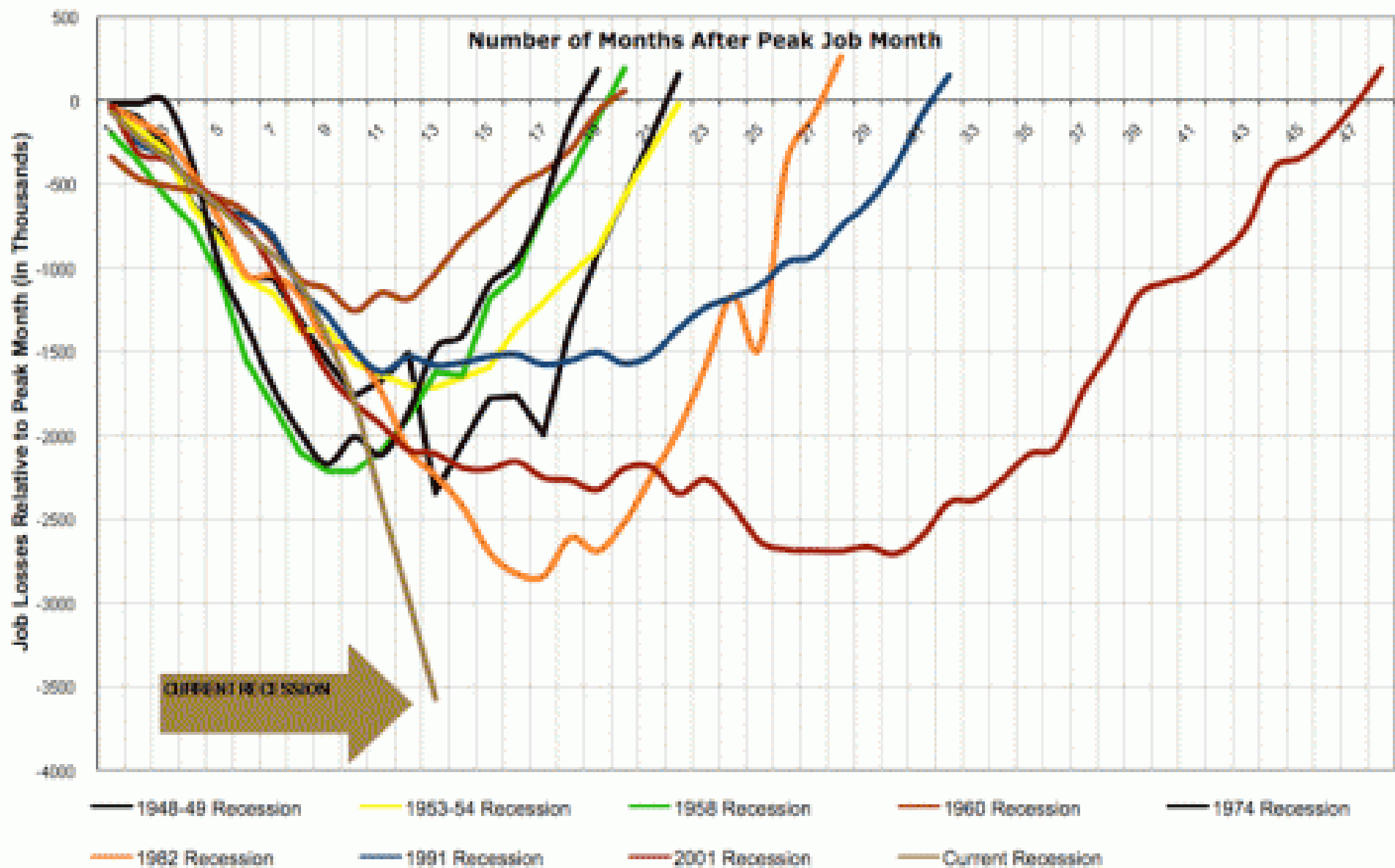
LL 20th Century Pros

- Encourage investment
- Foster diversification
- Encourage mgmt risk-taking
- Facilitate stock markets

