


GLOBESCAN

CENTER FOR
RESPONSIBLE
BUSINESS
Haas School of Business at UC Berkeley

# CONTENTS




Acknowledgements 3

Introduction 4

Executive Summary 6

Fundamentals: the role of finance in society 8

Who matters? The financial sector's stakeholder constituencies 11

The biggest challenge: regulating the financial sector 21

What's to come? Predictions and scenarios 26

What works? An inclusive innovation future 32

Appendix I: Thought Leader interviewees 40

Appendix II: About the Center for Responsible Business and GlobeScan 42

# ACKNOWLEDGEMENTS

The Center for Responsible Business at the Haas School of Business, University of California—Berkeley, and GlobeScan would like to thank the five financial institutions—BBVA, Barclays, Citi, Goldman Sachs, and TD Bank Group—who have supported this research both financially and intellectually, through interviews with select executives. Their engagement made this report possible and has added substantially to its content.

## Disclaimer

The following report represents the research findings and analysis of the Center for Responsible Business and GlobeScan. The contents of this report are entirely the work of the Center for Responsible Business and GlobeScan, and do not represent the official views of the supporting financial institutions. The quotations from individuals contained in the report represent their personal opinions, and their statements should not be understood as the official positions of their organizations.

# INTRODUCTION

## Background

More than three years on from its most serious crisis in decades, the global banking and financial services sector still faces an uncertain future. Its central role to economies worldwide makes it one of the most critical influences on future human development—one reason why its role in society has led to such division and discord. Since the crisis, debate has been joined on all sides by stakeholders seeking to influence how the financial sector operates and is structured. Governments have enacted reforms to financial sector regulation but have postponed their full implementation; investors are becoming increasingly active in influencing financial institutions' behavior through shareholder resolutions and initiatives; academics and influential commentators have weighed in with various prescriptions designed to encourage stability or future growth; and more recently, popular movements have sprung up around the world to protest perceived injustices in their economies and societies, with the financial sector often serving as the focal point of their frustration.

The Center for Responsible Business (CRB) at the Haas School of Business, University of California—Berkeley, and research consultancy GlobeScan observed a need to understand and address the divisions between and among the financial sector and its key stakeholders. Is this a strategic turning point for the financial sector? How contested is the sector's social license to operate, and how can it regain trust among stakeholders? Where are there points of consensus among diverse stakeholders on the future of the financial sector? What is the path forward to optimize both the sector's prosperity and resultant societal benefits?

Supported by five leading financial institutions—BBVA, Barclays, Citi, Goldman Sachs, and TD Bank Group—we have undertaken this study with the goal of pointing toward a possible consensus on how a future financial sector can be prosperous and sustainable, to the benefit of itself and all its stakeholders. We aim to identify and outline the path to a more productive future for finance, while characterizing the debate on key issues that will need to be addressed to get there. Along the way, we identify ways for the sector to maintain a positive relationship with its stakeholders and society more broadly.

## The Study

Our aim is to present and consolidate a set of highly informed and influential perspectives on the financial sector, representing the diversity of internal and external stakeholder viewpoints. We also aim for global coverage, incorporating stakeholders from emerging as well as developed markets, recognizing that the challenges and opportunities of the financial sector can only be fully realized in a globally interconnected context.

In total, we conducted in-depth interviews with 60 thought leaders representing the financial services sector, government, multilateral organizations, academia / think tanks, and civil society during summer and fall 2011. All were selected for their expertise, influence, and ability to represent an important constituency for the financial sector. The interviews focused on three broad topic areas: the fundamental role that banks and other financial sector institutions play in society; the factors that influence a stable and profitable operating environment for the industry; and expectations for how the industry will evolve in the coming decades.

# EXECUTIVE SUMMARY

***Thought leaders are unified in their view of the financial sector as crucial to a thriving society and economic system.*** Financial institutions' services make economic and social progress possible by providing liquidity, efficiently allocating capital, forming a link between savings and investments, and maintaining financial infrastructure. This broad-based endorsement of the financial sector's role provides a positive starting point for its relationships with stakeholders and society more broadly.

