

Banking on ethics



Challenges and opportunities for the European ethical banking industry in the aftermath of the financial crisis

Author: Valerio Carboni

Editing: Andrea Baranes,
Antonio Tricarico

Graphic design: Carlo Dojmi di
Delupis

**CRBM - Campagna per la
Riforma della Banca
Mondiale**

Via Tommaso da Celano 15
Roma (Italy)
tel. +39.06.7826855
Fax. +39.06.7858100
web: www.crbm.org
email: info@crbm.org

This publication has been
produced with the kind support
of the Ford Foundation and
the Charles Stewart Mott
Foundation.

March, 2011

Summary

Executive Summary p. 2

Introduction p. 4

1. Industry overview p. 6

1.1. Industry characteristics

2. The impact of the financial crisis on ethical banking p. 11

2.1. The cost of the financial crisis

2.2. Ethical banks' performance in a challenging environment

2.3. Basel III Accord on capital requirements

2.4. Which challenges from Basel III for the ethical banking industry?

3. Ethical banking with social goals p. 16

3.1. The French new economic regulation

3.2. The UK community banking experience

4. Ethical banking with environmental goals p. 26

4.1. The Dutch Green Fund scheme

4.2. Green Fund scheme overview

4.3. The case of Banca Etica in Italy

5. Conclusions p. 33

Bibliography p.36

Executive summary

The 2008 global financial meltdown has clearly revealed to which extent financial institutions operating in a free, unregulated and self interest mode can fail to protect themselves, the depositors and the community. While we are still far from reaching a conclusion on what are the best solutions to fix the financial system, there is a broad consensus pointing to the fact that shareholders' expectations for ever-increasing returns progressively pushed financial institutions to shy away from traditional banking activities in favour of increasingly complex, risky and highly profitable strategies that ultimately led to the financial crisis.

While rebuilding honesty and trust in financial practices is a critical first step towards a more healthy industry, in order to be ultimately successful, the financial reforms should not lose sight of the critical role that banks play in the communities in which they operate. Financial institutions do not operate just like ordinary companies but carry specific responsibilities towards the community; in a way, banks operate more like public utilities providing basic services to the public at large.

In other words, the way we save and invest, and how banks allocate capital between alternative uses, brings critical economic and social consequences that cannot just be ignored in favour of short-term profit goals. Inarguably, ethics still matters in financial transactions, and not surprisingly advocates of ethical banking are getting increasing attention from policy makers.

Sustainable and ethical banking has been developing for decades and is becoming a significant force in the financial industry. Unconventional banks focused on financing environmental projects and promoting social entrepreneurship and community businesses have also proved to be particularly resilient to the financial crisis and may well show a viable alternative to mainstream industry. Ethical finance is a broad concept that reflect a different

model of society where social and environmental variables are taken into account by investors' and savers' decisions. The European ethical banking industry is a multifaceted landscape characterized by a wide range of actors and practices. This research identifies key experiences of ethical banking in Europe in order to highlight the different business models emerged, particularly in reference to the type of institutions involved and the objectives pursued. This approach provides a reliable framework to the study of the public policies adopted by governments to support this industry, and to understand to which extent they have been successful. Excluding the public entities and the mainstream banks that enforce some CSR policy, but are still far away from a coherent approach to sustainable finance, some seventy institutions matching a strict definition of ethical banking and operating around a common set of principles and values have been identified in Europe.

These actors can be firstly divided into banking and non-banking companies, and further present different business models, corporate structure, mission and financial strategy. While some of these differences are linked to cultural or historical reasons, others depend on the way national policies and legislations are shaped and helped or slowed down the development of ethical finance. In this sense, some key legislations helped the development of particular sectors of sustainable finance. The cases of the French social economy, the UK CITS scheme, the Dutch green fund scheme led to good results, both in terms of economical goals and specialized financial intermediaries growth. Other ethical financial companies headed towards microcredit, while several focus their intervention on financial exclusion and access to credit. Some experiences, such as the Italian one, proves that a bottom-up development of ethical finance is possible even without specific legislative frameworks, but evidence

shows that the regulatory environment plays a critical role in shaping this industry and promoting its growth.

The policy measures discussed in this work aim generally at increasing the supply of funds into the social or

green economy through accredited financial institutions: their scope is to leverage the expertise of the private financial sector to promote or unlock social or environmental progress. These measures range from voluntary informational devices to binding legislations.

Other important policy initiatives may include tax incentives and other policies looking at stimulating the demand for ethical savings which provide savers and investors with

Financial institutions do not operate just like ordinary companies but carry specific responsibilities towards the community

an extra-incentive to invest into the green or the social economy through accredited institutions. They prove that financial institutions can effectively participate to the achievement of national objectives of economic policy if they can operate within a well-defined framework of incentives and objectives. In order to be effective such policies need to set precise and measurable standards and objectives in relation to the criteria that banks need to satisfy in order to participate to such schemes and the qualities or characteristics that the beneficiaries need to satisfy in order to access to such preferential funding channels.

While these examples provide some European best practices, more broadly it is questionable whether having a specific regulation for ethical banking would really help in the long-run, or would instead relegate by law this sub-sector in a niche while not impacting at all on the remaining vast majority of the banking industry. On the contrary, a European law recognising ethical banking could help to define by law the criteria that ring-fence this sub-sector in order to avoid that in the near future conventional experiences could set up affiliated ethical banks for green or whitewashing reasons, with the hope of regaining trust about their integrity in the wider public.

In any case, besides ensuring financial stability and investors' protection, financial regulations should take into account banks' special responsibilities and ensure that they are effectively committed to the public good. The ethical banking initiatives presented in this work prove that change is indeed possible. Unfortunately, the current regulatory reform initiatives do not seem to make any substantial progress in this direction, and while they correctly address some of the critical flaws of our financial system – from an increase of capital requirements to better regulation of OTC derivatives and control of systemic risk – they put less emphasis on what should be done to move bankers to change attitude. In some cases, such as the reform of the Basel agreement on banks' capital adequacy, these needs seem to be ignored.

At this point in time it is fair to assume that the Basel 3 agreement on capital adequacy will not include any specific criterion related to environmental and social sustainability in risk analyses and management requested to the banks - in particular as concerns capital requirements. And that instead the ethical banking sector should struggle in the next months so that at least the new agreement will be implemented at European and national level in a way that their business model would not be put at further

disadvantage comparing with conventional banking. Changing the rules is just one side of the coin. The current crisis is first of all a confidence crisis that in order to be repaired requires a long lasting behavioural change as much as a regulatory one. In other words, it is a change of mentality and behaviour that we are looking for and not just a change of rules. Ethical banking pave the way in this direction and show that economic profit should not be considered an end in itself but rather a mean for enterprises to pursue their mission. In order to earn back citizens' trust, banks and financial institutions are expected to engage in a drastic behavioural change and start looking again and seriously at people's real needs. At least this is civil society's legitimate expectation.

The ethical banking industry has so far kept a relatively low political profile, apart from few exemptions. However the time has come to get the voice of this sector strongly heard by decision-makers and supported by organised civil society struggling for a strict regulation of the financial industry. An enormous challenge which requires today vision and courage to speak up so that decision-makers and the public will know that alternatives exist and it is up to them to make them more real, relevant and more effective. In short, only keeping practicing in a way which shows clear cut difference from conventional banking will give the ethical banking sector new strengths and opportunities to produce a long-lasting and deep change in the whole financial world and society.

The time has come to get the voice of this sector strongly heard by decision-makers and supported by organised civil society struggling for a strict regulation of the financial industry

Introduction

The 2008 global financial meltdown has clearly revealed to which extent financial institutions operating in a free, unregulated and self interest mode can fail, under specific circumstances, to self regulate and protect themselves, the depositors and the community.

While decision-makers, financial industry and other stakeholders are still far from reaching a conclusion on what are the best solutions to fix the global financial system, there is a broad consensus pointing to the fact that shareholders' expectations for ever-increasing returns progressively pushed financial institutions to shy away from traditional low return banking activities in favour of increasingly complex, risky and highly profitable strategies that ultimately led to the financial crisis.

Aggressive short-term financing strategies and irresponsible lending practices, coupled with lack of due diligence and supervision, helped the financial industry to record extraordinary profits just before turning into a major debacle.

Inarguably, ethics still matters in financial transactions, as it matters in human relationships in general, and not surprisingly advocates of ethical banking are getting increasing attention from policy makers.

While rebuilding honesty and trust in financial practices is a critical first step towards a more healthy industry, in order to be ultimately successful, the financial reforms should not lose sight of the critical role that banks play in the communities in which they operate. As a matter of the fact, while financial markets at large should be shrunk and subordinated to the needs of the real economy and citizens, under whatever reformed financial system banks will keep playing a central role and the business model and practice they will follow in the aftermath of the financial crisis will bring crucial consequences in our societies in the future.

In other words, the way we save and invest, and how banks allocate capital between alternative uses, brings critical economic and social consequences that cannot just be ignored in favour of short-term profit goals.

If there are lessons to be learned from this financial crisis is that financial institutions do not operate just like ordi-

nary companies but carry specific responsibilities towards the community; in a way, banks operate more like public utilities providing basic services to the public at large. Savings have become fundamental to the way we live our lives – just like other fundamental needs – and capital allocation inevitably shapes power and social relations in society.

The current financial crisis provides hence an unprecedented opportunity to reform the financial system towards a more robust model, less dependent on short-term financial profits and more oriented to meet the urgent social and economic needs of communities around the world.

In this regard a key question is emerging around the need to build new institutions based on stronger ethical principles and operations in order to rediscover traditional banking practices enhancing access to credit for ethical and sustainable investments. And consequently it is legitimate to wonder which financial regulation would then be needed to promote this development within the financial sector, beyond the overall need to restore and promote financial stability by making conventional financial conglomerates more responsible, controllable and accountable to citizens, savers and small investors.

Looking back to the experience of ethical banking and microcredit could help to draw some lessons about how new “ethical” developments in the financial sector could be promoted. Ethical banks and microcredit providers have had an impressive growth in recent years, especially in emerging markets. The total assets of all microfinance providers are estimated at \$50 billion, serving over 80 million people in the developing world. While numbers can always be challenged, these figures unquestionably reveal investors' growing appetite for ethical or green products and solutions.

Alternative banks focused on financing environmental projects and promoting social entrepreneurship and community businesses in the overall – and in particularly in Europe - have also proved to be particularly resilient to the financial crisis and may well show a viable alternative to mainstream industry leaders and policy makers.

This research aims at identifying key experiences of ethical banking in Europe in order to highlight the different business models emerged, particularly in reference to the type of institutions involved and the objectives pursued. This approach provides a reliable framework to study the public policies adopted by governments to support this in-

dustry, and to understand to which extent they have been successful. Specific attention will be paid to the cases of France, United Kingdom, the Netherlands and Italy, where some of the most significant experiences of ethical banking have been recently developed.

However it is fair to say upfront that the research is far from being exhaustive in analysing the whole sub-sector of ethical banking – or more broadly, alternatives to conventional banking - and more analyses have still to be carried out about other specific national experiences in order to have a comprehensive understanding of the sector; Including several smaller experiences which merit the same to be considered for their innovative character and potentially even higher potential to transform the financial sector.

The work is organised in five parts. After this introduction -including the following methodological premise - chapter one presents an industry overview, part two analyses the impacts of the financial crisis on the ethical banking sector in Europe, chapter three looks at how ethical banking can contribute to social cohesion, chapter four sees how it can promote environmental progress, and chapter five draws some conclusions for the future.

Methodological premise

Ethical finance is a broad concept usually related to various forms of citizen commitment in the economy that reflect a different model of society where social and environmental variables, and more broadly the non-economic impacts of economic activities, are taken into account by investors' and savers' decisions.

Sometimes referring to different business models, Ethical finance is also known as Socially Responsible Finance, Social Responsible Investment or Sustainable Investment. It is a powerful concept closely related with the more used concepts of Corporate Social Responsibility (CSR) and Sustainable Development (SD).

Ethical, social or environmental criteria can affect saving and/or investment decisions. While logically closely related, these two steps of individuals' financial planning processes should be kept separate for the purpose of our study. Savers' concerns apply primarily to the institutions they choose to place their money with. These institutions need to offer depositors with satisfying guarantees in terms of corporate governance, balance sheet transparency and investment policies - that cannot be in contrast with depositors' ethical principles. CSR rules apply here

directly to the institutions that collect monies from savers. On the other side, investors' ethical goals are referred to the companies they choose to invest in. Private investors can leverage their influence through investment funds vehicles to encourage better environmental and social behaviour from the companies they invest in. However presently, there is not a commonly accepted definition of Socially Responsible Investment or Ethical Finance.

The literature on this subject is extensive and is often associated with similar or close concepts such as social economy, fair trade and responsible consumption that could easily carry away our research efforts from our initial goals. The difficulty to clearly set the limits of our research emerges also from the extreme variety of the actors and experiences involved in the field of ethical – or “alternative” - banking, which in turn can explain the absence of a clear and consistent legal and regulatory framework, both at a national or European level.

In order to concentrate our research efforts, this study will be delimited just to the saving process. This work focuses on how social, environmental or ethical variables (i.e. non-economic factors) are incorporated in savers' decisions, and how private financial institutions can match demand and offer of funds for ethical purposes. Our approach is empirical and aims at identifying, through a survey of few key experiences of ethical banking and finance in Europe, how effectively and to which extent alternative private financial institutions – with both a profit or not-for-profit goal - operating in any case in a market economy can channel financial resources from savers to borrowers and investors in order to promote a sustainable development of the economy. Four case studies have been chosen in order to balance both between major fields of interventions of the ethical banks – social and environmental – and to include those experiences which have been more significant in terms of size and finance mobilised.

Based on this approach, this work covers both credit and risk capital and excludes loans, grants or investments from public entities (national or local government, public foundations, public financial institutions, etc), grants from private institutions (charities, private donors, etc.) and non-financial assistance, except if closely related to the financial activity, as in the case of microcredit where, for instance, so-called coaching or advisory activities are considered.

Consideration will be given to public policies that have an impact on saving and some investment decisions. Government policies, laws or regulations affecting production or consumption patterns will be kept out of the scope of the present work.

This research aims at identifying key experiences of ethical banking in Europe in order to highlight the different business models emerged

1. Industry overview

The European ethical banking industry is a multifaceted landscape characterized by a wide range of actors and practices. As the industry finds itself at the crossroads between traditional private commercial banking and public policy driven banking, and it is split between profitable market-based organisations and non-for-profit or charitable entities, or between privately owned and public institutions, it is not always easy to determine the exact perimeter of this industry.

Since our research efforts aim to investigate how and to which extent ethical private banks and other financial entities can contribute to a positive social or environmental change, we have deliberately excluded from our approach the role of public entities or international organisations. It should be noted that the definition of ethical private banks include both profit and not-for-profit institutions – i.e. those following a cooperative or mutuality approach.

We've also made the distinction between dedicated actors – i.e. firms strictly adherent to ethical banking principles – and mainstream banks enforcing CSR policies or marketing products with specific social or environmental qualities. While we acknowledge that the notion of corporate social responsibility is slowing making progress in the financial community (trend which will presumably accelerate in the coming years), conventional banking happens to be still in too many occasions in conflict with ethical banking principles to be included in our research universe.