And Cons

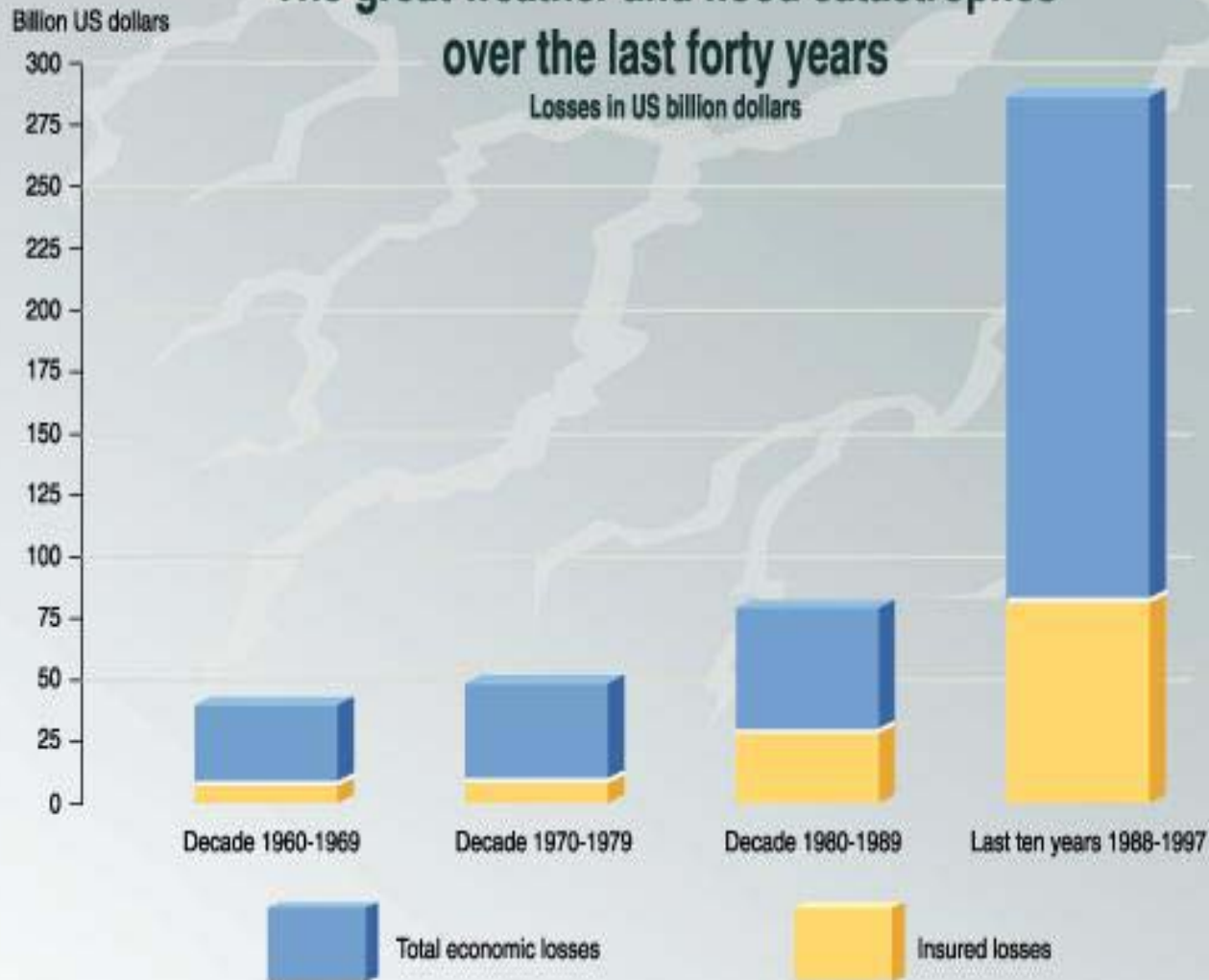
- Discourage extension of credit
- Insider opportunism
- Externalization of risks
- Irresponsibility onto the public

Job Losses* in Post WWII Recessions



* Change in Nonfarm Payrolls, Reported Monthly, Bureau of Labor Statistics, US Dept. of Labor

The great weather and flood catastrophes over the last forty years



Climate change – “the greatest market failure ever”

- Hurricane Katrina consistent with climate models – and tropical storms cost \$173 bn in 2005
- Yet, damage of carbon pollution still largely externalized and unpriced
 - BP's 87 mtonnes of CO₂-e generate \$7.3bn in climate damage, 38% of replacement profit for 2005
 - But damage of process and product emissions equivalent to at least \$56bn in costs, almost three times annual profit



NB Stern estimates \$85 as damage function for a tonne of CO₂

Insurance will not cover most climate change risks

Some damages to buildings, and restricted types of business operation loss, and minimal crop losses. ...**The larger socio-economic losses are not insurable..**

Risks covered today will cease to be covered tomorrow and geographies at risk will be priced out of the market. No storm insurance for Florida. All this will affect some mortgage lenders in a major way.