However, ***consensus breaks down regarding the roles that banks and other financial institutions play in the economy and society beyond these core functions.*** On banks' economic role, thought leaders debate the extent to which banks should participate in "purely financial activity"—and where the line can be drawn between actions that support the "real" economy and those that are purely financial. Debate on banks' social role revolves around whether banks should look to create value beyond their bottom line. Opinion leaders display a spectrum of perspectives on this issue, ranging from those who think banks should focus only on responsibly allocating capital, to those who think banks should play a more proactive role funding and advocating for the public good.

***Many experts encourage the financial sector to better appreciate the breadth and interconnectedness of its stakeholder universe, arguing that better stakeholder engagement is a foundational element for its long-term success.*** While some thought leaders maintain that the only true stakeholders in the financial sector are its customers, shareholders, and regulators, most argue that a more broadly based approach is critical to ensure a thriving sector in the future. The extent to which the sector does open up to wider stakeholder engagement will help define its relationship to society in the coming decade.

***Effective leadership and a responsive corporate culture are crucial to the healthy functioning of banks and the financial sector.*** Thought leaders agree that a bank's behavior is largely governed by the culture and incentives stemming from and cultivated by its leadership. The sector's success is as dependent on addressing issues in leadership and culture as it is on regulatory reforms.

***Protection for consumers, the management of systemic risk, and global coordination of regulation*** are familiar calls in the ongoing debate around financial sector regulation that are echoed by the thought leaders we interviewed. Many also identify an opportunity to promote growth in emerging markets

by contributing to the development of regulatory structures there. Thought leaders are also clear in their advocacy for a regulatory process in which the financial sector, government, and other stakeholders engage transparently and collaboratively to design a system that safeguards future stability and prosperity.

***Based on thought leaders' expectations for the future of the financial sector, we project three potential scenarios:*** "risky business as usual," "back to boring," and "inclusive innovation."

- ***Risky business as usual*** sees only incremental changes to regulatory structures and to the way the financial sector engages society. Political impasse, regulatory authorities' limited capacities, and lack of global coordination could result in minimal positive change. Incomplete or wrongly- directed reform may result in institutions continuing to take on unreasonable levels of risk without appropriate safeguards in place for the wider economy. An absence of engagement with a broader set of stakeholders will continue to put the industry's social license to operate in jeopardy, with a threat of even greater regulatory restrictions. Under this scenario, there is a risk of future crises, creating uncertainty to the detriment of the financial sector and the rest of society.
- ***Back to boring*** would be a result of sustained social and regulatory pressure on the sector, leading to a closing-off of some of its avenues for innovation and expansion. Under this scenario, the banking and financial services sector more broadly would come to resemble a financial utility, and would lack its current dynamism and ability to attract the most talented employees. This could limit growth but would result in greater stability.
- ***Inclusive innovation*** sees the financial sector proactively building a more positive relationship with regulators and other stakeholders by embracing business initiatives that seek positive social as well as financial returns. Thought leaders identify multiple opportunities for financial sector institutions to use their capabilities to drive positive changes in ways that also grow their businesses, while enhancing trust and making the sector more resilient to future shocks.

***Inclusive innovation can enable the financial sector to continue to grow and thrive*** while generating value for a wider range of stakeholders through a shared-value approach. While a more regulated sector is likely to emerge from the ongoing round of global financial reform, we see an opportunity to refresh the sector's innovative capacity, brand image, and reputation. Inclusive innovation is not corporate philanthropy but rather an approach to building business and generating growth that delivers social value and is in line with current best practices in other industries. Inclusive innovation would generate a range of benefits including enhanced market access, especially in emerging economies; more robust employee recruitment and retention; improved reputation and brand management; and new business development opportunities.