Based on these premises, we have identified over seventy institutions in Europe matching a strict definition of ethical banking and operating around a common set of principles and values.

These principles can be summarized as below:

- Ethical banking constitutes an alternative channel of financing for financially excluded individuals or enterprises: i.e. individuals or enterprises without a credit history or adequate guarantees to secure their loans;

- Ethical banking allocates credit towards sustainable activities; i.e. social and profitable economic activities which benefit the overall community or the environment, even though they present a below average financial rate of return;
- Ethical Banking is transparent in relation to the allocation of credit;
- Ethical banking favours mutuality and cooperation over market based organisations;
- Ethical banking promotes trust-based lending practices over collateral-based lending practices.

While these principles are generally shared among industry professionals, there are substantial differences in the business models emerged in Europe, which can be classified in relation to their corporate structure, mission and financial strategy.

Evidence also shows that the local regulatory and legislative environment plays a critical role in shaping this industry and promoting its growth.

Table 1 provides an overview of key European players and a classification based on their corporate structure, mission and portfolio size. This database has been built by cross referencing membership data from key ethical banking networks¹ in Europe and provides an honest picture of the shape and size of the industry.

We have identified over seventy institutions in Europe matching a strict definition of ethical banking and operating around a common set of principles and values

1.1 Industry characteristics

Market size

The firms shown in table 1 have over € 12 billions in outstanding loans and investments.

This number needs to be taken with precaution since the limited information available makes our database far than exhaustive. Furthermore, this figure probably underestimates the true size of the market, since it does not take into account the important role played by foundations and public entities, nor it considers historical players in the field of social and cooperative banking such as UK

¹ The principal networks of ethical and sustainable banking are "The Global Alliance on for Banking on Values" www.gabv.org, "FEBEA" the European Federation of Ethical and Alternatives Banks, www.febea.org, and "INAISE" the International Association of Investors in the Social Economy, www.inaise.org;

credit unions; mainstream banks and financial institutions are also kept out of this study.

That said this figure clearly points out to a niche market compared to the traditional banking industry: the equivalent figure for traditional credit institutions (loans to non-financial corporations) would be close to € 5,000 bln. in 2008!

In other words, ethical banking represents less than 1% of the traditional banking and financial industry and can be seen at best as an industry in an infancy stage of development, albeit growing rapidly.

Industry Composition

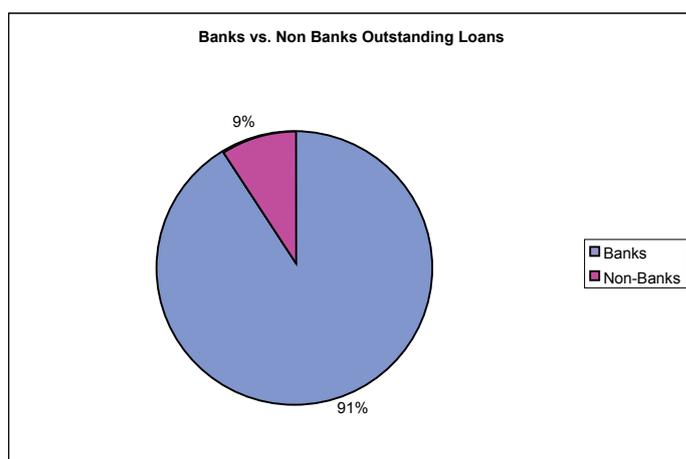
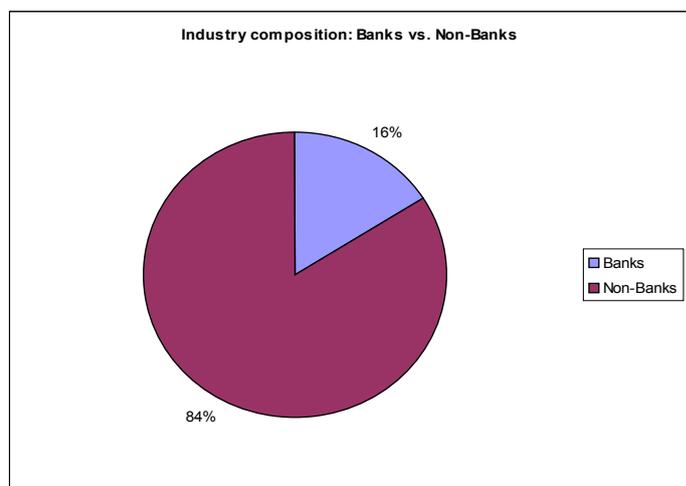
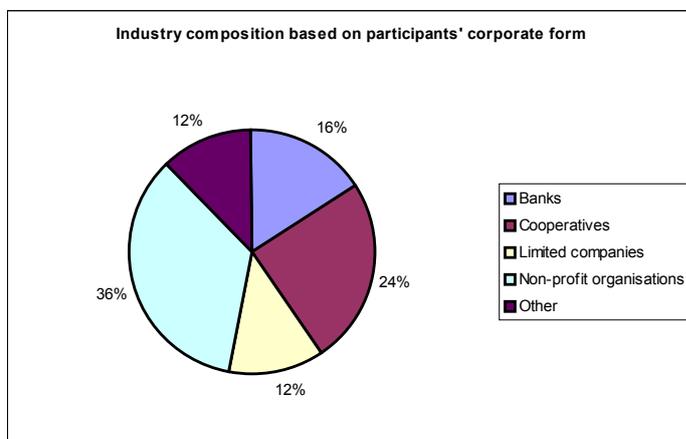
The ethical banking sector is shared between banks and non-banks actors. The latter group is composed principally by cooperatives, not-for-profit associations, charities and limited companies operating as financial intermediaries. The charts show the industry composition based on participants' corporate form. An interesting data emerging from this preliminary survey is that although the non-bank group represents the vast majority of the firms included in our database (84%), it is responsible for a very small portion of total lending, while banks, on the other side, make over 90% of the total amount of outstanding loans.

Although these data are only indicative (since banks' figures can be inflated with traditional banking revenues such as mortgage lending), they clearly shed some light on which is the optimal corporate structure to expand the industry potential: **banks or deposit-based institutions can in fact increase their lending capability well beyond their own resources, which is not the case for cooperatives and non-profit associations who are constrained by the availability of shareholder capital.** That said, it remains debatable whether an overall industry development based simply on size expansion of the sector and individual key players within it is the only possible strategy to follow, as well as which are the implications that such an approach might have on the long-term sustainability and ethical integrity of the sector, which is in any case acting within a market economy and vis a vis ruthless and aggressive competing conglomerates.

Business models

From an operational perspective, there is not a single definition of ethical banking suitable for all industry players, and lenders can be classified in relation to their targeted audiences and lending strategies. While microcredit is becoming the dominant force behind this industry and is progressively reshaping its principles, practices and objectives, the industry truly embraces a wide range of goals.

Charts 1: Ethical Banking Industry composition¹



¹ Not-for-profit organisations includes Not-for-profit associations, charities, social enterprises and not for profit companies; Other includes investment funds, regional development agencies, public partnerships and UK Industrial and Provident Societies.

Table 1 shows the industry composition in relation to key lending strategies, classified as follows².

Lending strategies definitions

Social economy: loans are granted to the third sector actors like cooperatives, not-for-profit organisations, charities and social enterprises. Firms active in this field support undertakings that operate outside traditional market dynamics in relation either to their ownership structure (cooperative or associations) or to their statutory objectives, which pursue social purposes instead of profit maximization goals.

Although the emphasis is on the ownership structure or the corporate form of the borrower rather than its function, we will find under this category beneficiary companies operating social services in the fields of healthcare, education, culture (child care, elderly assistance, etc.), or involved in fair trade and international cooperation.

Microcredit: microcredit lenders grant unsecured small size loans to financially excluded and less advantaged categories of individuals.

It is important to note here that the problem of financial exclusion is not relevant per se but to the extent it originates poverty. While both microcredit institutions and usury lenders serve unbanked individuals, their objectives are very different and if the former group aims at relieving the poor from a condition of financial exclusion, through a responsible use of credit, the latter exploits this condition at its own benefit. In other words, **microcredit lenders aim at short-circuiting the vicious cycle between financial exclusion and poverty, and relieving the poor from the typical symptoms of financial exclusion such as over dependency on usury loans, overexploited working conditions and public assistance.**

Additionally, microcredit lenders encourage borrowers to start their own businesses and provide coaching programs to assist small and inexperienced entrepreneurs in their early stages of their businesses.

Personal loans are also contemplated but under specific conditions (for example to satisfy healthcare or education needs).

Environmental, Social and Cultural: Within this broad category, which can be best described as sustainable

² Since lending strategies usually combine different approaches, some simplifications had to be made in order to highlight the principal characteristics of this industry.

lending, lenders deal with a wide audience of borrowers and do not pursue social objectives in the narrow sense. Borrowers can be individuals, small private enterprises and local entities. This strategy does not address primarily the problem of financial exclusion, and its related poverty effects (in other words, borrowers' social condition is not a relevant variable in lending policies), but it carefully excludes unsustainable activities with negative social externalities.

This strategy is practiced by banks and usually associated with other traditional banking services like mortgages, credit cards services, etc.

Environmental: Loans are directed to the sectors shown in appendix 2; these consist principally of renewable energy projects (wind, solar power and small hydro electric projects) but also include organic agriculture, and projects across the entire agricultural chain, from farms, processors and wholesale companies to natural food shops. Environmental technology, such as recycling companies and nature conservation projects, is also included in this category.

Triodos bank is the only institution considered in this study with a dedicated environmental focus. Although the bank has a well diversified loan and investment portfolio, which encompasses a wide range of activities other than environment, the area nature and environment is by far the most important representing 50% of the portfolio at the end of 2009.

Enterprise creation: Loans are granted to projects that provide employment opportunities to less advantaged individuals (long term unemployed, people with disabilities, etc.) or within disadvantaged communities. In order to stimulate job creation and strengthen social cohesion, this strategy promotes self-employment and projects within the social economy. This approach shares many features in common within traditional microcredit policies, but with some important differences as well:

- Loans are granted to both micro-entrepreneurs and small and medium size enterprises (SMEs).
- This strategy is functional to governments' overall strategy to strengthen social cohesion and foster enterprise and jobs creation. In this sense, it obeys more to public policies objectives rather than to commercial banking objectives. For example, it doesn't aim to be financially sustainable and loans are generally granted at below market rates, funded or guaranteed by state entities.

Table 1: European Ethical Banking and Finance: key players

Institution	Website	Corporate structure	Brief description	Capital*	Outstanding loans
CREDIT COOPERATIF	http://www.credit-cooperatif.coop/	Bank	Environmental, Social and Cultural	1,150,000,000.00	7,290,000,000.00
TRIODOS BANK	http://www.triodos.be/	Bank	Environment	314,000,000.00	1,661,000,000.00
GLS BANK	http://www.gls.de/	Bank	Environmental, Social and Cultural	67,500,000.00	717,200,000.00
BANCA ETICA	http://www.bancaetica.com/	Bank	Social economy	28,152,000.00	577,879,000.00
BANQUE ALTERNATIVE SUISSE	http://www.abs.ch	Bank	Environmental, Social and Cultural	39,172,111.00	460,379,159.00
CDFA**	http://www.cdfa.org	Non bank institutions	Social economy	n/a	445,198,931.15
OIKOCREDIT BELGIQUE	http://www.oikocredit.org/	Cooperative	MFI in emerging countries	45,468,000.00	353,870,000.00
MERKUR	http://www.merkur.dk/	Bank	Environmental, Social and Cultural	21,877,470.00	134,125,410.00
NEF	http://www.lanef.com/index.php	Cooperative	Social economy	19,900,000.00	68,000,000.00
ADIE	http://www.adie.org/	Non profit association	Microcredit	25,099,440.00	48,062,926.00
ESFIN	http://www.esfin-ides.com/	Limited company	Social economy	89,488,624.00	47,911,000.00
CHARITY BANK	http://www.charitybank.org/	Bank	Environmental, Social and Cultural	10,872,860.00	40,484,510.00
CULTURAL BANK	http://www.cultura.no	Bank	Environmental, Social and Cultural	4,694,748.00	30,158,794.00
ETIMOS	http://www.etimos.it/	International cooperative consortium	MFI in emerging markets	5,905,878.00	22,625,371.00
EKOBANKEN	http://www.ekobanken.se	Bank	Environmental, Social and Cultural	27,910,000.00	22,243,000.00
BANCA ETICA ADRIATICA	www.eticredito.it/	Bank	Environmental, Social and Cultural	13,154,605.00	21,819,000.00
INCOFIN	http://www.incofin.be/	Cooperative	MFI in emerging countries	11,781,488.00	20,824,277.00
FRANCE ACTIVE	http://www.franceactive.org/	Non profit association	Enterprise creation	9,269,001.00	17,172,052.00
CREDAL	http://www.credal.be/	Cooperative	Social economy	13,717,591.00	14,871,933.00
FIARE	http://www.proyectofiare.com/	Limited company	Social economy	1,650,397.00	13,698,000.00
HEFBOOM	http://hefboom2.nettools.be/	Cooperative	Social economy	14,030,083.00	12,734,352.00
QREDITS	http://www.qredits.nl/	Foundation	Microcredit	17,000,000.00	9,926,335.00
SIDI	http://www.sidi.fr/	Limited company	MFI in emerging markets	9,000,000.00	8,978,000.00
ALTERFIN	http://www.alterfin.be/	Cooperative	MFI in emerging countries	9,953,249.00	8,381,865.00
SOWECSOM	http://www.sowecsom.be/	Public partnership	Social economy	2,698,000.00	7,805,674.00
ASN BANK	http://www.asnbank.nl/	Bank	Environmental, Social and Cultural	105,199,000.00	4,866,397.00
PERMICRO	http://www.permicro.it/	Limited company	Microcredit	n/a	2,975,688.00
CRESUD	http://www.cresud.it/	Limited company	MFI in emerging markets	1,450,000.00	2,798,895.00
MAG4 PIEMONTE	http://www.mag4.it/	Cooperative	Social economy	975,926.00	2,534,875.00
MAG6 SERVIZI	http://www.mag6.it/	Cooperative	Social economy	2,384,000.00	2,441,059.00
CAISSE SOLIDAIRE NORD PAS DE CALAIS	http://www.caisse-solidaire.org/	Bank	Environmental, Social and Cultural	3,574,846.00	2,300,000.00
MAG2 FINANCE	http://web.tiscali.it/mag2/	Cooperative	Social economy	2,555,903.00	2,047,902.00
MAG VENEZIA	http://www.magvenezia.it/	Cooperative	Social economy	816,625.00	1,020,514.00
MICROCREDITO DI SOLIDARIETA' SPA	http://www.microcreditosolidale.eu/	Limited company	Microcredit	1,000,000.00	950,776.00
ÉCIDEC	http://www.ecidec.org/	Non profit association	MFI in emerging markets	37,764.00	221,783.00
				TOTAL OUTSTANDING LOANS	12,077,507,478.15

* From companies 2009 – 2008 annual reports, amounts in Euro.