80% off CC economic damage suffered today is not insured, and even less will be in the future.

Where do we go from here?

Depression and Climate Change: the game changers?

- Tipping point in climate, like tipping point in finance... afterwards catastrophe
- Slow death by thousand cuts vs quick catastrophe: will governments react in time?
- Political gamesmanship, “pragmatism” or centrist “bipartisanship”
- CC: Mitigation, adaptation, and luck of location
- \$ crisis: destruction, stocks to “right owners”

- “Growth” no longer the acknowledged panacea for the economy, jobs, well-being.
- Government green stimulus packages may avoid depression, not a long recession.
- What is the role of CSR in this scenario? A real chance for deep change? Will it end planned obsolescence? End phony demand creation?
- New added-value propositions and business models?

CSR vs regulation

- Voluntary CSR is incapable in and of itself to solve problems we would like it to solve
- Tough regulation of capitalism is needed to distribute fairly the surplus value created by corporations protected by limited liability
- Distribution via corporate Taxes, Salaries/Benefits/Bonuses, Dividends
- Scandinavian social democracy much better than Anglo Saxon capitalism.

SRI: what is it good for?

Aspirations

- Influence corporations for better ESG perf
- Improve coherence between ethical values of shareholders and behavior of companies
- Invest in good companies, channel capital to good uses

SRI Limitations

- SRI funds too nice, too modest, not powerful. Few engage. Those that do rarely win shareholder resolutions. Conflicts interest bank SRI funds.
- Portfolios of SRI funds very similar to portfolios of non SRI funds. Same large cap, index-following investment strategy. Chose MNCs that play CSR card.
- ESG on condition if business case for it, not ethics. Accept externalization of environmental risks because otherwise lower profits.
- Most SRI funds do not “invest in companies” but buy and sell shares to/from other investors.

Reformist regulatory ideas

- Eliminate quarterly reporting by companies.
- Eliminate mutual funds performance reporting and ranking shorter than quarterly
- Abolish the global oligopoly of the Rating Agencies. (form of Wall Street domination over other markets. Drives “flight to quality”.) Require own and independent risk assessment by institutional investors.
- Limit total compensation for executive managers, portfolio managers, traders, of listed companies at ceilings of multiple of median wage (eg 20x)

Radical regulatory ideas

- Make managers (directors and exec comm) personally liable for negligence (weaken limited liability immunities), particularly ref. product safety, GHG emissions, toxic pollution
- Abolish passive investment/ index investing (best way to eliminate herd behavior)
- Establish that Fiduciary Duty must include ESG; profits yes but not short term maximization, and not only if it will increase share price

Radical regulatory ideas (contd)

- Abolish personhood protections of the corporation, like right of free speech that permits false claims political intervention
- Revoke corporate license to operate of companies that grossly violate the public interest.
- Severely restrict corporate power to act as political force. Restrict PACs, campaign donations, front group funding.

Regulation for better SRI

- At least 25% of pension, life insurance, private equity and hedge fund investment portfolios must be allocated to profitable socially targeted purposes: low income housing, energy efficiency, mass transit, the arts
- Private equity funds must have an ESG plan for targeted and acquired companies; and it
- SRI funds must have a real engagement plan for their 10 largest holdings; and report in Annual Report.

Real CSR

- Some eighty years ago US Supreme Court Justice Louis Brandeis commented, "We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both."
- This crisis is the result of the wealth and power of a corporate and financial aristocracy managing, governing, ruling in its own interest.
- We need major surgery. We need to make CSR real. Tough regulations and governments with backbone.

Conclusions

- 1. Why CSR? Problem CSR seeks to solve?** Crisis of trust 90s (pollution, Enron, small is beautiful. The good vs the bad and the ugly. Positioning and differentiation)
- 2. What is this crisis about?** Bankrupt financial and economic system. The triumph of free market fundamentalism. Inequality, unfairness, concentration of economic and political power in a corporate aristocracy. Systemic problem. Higher order.
- 3. How get out of the global recession/depression?** The triumph of State Capitalism? China? Venezuela? France? Scandinavian social democracy? US capitalism not the only alternative.
- 4. We need radical regulatory change, robustly enforced.**