** Aggregate sum for the Community Development Finance Association.

The “Wild West” of microfinance?¹

The recent suicides by over 60 poor borrowers in the Indian state of Andhra Pradesh have brought the operations of microfinance institutions (MFIs) under public scrutiny. It is well documented that these debt-driven suicides were due to coercive methods of loan recovery used by commercial MFIs.

17 borrowers of SKS Microfinance were among those who reportedly committed suicide. In August 2010, the SKS Microfinance (the largest commercial MFI in India) raised nearly \$380 million in an Initial Public Offering (IPO) - the first from an Indian MFI. Thanks to the IPO, promoters and private equity investors of SKS Microfinance became instant millionaires while their borrowers remain desperately poor. According to media reports, the original promoters of SKS Microfinance have sold part of their stake to a hedge fund thereby making a 12-fold profit even before an IPO.

This shrewd act by promoters and top management raised serious doubts about their long-term commitments and the real motives of promoters.

Though initially started by women's groups and NGOs to empower poor people at local level, microfinance is no longer a micro or local phenomenon. Globally, the microfinance industry controls over \$50 billion in assets. Too often some MFIs end up charging exorbitant interest rates (60.5% in the case of SKS Microfinance) and are not able to reduce transaction costs, contrary to their original mission and tasks, given the social network on which they are supposed to be based to reach poor people in any region and context.

Throughout the world, MFIs are drawing greater public attention. In 2007, Banco Compartamos, a Mexican MFI, issued an IPO and consequently its original investors became instant millionaires. They received \$450 million for selling 30 percent ownership of the institution. The reason for such a high valuation of Banco Compartamos was that it had been generating super profits (returns on equity at 55 percent), arising out of very high interest charges at 85 per cent a year to poor borrowers. In September 2009, CARE (a US-based humanitarian aid agency) pocketed \$74 million when it sold a 77 per cent stake in a Peruvian MFI, Financiera Edyficar, to a local bank. More generally several malpractices are pursued by some MFIs in India in order to meet lending targets. The practice of multiple lending and loan recycling (which ultimately increases the debt liability of poor borrower) is very widespread. There are many instances of aggressive lending by MFIs with negative outcomes. In 2005, many poor borrowers (mostly women) landed themselves in a spiral of indebtedness in Andhra Pradesh. For these borrowers, MFIs were no better than traditional moneylenders as they charged exorbitant rates of interest (80 per cent and above). Some MFIs also used coercive methods of loan recovery that were humiliating to

women borrowers, including making them stand in the hot sun and locking up their homes. So that at some point some borrowers reportedly committed suicide in Andhra Pradesh as they were unable to bear the harassment by MFIs.

All these recent instances suggest that lending by MFIs could also be counter-productive if not properly regulated. In some countries, legislated interest rate caps for MFIs are under discussion.

Due to growing public concern, efforts are being made to launch a self-regulation code to discipline MFIs. But self-regulation codes are voluntary and non-binding and therefore cannot stop greedy promoters from reckless profiteering. At best, self-regulation codes can complement the regulatory measures.

In the last months some criticism has been raised also concerning the well-known activities of Grameen Bank of Bangladesh whose leader and initiator, Muhammad Yunus, was awarded the peace nobel price in 2006. Allegations have been moved, and in some cases confirmed, that interest rates became too high, so that the percentage of success stories in the long term is limited, while most of beneficiaries remains poor and in some cases gets more indebted. Secondly, despite the strong focus on women, it emerged that in most of the cases loans were then managed - or mismanaged - by men, so that this shifted on women the burden to repay loans. Finally a wider critique is moved about the fact that enhancing access to credit not automatically translates into empowering beneficiaries. Something which requires a much broader political and social strategy. Too often microcredit becomes de facto “consumer credit” so that the traditional distinction between conventional moneylenders and microfinance institutions cease.

That's why today there is a broad discussion about what an innovative microfinance approach entails beyond the “traditional” microcredit function.

However it would be erroneous to draw an analogy between microfinance and any other financial industry or services because the *raison d'être* of MFIs is to serve poor people and promote financial inclusion.

There are plenty of MFIs in India and elsewhere who follow a balanced approach between financial sustainability and social objectives in terms of collective action and borrower empowerment. The microfinance interventions by such institutions have produced better results because of their integrated approach towards building sustainable livelihoods. However it is critical that such MFIs should voice their concerns against greedy promoters and financiers who are no better than traditional moneylenders and loan sharks.

¹ This box draws upon analyses by Kavaljit Singh, director of the Public Interest Research Centre, in New Delhi, and in particular the following articles: Microfinance: Profiting from Poor, Kavaljit Singh, 5.5.2010. http://www.roubini.com/asia-monitor/258836/microfinance__profiting_from_poor. Taming the “Wild West” of Microfinance - Kavaljit Singh, <http://www.madhyam.org.in/admin/tender/Taming%201.htm>

2. The impact of the financial crisis on ethical banking

From a broad macroeconomic perspective, the 2008 financial crisis did not differ significantly from other crises that in the past have shaken western capitalist economies.

The circumstances under which the crisis matured, and the way it unfolded fit well into a general pattern that can be summarized by the following sequence:

- An excess of credit in the economy stimulates above-average growth and inflates investors' confidence in the future. As overly optimistic expectations get discounted into asset prices, late stage buyers and speculators are attracted into expensive markets in order to profit from rising valuations.
- At this stage euphoric expectations prove to be self-fulfilling and generate further increases in prices. Inevitably, the process ends up in a speculative spiral, where prices progressively lose touch from reality and ultimately a bubble emerges within a specific area of the economy.
- In this speculative environment investors' expectations are not distributed evenly, as they should under ordinary conditions, but are polarised on a single outcome – ever increasing asset prices – and the conditions for the bubble to burst are set.
- An unexpected event usually triggers a sudden reversal in investors' expectations and a consequential collapse in prices. The abrupt loss of financial wealth rapidly erodes trust in the financial system: as banks find it increasingly hard to borrow from the public, the burst of the bubble turns into a liquidity and banking crisis.
- Depending upon how far banks' balance sheets have been deteriorated by the collapse of asset prices, the liquidity crisis can evolve into a solvency crisis and a broad economic crisis.

While this typical adjustment process played once again in the latest financial crash, some specific elements that can be related to the process of financial deregulation clearly exacerbated and amplified the process. To the purposes of our work, we highlight the following critical factors:

- Shareholders' expectations for ever-increasing returns (and banks managers expectations for ever increasing bonuses) translated in spectacular rates of return on equity for major global investment banks, well in excess of 25% in the years preceding the crisis, but ultimately led financial institutions to over leverage their balance sheets, leaving them vulnerable to a reversal of investors' expectations.
- Financial deregulation coupled with financial engineering contributed to undermine the traditional sound relationship between lenders and borrowers. The ability to *systematically* transfer risk to *others* through the use of derivatives or securitization techniques induced lenders in excess risk taking. On the other side, the complexity and opaqueness of financial products made it increasingly difficult for investors to correctly assess the risk-reward characteristics of financial products and pushed financial institutions into unfair or even predatory lending techniques.
- Securitization and market mechanisms have amplified interdependence and systemic risk, and explain why initial losses in the US real estate market turned into a major international financial debacle.

Truth is that this "systemic recklessness" was not the fruit of a collective hysteria but rather built on rational individual behaviour

It is worth noting that the factors and the mechanisms described above played at a general level and affected all market participants to the same extent. Surprisingly, excessive risk taking, financial decisions (and investments) made on poor judgments and extreme greed characterized the behaviour of both professional

and non professional investors, private and institutional, Wall Street investment banks and small real estate lenders, hedge fund managers and home mortgage buyers, and so on.

Truth is that this *systemic recklessness* was not the fruit of a collective hysteria but rather built on rational individual behaviour, albeit excessively geared towards the quest of a short-term compulsive and selfish personal satisfaction; in other words, this systemic failure cannot be just attributed to a regulatory failure but has to be seen, in a way, as an inevitable consequence of the world in which we live, that greatly encourages greed, over consumption and over indebtedness. Therefore the question about ethics and finance at all levels is more and more urgent to be tackled in the aftermath of the crisis.

2.1 The cost of the financial crisis

The economic and social cost of the policy measures that have been necessary to stem a collapse of our financial system are still unforeseeable, but sadly preliminary figures available up to now do not bode well for the future.

IMF estimate of total writedowns for 2007-2010 by banks and other financial institutions tops the astonishing figure of \$ 4.1 trillions, including about \$ 1 trillion already taken.

In order to repair broken balance sheets and restore liquidity positions European banks had to drastically cut their lending to non-financial corporations, further aggravating the economic crisis. From an annual growth of over 12% at the end of 2007, year-to-year growth of loans to non financial corporations dropped to – 2.6% by the third quarter of 2009¹.

The catastrophic developments in the financial sector set the scene for the deepest recession in the Eurozone since the '30s. Eurozone real GDP growth dropped by 4.2% in 2009, industrial production collapsed (-21.39% in the month of April 2009 compared to the previous year) and unemployment sky-rocketed from a low of 7% at the start of 2008 to 10% in the summer 2010 and is still heading higher².

The impact of the financial crisis on the economy would have been undoubtedly much more serious, had central banks, governments and supra-national authorities, in Europe and elsewhere, not responded forcefully. Policy interest rates have been cut sharply, banks have almost unlimited access to lender-of-last-resort facilities with central banks, whose balance sheets expanded massively, and have been granted new capital or guarantees from their governments. Guarantees for savings deposits have been introduced or raised, and governments provided substantial fiscal stimulus.

While these measures succeeded to restore stability in the financial sector and avoid an economic depression, they raise new challenges, notably the need to orchestrate a coordinated exit from the policy stimulus in the years ahead, and leave public budgets in poor conditions.

Advanced economies entered the financial

crisis in 2007 with an average budget deficit of 1.1 per cent of national income. By 2010 this figure had risen to 8.4 per cent and general government gross debt is set to rise from close to 73 per cent of national income in advanced economies in 2007 to more than 110 per cent by 2015, according to the International Monetary Fund³. Such a rapid increase led in some cases to unprecedented sovereign debt crises in Europe, which are still unfolding and far to be solved.

2.2 Ethical banks performance in a challenging environment

The financial crisis left many casualties among European banks. **Confronted with over \$1.6 trillion in losses, European banks had to rely on massive central banks and governments support to avoid bankruptcy.** Run on deposits of cash strapped mortgage lenders were scenes out of movies or textbooks on the great Depression; even worst, the nationalization of a important chunk of the UK banking system would have been just unthinkable a few years ago.

While academics and international policy makers are shaping out the financial reforms ought to strengthen the international financial system and avoid such catastrophes in the future, an interesting lesson can be drawn from the results achieved by ethical banks in these turbulent years.

The table 2 below shows key financial indicators for European leading ethical banks in 2008/09.

Table 2: Ethical banks key financial parameters: % change 2009-2008

	Clients	Loans	Entrusted funds	Equity	ROE	Net profit	BIS ratio
TRIODOS BANK	34.52	30.78	24.45	53.92	-16	-5.94	25.38
MERKUR	16.42	11.32	33.14	6.12	-50	-45.28	-12
BANQUE ALTERNATIVE SUISSE	5.70	5.28	10.65	1.66	-93.69	-92.05	-6.98
GLS BANK	17.74	16.93	37.17	23.87	37.66	32.89	10.10
BANCA ETICA	16.27	23.20	15.02	15.04	-97.97	-97.63	12.75
Group average	18.13	17.50	24.09	20.12	-44.00	-41.60	5.85
Group average except Triodos	14.03	14.18	24.00	11.67	-51.00	-50.51	0.96

Source: Companies' annual reports

1 Source: Bank for International Settlements, <http://www.bis.org/>

2 Source: Eurostat, <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/>

3 Source: IMF, <http://www.imf.org/>

Banca Etica confronting capital adequacy and retail banking

It is very telling the case of the Italian Banca Etica, which is a savings based banks specialised in lending to the "third sector", which has currently set aside 8,38% of its capital¹ in order to comply with Basel parameters and may face problems in the future in lending more despite it receives more and more deposits and savings from citizens concerned after the crisis at least to deposit their money in a bank more ethical than others. At the same time, Banca Etica, which is aiming at increasing its presence on the territory through more retail branches and unconventional "door-to-door bankers", today cannot hire more staff given the difficulty to break-even described above.

This situation led to a need for Banca Etica to significantly increased its shareholding capital – the Bank is a popular bank with diffuse shareholders all over Italy – and thus have an easier life with Basel, at least for some time.

1 Core Tier One Ratio, 30th June 2010

Although the difficult economic background and the flattening of the yield curve have dented the group's overall profitability, ethical banks have still proved to be remarkably resilient and are all showing healthy rates of growth. In one of the worst years for the European banking industry, **Triodos, Europe's leading sustainable bank with over 200,000 clients and € 2.5 billion in entrusted funds**, registered record results, which are inarguably teaching an important lesson to mainstream traditional finance. **From 2008 to 2009, client base and outstanding loans grew respectively 34.5% and 30.8%; entrusted funds went from 2.077 billion to 2.585 billion and shareholder equity increased by 54% to € 314 million.** While these results were achieved on the back of lower profitability (the return on equity - ROE - went from 5% to 4.2%) the bank managed to stay profitable and recorded a net profit of € 9.5 mln in 2009. But more importantly, this growth was the product of sound and prudent policies, which translated in a remarkable solvability ratio of 16.3 %, an improvement of 25% compared to the previous year⁴.

Albeit slightly less impressive than Triodos's performance, but still in sharp contrast to the performance of traditional banks, ethical banks included in table 1 show healthy growth of customers, entrusted funds, shareholder capital and outstanding loans.

However low interest rates have limited significantly margins on lending thus generating a problem in covering administrative and transaction costs of the banks. This is also due to the lack of engagement of ethical financial institutions in investment banking practices, on the basis of stricter environmental and social due diligence criteria adopted. It should be further added that existing banking regulation on capital adequacy – which is about to be strengthened in the aftermath of the financial crisis with implications described below – has posed significant limitations for these institutions to increase their lending, in particular toward actors which despite their high social and environmental performance – such as cooperatives, NGOs and others – are regarded as riskier according to Basel Accord parameters. Thus lending to them requires higher capital requirements, which - given that ethical banks refuse to securitise their outstanding credits on ethical grounds - means less capacity to lend more and to a larger number of beneficiaries.

Record profits cashed by Wall Street managers have been made at the expense of the interests of customers, shareholders and the overall community

The ingredients of the overall positive performance of the sector, achieved in the background of a challenging economic and financial environment, are quiet simple and should not be underestimated in the current process of financial regulatory reform.

If there is in fact a lesson to be drawn from the current financial crisis, is that **record profits cashed by Wall Street managers have been made at the expense of the interests of customers, shareholders and the overall community.** In order to achieve *extraordinary* profits banks have been forced to shy away from tradi-

tional and sound banking activities in favour of increasingly complex and risky financial strategies, which ultimately eroded the foundations of our banking system.

Thus, like any other financial crisis, the current crisis is first of all a confidence crisis that in order to be repaired requires a long lasting behavioural change rather than just a regulatory one. In other words, it is a change of mentality and behaviour that we are looking for and not just a simple change of rules. Ethical banking pave the way in this direction and teaches us an important lesson, that is, economic profit should not be considered an end itself but rather one of the means for enterprises to pursue their mission and exercise their corporate social responsibility.

4 Triodos' 2009 annual report.

In the specific case of ethical banks incorporated and functioning as for-profit institutions, such as Triodos, their success today brings some fresh evidence to this conclusion and questions one of the fundamental postulates of traditional free-market ideology: that private enterprises should aim at maximising their profits and nothing more. Contrary to such common thinking, Triodos business model has been built on achieving a fair rate of return on equity, 4.96% on average in the last five years, rather than a maximum one, and, albeit significantly below the profitability of most admired Wall Street banks, this proved to be one of the key ingredients for a resilient and sustainable business.

2.3 Basel 3 Accord on capital requirements⁵

The Seoul G20 summit in November 2010 agreed on a new framework on capital requirements for banks, the so-called Basel III agreement. Capital requirements are a fundamental element in the regulation of banks. National regulations have been existing for many years. In the course of globalisation more harmonisation of the different regulations became imperative. This is why in 1988 the Basel Committee on Banking Supervision – gathering representatives of central banks and supervisory authorities of the OECD countries at the Bank for International Settlement (BIS), located in the Swiss town of Basel - adopted an accord (Basel I), which provided for common standards.

The core of the first Basel accord were minimum capital requirements of 8% for all banks. In 2006 a new agreement (Basel II) was adopted. Basel agreements are recommendations and legally not binding, but there is a strong de facto pressure to integrate them into national legislation. Common standards increase mutual confidence and thus reduce capital costs. With the agreement of the revised Basel accord by the G20 its status is even improved. Basel II was very much inspired by the neo-liberal thinking. It lowered capital requirements and gave more flexibility to the banks. It introduced a complex system of risk measurement, which was left to the banks. Furthermore, Basel II was only dealing with risks at micro-economic level. The accords only cover banks, whereas hedge funds, private equity funds and other non-bank actors are not concerned. In 2006 the EU had taken over Basel II in two directives. The US, however, had not yet adopted Basel II. Basel II has not met the expectations, as the failure of

European banks proves. At the contrary, it contributed to undue risk taking and weakened the resilience of the system. This is why there are negotiations for a Basel III agreement. This will not replace Basel II. Most elements of the former agreement will continue to be in place, whereas the core figures for capital requirements will be increased. The main elements of the new agreement are as follows:

- the core capital will be increased from 2% to 4.5% of total capital;
- a capital conservation buffer of 2.5% will be introduced, bringing the requirements all in all to 7%. Banks are allowed to draw on this buffer to absorb losses during periods of financial and economic stress. While using this buffer, there are restrictions to pay dividends;
- as a third component countercyclical buffer ranging from 0 to 2.5% according to the conjuncture should be implemented. This buffer will only be in effect when there is excess credit growth that is resulting in a wide system of built up risk. The obligation to accumulate the countercyclical buffer will absorb capital in a boom phase and work as a break to build up bubbles;
- For systemically important banks additional requirements beyond these standards have been announced and should be discussed in the G20;
- A leverage ratio of 3% has also been agreed upon. This means that leverage is limited to 33 times the banks core capital;
- Also a liquidity ratio is envisaged, which should allow a bank to meet its short term obligations. A figure has not been set;
- Finally, an essential issue is the definition of capital. According to the new agreement only own and liquid assets of the bank, i.e. equity capital and disclosed reserves, will be accepted as core capital, or common equity, as it is called in the insider jargon. This improves the quality of the core capital.

The implementation of Basel III shall start on the 1st January 2013. This would give banks the time to accumulate the additional capital. However, implementation will only be step by step and the transition period to full implementation will last until 2018. In sum, the agreement is reversing the trend to lower standards as it was the case with Basel II, and stability will increase to a certain extent with higher standards. The question is, however, whether the new requirements will be sufficient. In particular the long transition period seems to be very complaisant vis à vis the financial industry and the next crisis might come before the new agreement is fully implemented. Furthermore, it is questionable how much the philosophy of Basel II of self-assessment by the banks has changed, and

⁵ Compiled on the basis of the Factsheet "Basel III Accord on Capital Requirements: The Cornerstone of Financial Reform?"; WEED, Germany, 2010

whether the new measures will prevent banks from setting up a shadow banking system, a practice which was at the heart of the financial crisis.

2.4 Which challenges from Basel III for the ethical banking industry?

Basel III will undoubtedly have an impact on the operations of Ethical banks. Tighter capital requirements, combined with a categorization of not-for-profit economic actors as high risky borrowers – as it happens now for most of clients of these bank – would inevitably lead to a reduced amount of capital for lending. It should be added that given the limited size of their business, Ethical banks will keep using the “standardised” approach on risk assessment and management as defined by central banks, contrary to large banking conglomerates which are allowed to define their own management system upon approval by supervisors. In short, this remains a high competitive disadvantage for the sub-sector of ethical banking.

At the same time specific features of Ethical and other alternative banks risk not to be taken into account so that an additional burden could be placed on them, specifically as concerns the definition of core “Tier 1” capital. This is the case of cooperative banks⁶, whose capital primarily consists of cooperative members’ shares. A capital which, by essence, evolve with the actual number of members. Accordingly to the free membership cooperative principle, members are free to join and leave the cooperative and member shares are thus redeemable by the entity. Cooperative banks are non joint market company, thus member shares cannot be traded on an organized market, and therefore the departure of a member is not directly replaced by another member.

The fact that cooperatives have an unconditional right to refuse the redemption of member shares is regarded as a problem by regulators and supervisors according to what has emerged in the Basel III process. It will be now up to national regulators to have a final say on the issue. The possibility to make shares redeemable at a certain value and under certain conditions could contribute to identify a technical solution, instead of de facto making cooperative banks unable to operate any longer.

Finally, it should be pointed out that, as said, it is unclear

how much leverage and the abuse of shadow banking instruments will be limited in reality by Basel III. Such practices give conventional banking an enormous competitive advantage comparing with Ethical banks who rightly refuse to adopt such instruments and are reluctant to abandon their primary profile of commercial banks to endorse an aggressive investment banking logic. The fact that regulators keep refusing to weigh environmental and social factors and other non-financial factors to assess and manage lending risks makes evident that the Basel III agreement, fully focused on just restoring financial stability, does not award at all ethical banks for their action in the public interest – according to social and environmental goals or a logic of financial inclusion of the poor – and in some cases, as a paradox, penalise them further. This situation raises questions about which kind of regulation ethical banks should advocate for in order to avoid ending up in a trap built around them – and often without consulting them – in the name of financial stability.

⁶ Cooperative banks shares as Core Tier One Capital: Basel III impacts on the cooperative banking model; International Cooperative Banking Association, Policy paper, 2010

3. Ethical banking with social goals

Poverty, in developing countries as well as in advanced economies, can be attributed to different factors, which change over time and vary across geographic regions, but with a common feature: the poor do not have capital or access to bank credit, which means that entrepreneurship and capacity to decide on their own lives is a privilege for the wealthiest.

It is widely acknowledged that private financial institutions driven exclusively by market mechanisms and profit considerations are ill equipped to address the financing needs of the poorest sections of the society or to promote those activities that lead to a general social advancement of the community.

Ethical bankers' traditional mission is to combat poverty by addressing the problem of financial exclusion

Thus, ethical bankers' traditional mission is to combat poverty by addressing the problem of financial exclusion. At the same time some believe too that access to credit, in all its forms, should be regarded as a human right.¹

Although the idea of combining financial assistance and solidarity is certainly not a new concept – first banking experiences in Tuscany Renaissance at the beginning of modern capitalism had a strong mutual lending feature - it has been recently revitalized by the work of Yunus Muhammad, founder of the Grameen Bank, and many other practitioners of alternative finance at a small scale in developing countries during the '80s and the '90s, who demonstrated that **micro loans granted without collateral could prove to be powerful catalyst of social and economic advancement for the poorest**².

Inspired by first success and innovation achieved by these pioneering experiences – which however deeply changed over time in some cases, including the Grameen one - microcredit institutions have been spreading through the western financial community in the last twenty years, and are currently serving over 80,000,000 borrowers in emerging countries.

1 Manifesto of ethical finance, Italy, Associazione Finanza Etica, <http://www.finanza-etica.it/>

2 The interested reader can refer to Muhammad's biography "Banker to the poor micro-lending and the battle against world poverty Muhammad Yunus"

In the European context microcredit practices are less developed and they had to be adapted to the different institutional, regulatory and cultural environments. One obvious limitation is that while western currencies enjoy a tremendous purchasing power over local currencies of most emerging countries, this funding advantage cannot be exploited when projects are denominated in western currencies. In 2009 Grameen's average loan was only \$103³, and while this amount might constitute a fair sum to start a small business in Bangladesh, it has to be raised at least 20 times to achieve the same results in Europe. Not surprisingly, microcredit is defined by the EC commission as loans under € 25,000. Microcredit practices in Europe face also higher costs per loan (so-called transaction costs), which further stresses the financial sustainability of this business model.

Another set of problems is institutional and regulatory. **National and international banking regulations are not always supportive of non-bank financial lending – which characterize most of the initiatives in this field – and are poorly designed to correctly assess the benefits and intrinsic risks associated with such unconventional lending practices.**

It is also worth mentioning that microcredit policies, which usually aim at promoting self-employment within less advantaged categories of individuals, can conflict with social security programs and unemployment benefits adopted in the welfare state of most European countries.

3.1 The French new economic regulation

France has been historically a pioneer in micro credit initiatives and social banking in Europe, and civil society and non-profit associations have played an important role. Therefore, it is useful to see how policy makers have met the regulatory challenge posed by the increasing role played by non-bank financial microcredit institutions.

The development of this sector in France can be attributed to a large extent to the leading role played by ADIE (*Association pour le droit à l'initiative économique*). ADIE is a non-profit association founded by Maria Nowac in 1989. Its mission strictly adheres to Grameen's philosophy: the association targets mostly micro entrepreneurs

3 Grameen Bank website <http://www.grameen-info.org/>

within the area of unemployed persons or persons who receive social allowances (*revenu minimum d'insertion*, RMI) and provides coaching programs to support these people.

Since 1989 the association granted over 80,000 micro-loans, which enabled the constitution of more than 65,000 enterprises generating 78,000 jobs.

In 2009 ADIE has 14,581 loans outstanding for a total amount 48,062,926 Euro⁴; although the association suffered from the economic and financial crisis, the amount of outstanding loans in 2009 increased 14% compared to the previous year and made possible the creation of 12,121 jobs. After two and three years from constitution, respectively 65% and 57% of the micro enterprises funded are still up and running (which is above the national average) and **the loan default rate as of December 2009 is incredibly low at 2.21%**⁵.

Although these successes are remarkable it must be said that the Association faces its own challenges too. A critical element is the financial sustainability of the business model. While revenues from loans and investments cover the borrowing costs, the income generated from the lending activity is significantly below the association's total expenses: In 2009 credit operations generated a profit of 3,595,000 euro compared to 35,144,000 euro in total expenses. To meet its total obligations ADIE relies heavily on subsidies from the European union and state entities. In 2009 24,252,000 euro were granted to ADIE at various titles making 70% of the year revenues⁶.

A critical factor behind ADIE's financial weakness is related to the cost associated with coaching programmes. While coaching, training and mentoring activities are critical to the success of lending programmes, they produce no income and absorb a third of the association's total expenses.

Another element of financial weakness is inherent to the microlending business. ADIE's average loan is below 4,000 Euro and costs the association 735 Euro per year. Without increasing the average size of each loan, which would compromise the nature of the business, and beside any potential productivity gains – i.e. the reduction of the cost per loan – ADIE would have to raise significantly the interest rate charged on loans to reach its financial equilibrium.

Such policy option is limited by the already high level of interest rate charged and by the maximum rate allowed

under French usury loans.

It should also be noted that the interest policy alone would not solve ADIE's financial problems since, based on current levels of activity, the interest rate charged would have to be raised above the prohibitive level of 32% to bring the budget in equilibrium⁷.

A window lending opportunity for non-bank institutions

The French market for micro loans is a niche market compared to the total amount of outstanding bank loans. In 2008, 13,000 micro loans were granted from non-bank institutions for a total amount of 35 million Euro. In the same year, thanks to public guarantees banks made available 10,000 loans below 25,000 Euro.

Nevertheless, the social and economic benefits of these micro credit initiatives are remarkable. ADIE's strategy is to address primarily the poorest and less advantaged individuals: 77% of ADIE's clients are not graduate, 43% benefit of social allowances and 7% are illiterate. Furthermore, a recent study conducted for the French government estimates that the cost of the subsidies granted to ADIE is less than the cost of having unemployed individuals living under social allowances benefits. Public finance savings are estimated at 2,500€ per record every three year, which translates into 25 million Euro of savings for the government every year.

Beside its social utility, this market is growing fast with the number of requests for professional microloans estimated to rise to 100,000 per year.

French regulators have been historically supportive of such unconventional lending practices from non-bank actors.

According to the French banking act art. L.511-5: *"It is unlawful for any person or undertaking other than a credit institution to conduct banking operations. It is also prohibited for any company other than a banking institution to receive repayable funds from the public"*.

EU banking legislation (2006/48/EC) affirms the same principle (art. 5) and establishes a minimum capital of 5,000,000 euro (art.9)⁸ to conduct banking operations.

The trigger to fall under European Banking law is to take deposits. Financial institutions operating

7 Ministère de l'économie, de l'industrie et de l'emploi, Rapport N. 2009-M-085-03: Le Microcrédit, p.3

8 Although Member States may grant authorisation to particular categories of credit institutions the initial capital shall be no less than EUR 1 million

4 ADIE's Annual Report 2009

5 ADIE's Annual Report 2009

6 ADIE's Annual Report 2009

under European banking law have to fulfil all the requirements of banking legislation (regulation and supervision): transparency, minimum capital requirements, duties to report to banking authorities and other supervisory regulation.

While these requirements are justified by two overall objectives: the soundness of the financial market and the protection of banks' clients and investors, they de facto exclude non-bank institutions from engaging in lending practices.

French regulators have progressively relaxed such constraint in order to support the active role played by non-profit associations. Exemptions from the conditions set in art L.511-5 are listed in article L.511-6:

The restriction on credit operations does not apply:

Art.1 To non-profit organizations, which in the course of their duties and for social purposes shall make loans to their associates on their own resources;

Art.5 To non-profit organizations and foundations recognised of being of public utility making loans from their own resources or with funds borrowed from credit institutions [...] in order to create and develop companies with a limited number of employees fixed by decree or to fund social inclusion projects.

The new economic regulations law in 2001 (L. n. 2001-420, may 15, 2001) further relaxes the funding restriction on non-bank institutions by allowing non-profit associations to borrow directly from banks or other credit institutions in order to make loans to unemployed or individuals living from social allowances and willing to start a business; the amount of such loans being capped at € 6,000 for individuals and € 10,000 for enterprises.

This scheme has fundamentally changed the funding process of non-profit associations involved in micro-loans operations. Under traditional banking laws, this sector's lending capability was strictly limited to the availability of their own resources, while the new law opens the way to a significant growth of non-bank microcredit activity.

A law in 2008 (*Loi de modernisation de l'économie*) pushes further the refinancing capability of non-bank agents by widening the scope of the previous law to:

- Loans made to individuals - independently from their social condition - willing to start a new business or to take over an existing business, provided the undertaking hav-

ing a limited number of employee fixed by decree (currently three employees);

- Loans made for any kind of social inclusion projects for physical persons.

The specific conditions for non-profit associations to get access to bank credit are set by law under several articles of the French banking code. Further the introduction of the 2008 law on the modernisation of the economy, the last changes have been introduced with the June 12, 2009 decree n. 2009-682.

Beside the conditions set to assess the associations' experience and professionalism (R. 518-60), and the functioning of licensing committee (R.518-57/58), the most important criteria is related to capital requirements under art 518-63:

Capital requirements for non-bank micro-credit institutions are based on the following pillars:

- The outstanding amount of loans at risk of repayment needs to be provisioned for an amount equal to the expected loss;
- The outstanding amount of unsecured and non-provisioned loans requires the constitution of a reserve fund;
- The provision ratio of the fund is set by the licensing committee and must be equal to:
 - 30% of the outstanding amount of unsecured and non-provisioned loans, in the absence of any statistical evidence of the average default ratio of the loans granted in the last three years; or
 - 1.5 x the observed default ratio in the last three years, which cannot be below 10% and above 30%
- The total amount of equity and assimilated resources needs to be constantly above 12% of the outstanding amount of unsecured and non-provisioned loans
- The length of the outstanding loans can never be longer than the length of the funding resources.

It is worth noting that such capital requirements are more stringent than the current requirements under the Basel II Accord. Based on a traditional approach where the Cook ratio (8%) applies to equity, and loans less than 1 M€ are assimilated to retail loans: the Cook ratio needs to be weighted by a factor of 75% which translates into a overall ratio of own funds on risk-weighted assets of 6%, which is half the ratio required by non-bank institutions.

As of today three associations have been granted the authorisation to access to bank credit:

- ADIE since June 23, 2009 for personal and professional micro-loans;
- CREASOL since June 26 2009 for personal and professional micro-loans;
- CDSL since April 2008 only for personal micro-loans.

This window of opportunity for lending has proven to be an important source of funding for non-bank micro credit associations and it is constantly growing. As of December 31, 2008, banks funding stood at 27.7 million Euro, making 74% of the gross outstanding amount of micro loans. In 2009 this amount increased by 20%, with 88% of the new loans being refinanced by banks.

The role of enterprise savings (“Epargne solidaire”)

Enterprise saving plans have been introduced in France in 1967 in order to provide employees with an extra financial incentive to save for retirement related to the enterprise's results. There are three main categories of saving plans:

- PEE (*Plans d'épargne entreprise*), Corporate savings plan
- PEI (*Plans d'épargne interentreprise*), Inter-corporate savings plan
- PERCO (*Plans d'épargne pour la retraite collective*), Savings plan for collective pension.

The principal difference among these saving products lies in their length to maturity: While PEE and PEI are relatively short term plans and the invested amounts can be withdrawn after five years, savings in PERCO plans become available only after retirement. All these plans entitle both employees and employers to fiscal incentives.

Enterprise saving are growing fast (+50% in the last eight years) and represent a pool of assets under management of €76.5 bn as of June, 30, 2009.

In order to channel funds in the “social economy”, french regulations require enterprises to offer their employees the possibility to invest into solidarity funds (FCPES, fonds commun de placement d'entreprise solidaire) among the possible saving options.

This requirement has been mandatory for PERCO plans since 2003 (art. L. 3334-13 of the Labour code), and for PEE and PEI plans since January 1st, 2010 (art. L. 3332-17 of the Labour code).

Art. L.214-39 of the French banking code regulates

FCPES' asset composition and investment rules: between 5% and 10% of the capital needs to be invested into the social economy, while the remaining 90% - 95% can be made of traditional investments. The following entities can benefit from FCPES social investments:

- Licensed social enterprises as described by art. L. 443-3-2 of the Labour Code
- Venture capital firms as described by the law of July 11, 1985 art 1st-1 n. 85-695
- High risk Mutual funds (FCPR) as described by art L. 214-36 of the French banking code, provided 40% of their assets is made of securities issued by social enterprises as per art 433-3-2 description

Social enterprises statutory objectives have changed over time. The initial administrative description provided by art. L. 443-3-2 has been amended on May 1st, 2008 and replaced by art. 3332-17-1/21-1 till 21-5:

It is considered social enterprise an enterprise whose share capital is not negotiated through a regulated market and

1) Employs at least 30% of employees among the following categories:

solidarity employment contracts⁹
mentoring employment contracts¹⁰
individuals with social or professional integration problems requiring social assistance
individuals with disabilities

2) an enterprise created or taken over by an entrepreneur belonging to the above categories

3) an enterprise established as a cooperative or an association with strict rules governing directors' remuneration

It is assimilated to social enterprises all those financial institutions whose capital is made of at least of 35% of securities issued by social enterprises or credit institutions with at least 80% of the outstanding amount of loans and investments made into social enterprises.

It is worth highlighting that **the concept of social enterprise is related to the nature of the enterprise rather than its function.** Furthermore, French regulations make the distinction between two different categories of social enterprises: firms employing less advantaged individuals

⁹ Contrats aidés

¹⁰ Contrats de professionnalisation

(solidarity economy) and firms established under a specific legal form – cooperatives, associations, etc – (social economy).

FCPES investment funds have more than € 500 million under management in 2009, of which between 5 and 10% invested in social enterprises (between € 25 and 50 million), which represents less than 1% of total enterprise saving plans.

There are currently 58 registered FCPES funds made of 45 multi-enterprises funds and 8 dedicated funds. There are also four licensed intermediate organizations licensed to invest the funds coming from the FCPES pool into social enterprises; these institutions are: *Habitat et Humanisme*, *la NEF*, *la SIFA* and *ADIE*.

ADIE is presently the only micro credit institution benefiting from FCPES funding (€5.2 million in 2008); ADIE pays a 1.5% fixed rate on funds borrowed from FCPES, which makes this funding resource less expensive and more reliable than traditional bank credit. Although this funding channel has some advantages compared to traditional bank refinancing, and it is expected to grow significantly in the future, it represents a small share of ADIE's total funding resources. The arbitrage strategy between these two funding sources is not in fact determined only by their respective cost but takes in account the loan guarantees associated with bank lending: banks take on up to 30% of ADIE's losses while there is no such guarantee with FCPES funds.

Public guarantees

Public aid in the form of subsidies or loan guarantees plays an important role in the development of micro credit in France. While the study of public grants and financing would bring us out of the scope of the present work, the establishment of public loan guarantees is an important part of the overall strategy adopted by French regulators to support micro credit lenders. The rationale behind loan guarantee schemes is straightforward. Micro credit institutions serve principally less advantaged individuals that can not provide any caution or guarantee; thus, public guarantees can fill this gap and support micro credit lenders.

The Social Cohesion Fund (FSC) was set up in 2005 in order to support the development of professional micro loans and subsidise the associated coaching programs. Since 2005 the fund was granted € 56.5 million, with 80% of the resources administered by France Active. As of October 10, 2009, € 3.494 million were granted directly to banks engaged in personal micro loans

activity, although it should be noted that only a fraction of the available guarantees have been effectively used by banks.

To conclude, in the overall French major organisations involved in micro lending or enterprise start up benefit from over € 100 mln per year in subsidies from state entities and the European union. It is important to highlight that this aid is aimed at supporting the actors involved in micro credit, rather than the development of micro credit by itself, and that effort is part of the general government strategy to promote self-employment and enterprise creation.

3.2. The UK community banking experience

Ethical or social banking in the UK is generally referred as "Community banking" and shows interesting similarities with the French model, both in terms of the business model and the regulatory framework.

Although the oldest organization in this field dates back to 1973, the community-banking sector is on average less than 10 years old. The roots of this resurgence lie principally in the economic downturn in the mid-80, which left many areas in the UK with high levels of unemployment and a low entrepreneurial activity. As it became clear that high levels of unemployed resources were related to the difficulties that many small businesses encountered in accessing credit from mainstream banking, Community Development Finance Institutions (CDFI) were established to fill this gap and provide financing to less advantaged and financially excluded individuals.

Thus, as for the French business model, **the UK community-banking sector is highly geared towards social objectives. The main goal of CDFI is to provide credit access to financially excluded individuals or enterprises in deprived areas, with a dedicated capability to promote self-employment and micro-enterprises start-ups.** The breakdown of CDFI's key markets is reported in the table 3¹¹

Social enterprises are important beneficiaries of CDFI's loans and this category has shown the most consistent growth over time. Furthermore, as many of the lenders operating in this space deal with comparatively large loans, this sector represents the lion's share of CDFI's overall portfolios.

¹¹ CDFI (2009), Inside Out, The state of Community Development Finance, Weathering the Storm

Table 3 - CDFI's Lending coverage and customer base

Key markets	CDFIs able to serve	CDFIs with current customers
Micro enterprise	76%	71%
Small business	60%	44%
Medium business	33%	16%
Social enterprise	48%	33%
Personal	22%	22%

Source: CDFA (2009), Inside Out, The state of Community Development Finance, Weathering the Storm

Customer support and coaching programs play an important role as well: over 70% of the institutions surveyed by the latest CFDA, Community Development Finance Association, report on community banking provision of one-to-one mentoring services and 44% provide training assistance. However, it should be noted that such services, even though they have proven to be highly successful, are often subject to budget constraints and, therefore, vulnerable during period of revenue contraction. Confronted to ADIE's business model (where coaching expenses absorbs one third of total expenses), coaching and training services provided by CDFI do not have the consistency characterising the French model and seem to be more occasional and dependent on resources availability.

Market size and Growth¹²

Micro finance in the UK is not recognised per se as an independent source of financing so it is hard to figure out the exact market size. Figures referred to the CDFI community might not be exhaustive (since they do not take into account bank lending to small businesses) but should still provide a reliable picture of the UK ethical banking market size and growth.

As per the French market, it is clearly a niche market compared to the total amount of outstanding loans in the economy. **In the year 2008/09 the community finance industry disbursed loans for a total value of £ 113,134,045, consisting of 10,937 applications and bringing the total amount of outstanding loans to £ 393,981,355.**

Although this market represents a very small fraction of

the traditional banking market, it is growing fast and more importantly, it proved to have a positive social impact on most deprived communities: CDFI's total outstanding loans enjoyed a 21.5% growth rate in the last 6 years. **In the year 2008/09, thanks to CDFI's financial and non-financial initiatives 9,817 jobs were created or sustained, bringing the total number of jobs created since 2003 at 96,000.**

The growth of this promising industry is clearly demand-driven but unfortunately it is often hampered by capacity constraints, and the recession in 2009 even worsened this financing gap. As a consequence of the last credit crunch more individuals and small businesses have turned to the CDFI community to meet their financing needs. In 2009 the demand for loans increased by £160 million (to £360 million) but CDFIs were able to serve only one-third of this demand. Generally speaking, prior to the credit crisis the CDFI sector had the capital and organisational capacity to finance nearly half or more of loan applications, depending on market segment. In 2009 loan conversion rates dropped across the board due to the exceptional rise in loans applications. CDFIs stepped up to serve this surge in demand by providing more loans of a greater total value, but were unable to meet the same rate of demand as in previous years, and while some CDFIs report tightening their risk management regime, many simply didn't have the funds to responsibly meet demand.

Loans size

While CDFI are not stricto sensu micro credit institutions, the average loan size is still relatively small. The table below shows the average loan size per market segment.

Table 4 – Average loan sizes 2008/09

Markets	CDFI average	CDFI sector portfolio
Micro Enterprise	£ 10,353	£10,567
Small business	£ 27,919	£29,056
Medium business	£ 95,533	£164,171
Social enterprise	£78,796	£184,869
Personal	£606	£593

Source: CDFA (2009), Inside Out, The state of Community Development Finance, p. 13

Loans to micro enterprises, small businesses and personal loans clearly fall under the definition on micro credit – i.e. loans below 25,000 euro – while loans to social enterprises and medium businesses are significantly higher.

¹² CDFA (2009), Inside Out, The state of Community Development Finance, Weathering the Storm

Funding resources and grants dependency

CFDI's funding base is diversified although it is heavily dependent on subsidies, grants and endowments: grants and funds raised through the market (commercial loans, private investments and withdrawable shares) are responsible for respectively 49% and 25% of CFDI's funding, while the rest being made of earned income from interest and fees.

It is also worth mentioning that banks financed only a small fraction of the total amount of disbursed loans by CFDIs in 2008/09: **banks refinancing rate stood 14.12% in 2008/09 compared with an ADIE's 88% rate.**

Profitability: Interest rates charged, portfolio at risk, portfolio yield

On average, CFDI charge high interest rates on their loans to compensate the risk they accept by serving high-risk borrowers. Although average interest rates for micro and small business loans are level at 11.8%, rates for micro enterprises can reach as high as 25%. Personal loan rates are even higher with the average standing at 24.4% and the maximum rate reaching 35%.

High interest rates are justified to compensate the fact that a significant share of lending is unsecured. Based on the latest available figures, 28% of the value of all outstanding loans is made without asking any collateral; since CFDI lending is geared towards micro loans, which are usually unsecured, 51% of loans made by CFDIs are not guaranteed. **It is worth noting that CFDI's business model is much more risk oriented compared to ADIE's** (thanks to public and bank guarantees only 10.9% of the amount of outstanding loans is unsecured and weighs directly on ADIE's books).

Delinquency rates are another interesting element of comparison between CFDIs and ADIE, and while it is legitimate to assume that higher public guarantees should lead to higher default rates – since the lender does not bear directly the cost of the default – actually the opposite is true. CFDI's average PAR rate¹³ is at 25% and the default rate stands at 13%, while ADIE's equivalent figures are much lower, respectively 8.36% and 2.21%.

¹³ A par rate is an observable rate on a financial instrument traded in the marketplace and is typically for a bond or a swap that pays periodic fixed coupons - examples would be the yield on the 30-year US Treasury bond or the 5-year swap rate.

Mentoring and coaching services can explain this difference: ADIE's special expertise in providing coaching and training services to customers seems to translate into lower default rates. A similar conclusion is reached by the latest survey of the CFDA, which found that CFDIs providing advisory services reported an average default rate 3% lower than those who didn't.

ADIE has put in place a system of witnesses and cautions to secure the loans that seems to be effective in discouraging irresponsible borrowing. In order to qualify online for a micro loan, the borrower is asked to name a witness who will act as a moral guarantor. In reference to standard loans, ADIE requires the borrower to name a well know guarantor who will secure 50% of the loan, although no cash disbursement is asked.

Overall, the UK community banking shares many features with ADIE's business model, including the struggle to reach financial sustainability. Both entities are excessively dependent on grants and subsidies and need to generate more income from interest and fees in order to become viable long-term businesses.

However, some progress has been achieved in recent years and for the first time in 2009, earned and investment income made up over half of CFDI income.

The Portfolio yield is another way to measure CFDI's efficiency. This rate captures the interest and fees earned over a twelve-month period as a percentage of average portfolios outstanding. In other words, this ratio gives an insight into the relative productivity of CFDI's portfolios, and shows the portfolio's capacity to generate income.

Portfolios yields vary per market segment, with personal lending CFDIs holding the highest average portfolio yield – 12.3% – mirroring the higher interest charged on personal loans.

Regulatory framework

UK policy makers have put in place over time a specific regulatory framework to support the community-banking sector and promote investments into CFDIs.

Most of CFDIs has charitable status and is registered as companies limited by guarantee (CLGs). These companies do not have a share capital, but the members act as guarantors. The profit generated by these CLGs is not distributed among its members, but retained to be reinvested in the organisation.

table 5 - Key representative UK Community Development Finance Institutions

Institution	Website	Corporate structure	Brief description
ABI Associates- Faith in Business	http://www.abi.co.uk/	not for profit Company limited by guarantee	microcredit
Acorn Fund	http://www.hullbdf.com/	not for profit Company limited by guarantee	microcredit
Aston Reinvestment Trust	http://www.reinvest.co.uk/	mutual society	social economy
Big Issue Invest	http://www.bigissueinvest.com/	social enterprise	social economy
Black Country Reinvestment Society	http://www.bcrs.org.uk/	mutual society	social economy
Bridges Ventures	http://www.bridgesventures.com/	investment company	Sustainable lending
Bristol Enterprise Development Fund	http://www.bedf.co.uk/	not for profit Company limited by guarantee	microcredit
Business Enterprise Fund	http://www.befund.org/	not for profit Company limited by guarantee	enterprise creation
Business Finance North West	http://www.bbvonline.net/funding.asp	limited company	social economy
Business Finance Solutions	http://www.business-finance-solutions.org.uk/	not for profit Company limited by guarantee	enterprise creation
Capitalise Business Support	http://www.capitalise.org/	not for profit Company limited by guarantee	microcredit
Co-operative and Community Finance	http://www.co-opandcommunityfinance.coop/	mutual society	social economy
Coventry and Warwickshire Reinvestment Trust	http://www.cwrt.uk.com/	not for profit Company limited by guarantee	small business lending
Cumbria Community Asset and Reinvestment Trust	http://www.ccart.org.uk/	industrial and provident society	small business lending
Development Strathclyde	http://www.dsl-businessfinance.co.uk/	not for profit Company limited by guarantee	small business & social economy
Donbac	http://donbac.co.uk/	limited company	small business lending
East London Small Business Centre	http://www.goeast.org		
not for profit Company limited by guarantee	small business lending		
Enterprise Loans East Midlands	http://www.emda.org.uk/smallloans/	regional development agency	microcredit
Finance South Yorkshire	http://www.syif.com/	investment fund	business lending
Five Lamps	http://www.fivelamps.org.uk/	charity	social economy
Foundation East	http://www.foundationeast.org/	not for profit Company limited by guarantee	business lending
Fredericks Foundation	http://www.fredericksfoundation.org/	charity	microcredit
GLE oneLondon	http://www.gle.co.uk/advice/index.php	public owned company	business lending
HBV Enterprise	http://www.hbv.org.uk/	charity	microcredit
Impetus	http://www.impetus.org.uk/	charity	social economy
Key Fund Yorkshire	http://www.keyfundyorks.org.uk/	not for profit Company limited by guarantee	social economy
London Rebuilding Society	http://www.londonrebuilding.com/	mutual society	social economy
Merseyside Special Investment Fund	http://www.afm.uk.com	investment fund	business lending
Norfolk & Waveney Enterprise Services	http://www.nwes.org.uk/	charity	microcredit
North London Enterprise Credit Union	http://www.northlondoncommunityfinance.org	credit union	microcredit
North Staffordshire Risk Capital Fund	http://www.nsrcf.co.uk/	investment fund	business lending
Robert Owen Community Banking Fund	http://www.rocbf.co.uk/	credit union	microcredit
Social Investment Scotland	http://www.socialinvestmentscotland.com/	charity	social economy
South Coast Moneyline	http://www.scmoneyline.org.uk/	industrial and provident society	microcredit
South West Investment Group	http://www.southwestinvestmentgroup.co.uk/	not for profit Company limited by guarantee	small business lending
Street NE	http://www.streetnortheast.co.uk/	not for profit Company limited by guarantee	microcredit
The Social Enterprise Loan Fund	http://www.tself.org.uk/	not for profit Company limited by guarantee	social economy
UK Steel Enterprise	http://www.uksteelenterprise.co.uk	limited company	business lending
Ulster Community Investment Trust	http://www.ucitltd.com	charity	social economy

CFDIs can also be incorporated as Industrial and Provident Societies (IPS), i.e. businesses or organisations trading for the benefit of local communities or as cooperatives. Although IPSs are registered under the FSA, they benefit from a light touch regulation compared to other FSA regulated firms, especially in regards to financial promotion rules.

In both cases **CFDIs rely on withdrawable share capital to raise funds and are exempted from FSA and European banking regulation in spite of being involved in lending activity.**

It is worth noting that the soundness of this “alternative banking sector” has been questioned recently by the UK’s Treasury Department, but a study conducted by the FSA concluded that, even though this system presented several market failures and weaknesses, the cost of traditional banking regulation would be prohibitive for CFDIs and could stifle the growth of this industry in its early stage of development¹⁴.

Fiscal policy

The Finance Act 2002, Section 56, Schedule 16 introduced the Community investment Tax Relief (CITR scheme) in order to stimulate private investment in disadvantaged communities by providing a tax incentive to individuals and companies investing in businesses serving those communities.

The tax incentive is targeted at investors in accredited CFDIs, which invest (directly or indirectly) in enterprises in, or serving, disadvantaged communities. In order to be accredited, CFDIs must satisfy key criteria as outlined by Section 340 of Income Tax Act 2007:

- Be set up with the intention of carrying on its activities for the long term, and for a minimum of five years, as demonstrated by: the body’s chosen structure; its funding and investment record or strategies; its track record of existing operations as appropriate; and other aspects of its business plan for the expected period of accreditation (for example by projected income from operations contributing towards covering administrative costs).
- Intend, throughout the period for which it seeks accreditation, that not less than 75% of the activities and operations of the body are directed at the provision of

finance, or the provision of finance and access to business advice, for enterprises for disadvantaged communities (as described in another paragraph below).

- Will only provide finance to enterprises that have been unable to obtain funding from other sources, especially mainstream providers of finance, and will collect whatever information and apply whatever tests it considers appropriate as part of its loan making process. It will offer a range of products applicable to the needs of its customer base.

- Will only provide finance to small or medium sized enterprises (SMEs) having: fewer than 250 employees; either an annual turnover which does not exceed 50 million Euro or an annual balance sheet total which does not exceed 43 million Euro; and no more than 25% of their capital or voting control rights are controlled by an organisation that is not itself an SME¹⁵.

- Will only provide finance to those SMEs which meet at least one of the following criteria in relation to disadvantaged communities: i) are located in a geographic area identified in a specific list; ii) are located in an area not identified in the list but in which, by reference to Government recognised measures of disadvantage relating to: Income; Employment; Health; Deprivation and Disability; Education, Skills and Training; Geographical Access to Services; and Housing, there is a level of disadvantage comparable to that in the areas identified in the list; or iii) are owned and operated by, or intended to serve, individuals recognised as being disadvantaged on account of their ethnicity, gender, age, religious beliefs, disability or other defining characteristic.

Where finance is provided to SMEs that are eligible according to criterion ii), the body must also be providing at least an equivalent level of finance, measured in terms of transaction value and volume, to SMEs that are eligible according to either criteria i) or iii).

- Will not invest directly or indirectly in residential property.

The tax relief is available to individuals and companies and is worth up to 25% of the value of the investment in the CDFI. The relief is spread over five years, starting with the year in which the investment is made (5% in each tax year).

¹⁴ FSA, Regulation of Microcredit, Presentation by Michael Cook and Ramona Taylor of the Financial Services Authority, London

¹⁵ Some circumstances where an enterprise may be treated as autonomous even if this 25% threshold is reached are set out in Commission Recommendation 2003/361/EC of 6th May 2003.

There are currently 18 CFDI registered under the CTR scheme. In the year 2008/09 £6.5 million of investment was raised using CTR, bringing the total raised since 2003 to £58 million. Based on the latest CFDA survey, only 14% of respondents reported using CTR in 2008, and 80% of the investment raised was by three large social enterprise lenders having the structure and capacity to use the scheme to its potential.

Although CTR has demonstrated its efficacy as an investment tool, certain obstacles preventing greater take-up clearly need to be addressed before it can become a vehicle as a major source of private capital for deprived communities and underserved markets.

Public Loan Guarantees

The Small Firms Loan Guarantee (SFLG) was a UK Government loan support scheme for small businesses that ran from 1981 to January 2009.

Under the scheme participating banks could lend up to a maximum of £250,000 to eligible UK companies trading less than 5 years with a turnover of less than £5.6 Million, and have 75% of the loss at default met by the Government.

The SFLG was replaced by the Enterprise Finance Guarantee on 14 January 2009

The new scheme has wider criteria, in that it offers guarantees of loans of £1 million, rather than £250,000, and is available to businesses with turnover of up to £25 million, rather than £5.6 million. It provides lesser support to lenders, in that the total amount paid by the Government to each participating bank may not exceed 9.75% of the total amount advanced by that bank on all loans in the period, whereas SFLG contained no such cap. It allows the participating bank to insist, for the first time, on personal guarantees.

In total, for its first period from January 2009 to March 2010 the Government announced that it would support a total of up to £1,300 million loans under the scheme. For its second period from April 2010 to March 2011 the Government announced that it would support a total of up to £500m loans under the scheme.

4. Ethical banking with environmental goals

It is now evident to all, citizens and decision-makers, the environmental crisis we are living. Global climate change represents probably the greatest environmental challenge today, threatening prosperity, livelihoods and security of billions of people worldwide, as recognised by the international scientific community¹.

More generally nearly 20 years from the Rio Summit, policies on sustainable development promoted by governments, the private sector and other stakeholders have not achieved much comparing with the scale of the challenge to promote a just transition to a low carbon economy, which involves any production and consumption sector of our economies.

A just transition will require a radical change of habits and mentality in advanced economy as well as a new type of cooperation agreements internationally. Of course it is key to generate and mobilise adequate financial resources to invest in the long-term and support such a dramatic shift in our economies and societies. It is a matter of public policies and old and new instruments of public finance, including taxation, but also an issue related to identify private sector responsibilities and actions in this transformation, in particular as concerns the private financial sector.

In this context many have already raised their voice against leaving most of the actions in the end of unregulated markets, because this would inevitably lead to new financial bubbles and crisis, and would not help at all to slow down and reverse the environmental crisis. A key example is the faith put in carbon markets in the last decade, which so far have not produced any significant reduction of greenhouse gas emissions, have generated further environmental and social problems in the Global South, absorbed public resources which could have been used in different and more effective ways, and could easily generate the next "green" bubble.²

Today it is needed to abandon a pure market-based approach centred on further development of financial

markets, and look for alternative strategies. Clearly, banks need to play their part in this process by freeing resources away from traditional investments in energy intensive industries and polluting energy sources into renewal energies and green technologies³. And in particular ethical banking could play a role, if adequate public policies are put in place, as well as citizens, savers and small investors are urged to act in a responsible manner by investing in their own and all mankind's future.

4.1. The Dutch green fund scheme

The Dutch Green Fund Scheme represents a quite advanced, effective and innovative environmental legislation in Europe. This scheme shows that within an appropriate regulatory framework banks can positively contribute to some environmental progress.

The Dutch government set up the scheme in 1995 as a global policy framework to encourage environmental initiatives. Within the Green Funds Scheme, the term 'environment' was considered in the broadest sense and also included nature and energy.

The early success of the scheme pushed Dutch regulators to broaden its initial reach beyond environmental goals to serve social and cultural objectives as well⁴.

Thus, the scheme can be viewed more in general as a comprehensive policy tool to promote a sustainable development path for the Dutch society.

Beyond traditional tax incentives, the innovative character of the scheme lies in its capability to actively involve the private financial sector in the achievement of national environmental objectives. Thanks to a well-designed policy framework, financial institutions have an extra incentive to invest into specific and pre-determined environmental projects, thus improving the allocation of capital towards sustainable investments.

As a result of this scheme, some Dutch banks have honed over time their expertise in financing green, sustainable

³ For an overview of the responsibility of banks in the climate change process refer to Bank Track (December 2009), A Challenging climate 2.0, What Banks must do to combat climate change.

⁴ In 2004, (cf. Regeling sociaal-ethische projecten 2004, published in the "Staatscourant no.44 on March 4th 2004 (DJZ/BR/0163-04), the scheme as been extended to finance projects in the socio-ethical-cultural field, although the green theme is still dominant.

¹ Climate Change 2007 - IPCC Fourth Assessment Report, United Nations, Geneva

² Sub-prime Carbon? Re-thinking the world's largest new derivatives market, Michelle Chan, Friends of the Earth US, March 2009

and technologically innovative projects and this in turn helps citizens to find the resources to fund these initiatives.

The scheme is a clear regulatory framework based on three pillars:

- A traditional tax incentive to encourage citizens to invest into green projects
- The Green Institutions Scheme, which outlines the criteria that institutions need to satisfy in order to participate to the scheme, i.e. the Green Banks and the Green Funds
- The Green Project Scheme, which indicates the project categories eligible for green project status.

Tax Incentives

The Green Funds Scheme is a tax incentive instrument that has been included in the 2001 Income Tax Act⁵ and fits into the government's general plan of "greening the tax system. This greening process consists of a shift away from labour-based taxes to those that are based on the use of raw materials, emissions or expenditures, whereby activities that have more environmental impact are taxed more heavily⁶.

Under this scheme citizens that purchase shares in a green fund or deposit their savings in a green bank are exempted for 1.2% from the flat tax rate on the amount of invested/saved capital. This exemption is worth up to a maximum of € 55,145 (2009) per person. Furthermore, investors in green institutions receive an additional 1.3% tax reduction, bringing the total tax advantage to 2.5%. This tax advantage compensates investors for the lower rate of interest paid by the green banks, who can in turn offer loans to green projects at competitive-below market rates to spur their development.

Green Banks

The Green Funds Scheme implements the accreditation of credit and investment institutions as 'green banks' and sets the criteria within which they must function. The green banks are supervised by the Netherlands Central Bank and by the government's tax department (*Belastingdienst*).

5 Art. 5.13, 5.14 and 5.15

6 The Green Funds Scheme does not stand alone, but is also closely involved with other schemes such as the accelerated depreciation of environmental investments (VAMIL), the environmental investment allowance (MIA) and the energy investment allowance (EIA).

The Green Funds Scheme stipulates that in order to be accredited a green bank needs to invest at least 70% of all its capital in green projects. By complying with this threshold, banks keep some flexibility in their investment strategies, while reassuring depositors that the majority of their savings are effectively devoted to green projects.

Most Dutch banks have set up green departments and offer green funds⁷.

Citizens can save money with a green bank by purchasing negotiable bonds, such as green bonds, green certificates or green banknotes. These have a fixed value (EUR 1,000 or EUR 5,000), a fixed term (often 3, 5 or 10 years), and a fixed interest rate. The total amount is paid back to the saver at the end of the agreed term. Investors can also purchase shares in a green investment fund, either directly via the stock exchange or through the banks. These funds pay dividends, depending on the results that they achieve in lending money to green-certificate projects. Investors can always resell their shares, with the selling price being determined by standard market forces.

Green Projects

The Green Project Scheme indicates which project categories are eligible for green project status. If a project complies with the criteria for that category, then SenterNovem or the Dienst Regelingen (Applications Department) at the ministry of LNV (Agriculture, Nature and Food Quality) will issue a green certificate on behalf of the State Secretary of VROM (Housing, Spatial Planning and the Environment). The green certificate allows project managers to obtain green financing from one of the green banks or green funds.

The certification scheme is critical to guarantee transparent procedures and to ensure that the flow of investments is effectively routed towards the projects with specific, pre determined, measurable and objective environmental characteristics.

More specifically, the Green Fund Scheme is a collaborative project by the Ministry of Spatial Planning, Housing and the Environment (VROM), the Ministry of Finance and the Ministry of Agriculture, Nature and Food Quality. The Minister of VROM is responsible for the implementation of the scheme.

7 Accredited green institutions can be found on SenterNovem website http://www.senternovem.nl/greenfundsscheme/finance/banks_with_their_own_green_funds.asp or in the Green Fund Scheme 2005 Annual report, p.41

The implementation organisations LASER and SenterNovem have received a mandate from the Minister of VROM to issue green certificates on its behalf. LASER evaluates the applications for green certificates in the categories a-f. SenterNovem evaluates the applications in the project categories g-k, plus applications received from the Netherlands Antilles and Aruba - see table 6.

LASER

LASER specialises in implementing subsidies and schemes concerning agriculture, fisheries, the processing industry, forestry, recreation and the management of nature and landscape. LASER also issues permits, defines exemptions, gives advice and manages goods. It receives tens of thousands of subsidy applications each year based on European schemes, e.g. animal subsidies, arable-farming subsidies and nature management subsidies. Over 150 schemes are implemented, largely consisting of financial schemes (e.g. revenue supporting schemes within the framework of the European Common Agriculture Policy as well as national subsidy and encouragement schemes). Various national and international exemption and permit tasks are also implemented.

LASER organises the complete implementation path: from advice on the implementation of the scheme, supervision and detailing of the design process, the communication, implementation (including the physical monitoring and processing of any protests), including the final responsibility. Registering and evaluating data for the principals also fall under this complete package of activities.

SenterNovem

SenterNovem encourages the development of national and international communities with respect to energy and the environment. As an agency of the Ministry of Economic Affairs, SenterNovem supports both governments and market parties in their sustainable development efforts and ensures that government objectives are realised. As an intermediary, SenterNovem brings the objectives of the government and market together, matches supply and demand, makes knowledge accessible and encourages technical development. Most programmes are implemented on behalf of the Dutch Ministries, e.g. the ministry of Economic Affairs; Spatial Planning, Housing and the Environment; Transport, Public Works and Water Management; and Agriculture, Nature and Food Quality. SenterNovem is also active outside the Netherlands, implementing programmes for international bodies such as the International Energy Agency and the European Union.

4.2 Green Fund scheme overview

Financial results

The Green Fund Scheme has been well received by Dutch savers and investors. At the end of 2008, the scheme counted 234,000 savers/investors with an average investment of 24,868 Euro. **Since 1995, green banks have raised 6.849 billion euro to fund green projects, which translates in an average sum of 450 million euro per year.** From 162 projects in 1995/96, the number of green certificates issued has been increasing constantly to a maximum of 676 in 2005. In recent years, this figure has stabilized lower around the 400 mark per year. The table shows the certificates issued and the projected capital from 1995-96 to 2008 per category of project.

Green Label Greenhouses and Renewable energy attracted the highest number of projects representing 66.8% of the total capital committed from 1995 to 2008⁸.

Environmental benefits

Quantifying the effects of green projects on the environment is a very complex task. Since green projects aim at improving the integral environmental quality, they often achieve various effects. This makes it very difficult to monitor a single project, let alone the Green Projects Scheme as a whole. An example: organic farming reduces the environmental impact through fewer crop protection chemicals (pesticides) as well as fewer emissions of pollutants (e.g. ammonia). Biodiversity is also improved. This total effect is extremely difficult to quantify, particularly since such parameters would need to be determined for the total amount of products grown. Supporting organic farming projects also contributes to animal welfare. Here too, it is almost impossible to quantify, but does have visible results, such as breed-specific housing and minimal use of medicines and physical intervention. Other examples include sustainable construction and sustainable horticultural greenhouses. The former has consequences for energy, water and material usage, and for the indoor climate of residences. The latter (Green Label Greenhouses) has positive effects on the integral environmental quality through energy conservation, reduced use of pesticides, limited use of

⁸ The Green Fund Scheme Annual Report 2008; The interested reader in a detailed overview per project category can refer to the annual reports published on SenterNovem website; In the course of 2010 SenterNovem has become part of Agentschap NL.

Table 6 – The Green Project Scheme: certificates issued and projected capital 95-08

Number of projects

Category	96	97	98	99	00	01	02	03	04	05	06	07	08	Total
a-d Nature, Forests and Landscape	2	16	2	3	3	17	26	67	210	291	82	17	36	772
e1/e2 Organic Farming	17	244	140	143	94	162	87	69	80	86	88	117	160	1.487
e3 Green Label Greenhouses			26	77	64	250	281	92	188	189	129	234	109	1.639
e4 Closed Greenhouses											5	3		8
f Agrification		1				1	1			2	1			6
g Renewable Energy	120	77	68	62	56	57	218	97	99	74	41	60	65	1.094
h Sustainable Construction	4	42	100	103	75	44	39	28	18	9	11	20	29	522
i Cycle-track Infrastructure									1					1
j Voluntary Soil Sanitation					1		1							2
k Other Projects	17	17	23	24	14	8	18	11	18	25	39	8	8	230
Total	160	397	359	412	307	539	671	364	614	676	396	459	407	5.761

Project Capital in million Euro

Category	96	97	98	99	00	01	02	03	04	05	06	07	08	Total
a-d Nature, Forests and Landscape	9	268	0,1	1	62	104	16	24	56	282	40	2	120	986
e1/e2 Organic Farming	5	100	40	66	44	78	48	36	37	43	53	102	117	769
e3 Green Label Greenhouses			25	119	156	439	591	288	551	662	319	1.009	459	4.619
e4 Closed Greenhouses											10	26		36
f Agrification		2				1	8			33	1			45
g Renewable Energy	179	295	240	137	95	188	350	199	227	304	273	232	142	2.861
h Sustainable Construction	8	61	63	76	87	55	51	77	33	15	11	69	47	653
i Cycle-track Infrastructure									7					7
j Voluntary Soil Sanitation					1		0.2							1,2
k Other Projects	165	154	135	209	29	48	44	4	110	159	95	7	56	1.215
Total	366	880	504	608	474	913	1.108	628	1.022	1.499	803	1.447	940	11.192

Source: The Green Fund Scheme Annual Report 2008

fertilisers, reduced soil and air emissions, plus water conservation.

In the year 2008 the green projects funded under the scheme resulted in 307,831 tons of avoided CO₂ emissions and 5,996 hectares were organically farmed.

Environmental benefits translate into economic benefits than can be quantified and then compared to the loss of revenues for the government generated by the tax incentive scheme. **The economic assessment of the environmental benefits of the Green Fund Scheme conducted by the KPMG report concluded that every Euro the government invests via the Green Funds Scheme produces 40 euro in investments by the private sector in green projects⁹.**

4.3 Banca Etica

The Italian Banca Etica is quite a unique case in European ethical finance. While Triodos focuses its activity on environmental projects and French alternative financial institutions were born to fulfil social objectives only, Banca Etica was not created with specific objectives, nor after a legislative framework got into force, but simply with a bottom-up approach within existing regulation. Several civil society organisations decided to set up “their own” bank, in order to challenge the flaws and the lack of transparency of the mainstream banking system and to have an institution that could fulfil their expectations in terms of access to credit and attention to social and environmental goals.

The principles which inspired Banca Etica, and which today distinguish and characterise its everyday work, are stated in article 5 of its Articles of Association:

“The Company adopts the following principles of Ethical Finance:

- *ethically oriented finance is aware of non economic consequences of economic actions;*
- *access to finance, in all its forms, is a human right;*
- *efficiency and sobriety are components of ethical responsibility;*
- *profit produced by the ownership and exchange of money must come from activities oriented towards common well-being and shall have to be equally*

⁹ KPMG/CE Report (September 2002), Sustainable Profit: An Overview of environmental benefits generated by the Green Fund Scheme, p.13: The methodology to quantify environmental benefits developed by KPMG authors consists in taking the difference in environmental benefits achieved by ‘green projects’ (e.g. a wind turbine) and compare them with results achieved by standard projects (e.g. gas-fired or electricity plants)

distributed among all subjects which contribute to its realisation;

- *maximum transparency of all operations is one of the main conditions of all ethical finance activities;*
- *the active involvement of shareholders and savers in the company’s decision-making process must be encouraged;*
- *each organisation which accepts and adheres to the principles of ethical finance undertakes to inspire its entire activity to such principles.”*

Why to set up a “retail” Ethical Bank?

Banca Etica is the first banking institution of ethical finance in Italy. The bank’s roots are to be found in the world of the so-called “third sector” organisations, of NGOs focused on international cooperation and not-for-profit and voluntary work associations working in Italy and abroad.

The first experience of ethically oriented finance in Italy is represented by the MAG co-operative companies – incorporated as self-managed mutual associations (“*Mutua Autogestione*”). Their traditional aim is to raise savings among their members and to finance “socially oriented projects”.

In the 90s the MAG cooperatives had to review their organisation, as a consequence of new legal rules introduced by regulators concerning the banking sector – and in particular popular and cooperative banks. This forced them to seriously consider the possibility of incorporating the first “ethically oriented” bank in Italy in order to survive. In order to create such a bank, many social co-operative companies and not-for-profit organisations got actively involved in the project.

In December 1994, the whole MAG movement and 21 not-for-profit organisations^{10*} founded “*L’Associazione Verso la Banca Etica*” (The Association Towards Banca Etica). In June 1995, this was incorporated as a cooperative company, with the purpose of gathering 6.5 million Euro, the amount necessary to incorporate a popular bank according to the Italian banking law. After a successful popular fund raising campaign, in December 1998 the Italian Central Bank granted Banca

¹⁰ Banca Etica’s founder members are the following: ACLI (Italian Workers Christian Associations), AGESCI (Association of Italian Catholic Guides and Scout), ARCI (Italian Cultural Associations), Ass. Botteghe del Commercio Equo Solidale, Ass. Italiana Agricoltura Biologica, CGM (Consorzio Gino Mattarelli), Cooperativa Oltremare, Cooperazione Terzo Mondo, CtmMag (today Consorzio Etimos), Emmaus Italia, Europe Conservation, Fiba - Cisl Brianza, Gruppo Abele, Janus, Mag 2 Finance Milano, Mag 4 Piemonte Torino, Mag Venezia, Mani Tese, Overseas, Uisp, Ust - Cisl Brianza

Popolare Etica the authorisation to start operating as a bank. On March the 8th 1999 Banca Etica opened its first branch office in Padova, where its headquarter is still today.

Today Banca Etica has 14 local branches, one in each of the main Italian cities.

The bank offers main banking products and services, such as: bank accounts, for individuals and companies, associations and NGOs, and further services such as direct debit cards, credit cards, home banking, credit transfer in Italy and abroad, "bancalight" (banking operations management from the mobile phone), internet banking; certificates of deposit; saving books; bonds; investment funds named "Responsible Values" and managed by Etica Sgr – an entity part of the Banca Etica Group; foreign services: bank accounts and related services; Fair Money Transfer (rapid transfer of money towards the countries participating in this initiative).

At the end of January 2011 the bank's shareholding capital amounted to more than 31 million Euro; Banca Etica managed 663 million Euro savings and had more than 4,700 outstanding credits for a total of 645 million Euro. On the basis of these figures, Banca Etica's business is roughly one fourth of Triodos Bank's one, despite Triodos operated in five countries and is less projected towards retail banking.

Legal profile

Banca Etica has the legal form of a popular banking institution which, according to the Italian law, allows it to operate on a national level, in full respect of its co-operative and solidarity intents. This legal frame guarantees:

- (i) a high level of participation in the bank's shareholding capital, which means a very high number of shareholders;
- (ii) since shareholders reside all over the country, this creates an important network of actors throughout the Italian territory;
- (iii) notably democratic decision-making processes: Banks with this legal frame are characterised by the principle of, so called, shareholder supremacy: when voting all shareholders have the same power, regardless of the number of shares owned, according to the principle 'one head, one vote'.
In January 2011 Banca Etica had more than 35,000 shareholders, and namely some 30,000 individuals and 5,000 organisations.

Shareholders' active involvement: The local groups

The real capital of the Bank is represented by its shareholders, by the trust they put into the project of the Bank. Banca Etica considers its shareholders as the human resource they represent, and not only as the capital they helped to raise. For this reason, **their active involvement in the bank's life is considered of primary importance.**

Today, the Bank counts on more than 60 local shareholder groups, which represent the meeting point where shareholders participate in the bank's social and cultural activity.

The local groups aim to achieve the following targets:

- to promote public awareness about ethical management of savings;
- to create a stronger link between individual members and the bank, thus promoting the idea that human relations are one of the most important values promoted;
- to facilitate the active participation of shareholders in the decision making process, by stimulating the circulation of ideas, proposals, debates and dialogue;
- to create a network through which the bank acquires important and real links across the entire territory;
- to guarantee the promotion of Banca Etica at local and individual level;
- to regularly verify whether Banca Etica's activities meet the public consent.

Banca Etica is progressively promoting decentralisation, which is the first important step in strengthening the relationship between the bank, the public on the national territory, and local shareholder groups.

Lending strategies

Banca Etica grants financing to organisations operating within the third sector which carry out socially oriented economic projects, having the legal form of co-operative societies, associations or social institutions, operating in one of the following areas:

- **Social Co-operation:** social, sanitary and educational services; fight against social exclusion and integration of disadvantaged people in the community;
- **International Co-operation:** social and economic development of the poorest areas of our planet, supporting fair trade, training and educating, promoting micro-enterprises, assisting and supporting migrants, and aiding partnerships between solidarity organisations from the South and from the North of the world;

- **Environment:** promoting research, experiments and use of: alternative and renewable energy sources; non polluting production techniques; waste disposal services; ecological public-transport; productive and distributive processes with a positive impact on human beings and their environment; management of natural heritage; development of biological and bio-dynamic agriculture; promotion of ecological awareness and culture;
- **Culture and civil society:** management and protection of artistic and cultural heritage, promoting social-cultural animation, in areas most affected by social decline, and helping develop not-for-profit associations, artistic and cultural initiatives, aiding access to sport activities for the most disadvantaged categories.

Transparency

In order to guarantee correct and transparent use of all money entrusted to it, not only does Banca Etica comply to all applicable laws, but it also applies the following guidelines:

- all of *Banca Etica's* customers, savers and financed organisations undertake, in writing, to adhere to the bank's "Tasks - Fundamentals" (i.e. article 5 of the bank's Articles of Association) and in particular beneficiaries undertake not to invest the money they receive in ways which may be contrary to such tasks;
- all information regarding the loans granted are public: names, terms of contract, including the capital amount granted, are all published on the bank's internet site.

A further step in Banca Etica's pursuit of transparency is granted by the "*Comitato Etico*". This "Ethical Committee" is a board consisting of 7 members, elected by the Shareholders' Assembly, whose task is to overview and guarantee that in all of its activities, Banca Etica fully respects the ethical and social values on which it is founded. To pursue such goal the Comitato Etico regularly expresses opinions and forwards proposals to the bank's Board of Directors, in accordance with the Tasks - Fundamentals on which the bank is founded (ref. Article 5 Articles of Association).

Credit risk analysis and management

To grant financing, Banca Etica gives primary importance to the following aspects: (i) the reliability of the project, which undergoes a thorough economic and practical feasibility analysis, and (ii) the relation of personal trust between the Bank's personnel and those who represent

the organisation requesting the financing. Therefore, *Banca Etica's* assessment is not based exclusively on financial parameters, that are usually the guarantees the client is requested to ensure.

Beyond the conventional economic evaluation procedures, the projects to be financed undergo an environmental and social assessment aimed at identifying project impacts on the common welfare and the natural environment. In this respect, Banca Etica carries out a thorough analysis of the social and environmental responsibility of each loan. Both the economical assessment and the social and environmental one have to be positive in order to approve the loan.

Banca Etica's Energy project

Primary fields of intervention of the bank are supporting not-for-profit and cooperative entities having a social added value and to enhance credit for environmentally-friendly small-scale investments by individuals and economic actors.

In particular Banca Etica carries out a specific "energy project", which finances:

- energy efficiency measures (thermal energy and electric power; water use efficiency; co-generation; sustainable mobility);
- housing renovation to improve energy standards (including mortgages to buy more efficient houses);
- renewables energy (solar panels, and other small scale renewables plants – wind, geothermal and biomass).

Banca Etica does not engage in venture capital nor has equity stakes in other companies.

However through the energy project it lended to support new business approaches to sustainability. For instance, it supported new Energy Service Companies (ESCO) – such as INNESCO - aimed at promoting technological improvement in favour of energy efficiency by reducing financial costs for clients, including individuals and companies or not-for-profits organisations.

5. Conclusions

The failure of conventional finance and the long way towards new rules

Inarguably, predatory lending practices and irresponsible borrowing played a major role in this crisis, and both concurred to undermine the sound foundations of our banking system. In order to earn back citizens' trust, banks and financial institutions are expected to engage in a drastic behavioral change and start looking again and seriously at people's real needs. At least this is civil society's legitimate expectation.

Therefore, in their effort to reform the financial world, policy makers should not lose sight of the simple ingredients at the heart of ethical banking, which we discussed in this work and that can be best summarized as transparency, democracy and commitment to the community.

Unfortunately, the current regulatory reform initiatives do not seem to make any substantial progress in this direction, and while they correctly address some of the critical flaws of our financial system with several measures – from an increase of capital requirements to some better regulation of OTC derivatives and more control of systemic risk – they put less emphasis on what should be done to move bankers to change their overall attitude.

This sounds quite irresponsible after governments bailed out banks and the financial system with public money in an unprecedented manner. It should be pointed out that bail outs and public support have not benefited at all the ethical banking industry nor those financial experiences closer to citizenship and the real economy. Despite their limited weight today within the overall global financial system, these alternative practices have been playing a more effective and verifiable role in generating jobs and improving common welfare in our societies. In short, moral hazard has been renewed by governments and central banks, while more responsible actors have been neglected once again.

The adoption of financial regulations centred on binding corporate social responsibility standards and procedures is in our opinion a critical precondition to reform the financial system towards a more healthy industry, and while we acknowledge that CSR is critical to both financial and

non-financial corporations, there are several good arguments why banks and financial institutions should lead the way in this direction.

Banks and capital markets' role is precisely to match savers and investors needs; this process determines the allocation of resources within the economy and ultimately its long-term growth path. Unfortunately this process is not neutral nor it is necessarily optimal from a collective standpoint.

Additionally, it should be noted that banks do not operate like normal companies but more like public utilities providing basic services to the general public at large. In our every day life we rely on banks for vital and basic services such as processing payments, ATM services, custody services, and so on and we could barely live without them. Besides ensuring financial stability and investors' protection, financial regulations should take into account banks' special responsibilities and ensure that they are effectively committed to the public good.

In short this means a strong departure from traditional *laissez-faire* ideology, especially in the aftermath of thirty years of financial deregulation and liberalisation. This would imply to rediscover key functions of public finance, including the possibility to set up public development banks, despite according to models which do not commit mistakes of the past, as well as putting private banks and finance in the right place at the support of societal needs. Regarding the latter – which has been the scope of this study – therefore the current financial and economic crisis presents a unique opportunity to reform the financial industry towards more healthy standards, and the ethical banking initiatives presented in this work prove that change is indeed possible.

The reality of ethical banking and dilemmas ahead

Ethical banking is a reality in Europe, despite still limited comparing with conventional banking industry. Major experiences should be regarded as a success, given their capacity to develop and emerge in a quite hostile environment for actors inspired not just by profit maximisation. The fact that today major European ethical banks are able to gather more and more savings by citizens who are concerned about which hands they put their money in in the aftermath of the financial crisis, is an evident signal that there is a growing demand in society for ethical banking.

However, different experiences show us that the future of

this industry is uncertain and depends on policy choices and regulations. Even those who are more developed today and could be able to navigate in the rough sea of global financial markets, are faced with dilemmas and choices.

Today ethical banking is at a crossroad: either to advocate for a selected set of rules just for this sub-sector of the banking industry – what you might call an ethical bank Basel-type accord – in order to be given more competitive terms than the conventional industry because of the “social function” that ethical banking plays in society; or to keep competing with mainstream banking, despite the unfair balance of power, while exploring for wider policy instruments which can strengthen and develop further their business model, also involving public support or guarantees, and keeping advocating in the long run that sustainability criteria will be included in all banking regulations, starting from the Basel Accord.

At this point in time it is fair to assume that the Basel 3 agreement – as approved by G20 governments in Seoul in November 2010 - would not include any specific criteria related to environmental and social sustainability in risk analyses and management requested to the banks - in particular as concerns capital requirements. And that instead the ethical banking sector should struggle in the next months so that at least the new agreement will be implemented at European and national level in a way that their business model would not be put at further disadvantage comparing with mainstream conventional banking. Under these assumptions both strategic options highlighted above present pros and cons.

While microcredit might need specific legislation given the peculiarity of this financial practice, also aimed at avoiding recent negative experiences in developing countries which betrayed the original principles of this type of financial service, it is questionable whether having a specific regulation for ethical banking would really help in the long-run, or would instead relegate by law this sub-sector in a niche while not impacting at all on the remaining vast majority of the banking industry. On the contrary, a European law recognising ethical banking could help to define by law the criteria that ring-fence this sub-sector in order to avoid that in the near future conventional experiences – heavily affected by or involved in generating the financial crisis - could set up affiliated ethical banks for “green- or white-washing” reasons, with the hope of regaining trust about their integrity in the wider public.

While in the long-run a refoundation of the logic of the Basel Accord according to the principles of environmental and social sustainability – beyond that of just preserving

financial stability - is needed, concerning the second option of not calling for any specific regulation just for the ethical banking sector, in the shorter term ethical banking might benefit from specific exemptions or additions in Basel 3 implementation. In particular as concerns the “risk weight” given to lending to clients having a social function – such as cooperatives and other not-for-profit actors - and whose financial risk in reality is not so high as assumed by regulators. This has been the case of France for instance, where such an approach helped microcredit finance.

It would therefore be quite helpful that a different industry classification would be introduced in the Accord which would discount capital adequacy for some virtuous sub-sectors – such as renewables energy – to be further supported and whose financial risk has proved to be acceptable or comparable with other sectors.

However also under this option, the experience of ethical banking in key European countries – as documented in this study - show that much more can be achieved through the introduction of public policies which incentivise in a clever manner the ethical banking practice, including through tax incentives and public guarantees, as shown by the experiences in France and UK.

It should be noted that so far the lever of taxation has been used only to a limited extent, while this could help steer the sector’s capacity through more visionary and sustained interventions. This has been the case of the Netherlands where the tax incentive instrument has been part of a wider regulatory approach to favour the sector while supporting both profit and not-for-profit entities. And the lesson to draw so far is that such hybrid and comprehensive scheme could be the right way forward in the short and medium term while waiting for a comprehensive regulation of global finance which takes on board environmental and social parameters.

Ethical practice: beyond markets and back to politics?

That said public incentives would not be enough to guarantee a long-term sustainability of this industry. The experience of Banca Etica in Italy and ADIE in France however shows that other features are key to give long-term sustainability to ethical banking industry in this overall hostile environment. And democratic governance is central to root ethical banking in society and thus give more opportunity in the long run. A popular or cooperative structure does not limit the growth of these experiences, but guarantee that key principles are not diluted in

a highly competitive market environment. At the same time being rooted in society and having society represented in its own governing structure established a structural link between banking and real economy, which could help develop joint planning and implementation of new business models and practices. This is the key to see ethical banking as part of a wider approach to ethical finance, which would bring an added value that the conventional sector will never have, given its obsession for profit maximisation. What one might call a “thorough approach” to ethics and finance, within which alternative banking practices are just one instrument.

However, the ethical finance movement as a whole has two political dilemmas to tackle soon also while endorsing rightly this visionary perspective.

Size matters and the challenge of growth and which business model to follow is still unresolved. Major experiences show that risks of contamination with conventional banking, in particular as concerns asset management and investment banking practices are high. Assuming always the good faith and motivation in the ethical banking sector, it is inevitable that to grow faster some trade-offs are needed with existing players and pure market dynamics. And it has still to be seen how much beyond its clear social function ethical banks see themselves primarily as market actors, or instead as some actors of a new social economy to come. The experience of the recent crisis shows that markets are not just able to self-regulate, but structurally failed and will fail to take public interest on board, so that new institutions outside existing market logics and constraints need to emerge and develop. It is still an open question whether the ethical banking sector as a whole is ready to gear up towards these challenge, by multiplying its initiatives and affiliated institutions, or not. The case of Banca Etica, interested in building the first European ethical bank – to be possibly incorporated as a new type of European cooperative entity – shows that there is some appetite by some actors to think along this line, despite it is still a long way and not necessarily all actors in the sector share the same vision.

Consequently, the ethical banking industry has so far kept a relatively low political profile, apart from few exemptions. This is quite understandable given the risks of being “double charged” by central banks for their too proactive or critical stand of conventional finance and existing financial regulation. However the time has come to get the voice of this sector strongly heard by decision-makers and supported by organised civil society struggling for a strict regulation of the financial industry. The ethical finance movement in Europe has to become a cultural and political force for promoting change in the wider finance

industry, given that this in the end will change only if through regulation some practices will be limited as well as through a cultural change a new generation of ethical bankers will emerge, possibly managing new institutions and moving new practices according to new principles. An enormous challenge which requires today vision and courage to speak up so that decision-makers and the public will know that alternatives exist and it is also up to them to make them more real, bigger and more effective. In short, only keeping practicing in a way which shows clear cut difference from conventional banking will give the ethical banking sector new strengths and opportunities to produce a long-lasting and deep change in the whole financial world and society.

Bibliography

- Eurosif (2008), European SRI Study 2008
- Kreander et al., Journal of Accounting and Finance, 2002, The Financial performance of European ethical funds 1996-98
- R. Bauer et al. / Journal of Banking & Finance 29 (2005), International evidence on ethical mutual fund performance and investment style
- The Asset Management Working Group, United Nations Environment Programme Finance Initiative, World Business Council for Sustainable Development (march 2010) Report from an international workshop series of the WBCSD and UNEP FI, Translating environmental, social and governance factors into sustainable business value, key insights for companies and investors
- BSR | ESG in the Mainstream: The Role for Companies and Investors in ESG Integration (2009)
- Targett, S. (2000) "Friends Plans to Give Ethical Lead", Financial Times, Companies & Markets, Monday 8th May
- Global Reporting Initiative, Beyond Laissez-faire Reporting: Towards a European ESG Disclosure Framework (February, 2010)
- United Nations Environmental Program (UNEP), The Global Reporting Initiative (GRI) and KPMG (May, 2010), Carrots and Sticks – Promoting Transparency and Sustainability: an update on trends in Voluntary and Mandatory Approaches to Sustainability Reporting
- Jordan, A., Wurzel, R., Zito A., L. Brckner, University of East Anglia (2003), Consumer Responsibility-taking and National Eco-labelling Schemes in Europe
- United States Environmental Agency (1998), Environmental Labelling Issues, Policies, and Practices Worldwide
- Reinhard Steurer et al., (2008), Vienna University of Economics and Business Administration, Socially Responsible Investment in EU Member States: Overview of government initiatives and SRI experts' expectations towards governments, Final Report to the EU High-Level Group on CSR
- Laura O'Neill, Shareholder Association for Research and Education (2009), Pension Fund Investment and Disclosure: Acknowledging Environmental, Social and Governance Considerations
- Friends of the Earth, Top 100 UK Pension funds – how ethical are they?
- Aris Solomon and Jill Solomon (2003), The Centre For Business Relationships, Accountability, Sustainability and Society WORKING PAPER SERIES No. 7 The SRI Dilemma for Pension Fund Trustees: Some Perceptions of their Evolving Role
- Bank Track (April 2010) Close the Gap, Benchmarking investment policies of international banks
- Bank Track, Incorporating Human Rights in Bank Policies
- IKV Pax Christi and Netwerk Vlaanderen, (April 2010 update) "Worldwide Investments in Cluster Munitions: a Shared Responsibility"
- Netwerk Vlaanderen and BankTrack (June, 2008) "Ending Harmful Investments"
- Netwerk Vlaanderen and BankTrack (November, 2007) "Too risky business, Financial Institutions and Uranium Weapons"
- Netwerk Vlaanderen (July, 2006) "Explosive Portfolios, Banks groups and cluster munitions"
- Netwerk Vlaanderen (July, 2006) "Banks Disarmed: An overview of the results of the campaign My Money, Clear Conscience"
- Netwerk Vlaanderen (April, 2004) "Cluster Bombs, Landmines, Nuclear Weapons and Depleted Uranium Weapons: A report on the financial links between banks and the producers of controversial weapon systems"
- Muhammad Yunus, "Banker to the Poor, Micro-Lending and the Battle Against World Poverty"
- Ministère de l'économie, de l'industrie et de l'emploi, (2009) Rapport N. 2009-M-085-03: Le Microcrédit
- Association pour le Droit à l'initiative économique (ADIE), 2009, Annual Report
- CDFA (2009), Inside Out, The state of Community Development Finance, Weathering the Storm
- KPMG/CE Report (September 2002), Sustainable Profit: An Overview of environmental benefits generated by the Green Fund Scheme
- Bank Track (December 2009), A Challenging climate 2.0, What Banks must do to combat climate change
- A.R. Ballesteros, J. Coequyt, et al (2007), Future Investment: A Sustainable Investment Plan for the Power Sector to Save the Climate, at 10 (European Renewable Energy Council and Greenpeace International)
- Reinhard Steurer, Sharon Margula, André Martinuzzi, Vienna University of Economics and Business Administration (April 2009), Socially Responsible Investment in EU Member States: Overview of government initiatives and SRI experts' expectations towards governments. Final Report to the EU High-Level Group on CSR