# FUNDAMENTALS: THE ROLE OF FINANCE IN SOCIETY



## Key Findings:

- There is consensus across all thought leaders, irrespective of their profession or region, as to the central role of the financial sector to economies and societies worldwide.
- However, they are divided when it comes to the extent to which banks should be involved in "purely financial activity," although there is broad agreement that separating such activity from banks' core functions is a challenge.
- Many call for financial sector companies to seek to drive positive social outcomes through their work, although others reject using such non-financial criteria for business decisions.

### Agreement on the fundamentals

Opinion leaders across all stakeholder groups and geographies agree that finance plays a fundamental role in our social and economic systems. Asked to describe the role that banks and the financial sector should play in society, most thought leaders give what might be considered a standard definition: banks provide liquidity, allocate capital, transfer maturities, match borrowers and lenders, and provide financial infrastructure. This view is endorsed both by non-governmental organization (NGO) thought leaders and bank executives.

Professor Robert Shiller of Yale University explains that "banks work to reveal and pool information, give us discovery of value, and help us manage risk. All these benefits are essential to a functioning world economy."

Mark Tercek, President and CEO of the Nature Conservancy, agrees that the role of banking is fundamentally social, but that it is sometimes misunderstood. "Banks allocate capital—they're not the only ones, but they have an enormous role. Investment bankers work with issuers on how and when to raise capital, and with investors on how and where to invest... Banks have a role in helping society understand that capital should be allocated to risk-adjusted productive opportunities."

Peer Stein, Manager at the International Finance Corporation's Access to Finance Advisory, underscores that banks occupy a key economic leverage point and can confer broad social benefit. "Banks support economic development by financing productive enterprise… they play an important role in society as a multiplier."

The consistency in views across stakeholders regarding banks' fundamental role in society provides a reference point for constructive dialogue, even in the presence of disagreements and criticism on other issues. It also highlights the potential the financial sector has to stimulate change and drive positive social outcomes.

## A source of discord: the sector's social and economic responsibilities

### *Disagreement over the banking sector's economic role*

Although thought leaders agree that banking plays a fundamental role in society and in economic systems, consensus breaks down on the subject of how far the sector should extend its role in the economy. Some thought leaders argue that its role should be limited to funding growth in the real economy (goods and services) as opposed to buying and selling in financial markets. These respondents think banks should focus on effectively carrying out their traditional role of efficiently allocating capital. Other thought leaders prefer a vision of financial services firms as innovative global businesses that drive economic growth by funding the real economy, delivering increasing returns to shareholders, and growing relative to global GDP. In this view, the sector is more dynamic.

Several thought leaders suggest that banks engaging in purely financial activity, or activity that does not contribute to the "real" economy, were a factor in creating the financial crisis. However, defining this activity is challenging, and many respondents note that the complexity of today's banking sector makes it difficult to separate the "real" economy from that which is purely financial.

Some thought leaders take a strong stance on where to "draw the line," with one saying, "I'm an adherent to the Volcker rule. Banks shouldn't be doing proprietary trading."

Most are more equivocal. "It's difficult to draw some kind of dividing line for regulation to ensure risk is not taken past a certain level. There's no clear line between the real economy and purely financial activity, which is sometimes how the debate is conducted," says one NGO leader. "Purely financial activity may deliver some social benefit, but if the benefit is unsustainable, it's not very helpful."

### *Disagreement over the banking sector's social role*

Opinion leaders hold diverse perspectives on how the banking sector generates social value, and there is a wide spectrum of views on the extent to which banks have a responsibility to create value beyond their bottom line.

Some feel that banks' involvement in society should be limited to the basic function described above: connecting borrowers and lenders to fund productive enterprise. In this scenario, banks are socially and environmentally agnostic, but according to The Nature Conservancy's Mark Tercek, society benefits from the positive externalities associated with their role in allocating capital efficiently.

"I think it's not so much getting distracted by new and different things, but rather being very responsible allocators of capital and being stewards of the capital allocation process. It's not only being a good risk

manager, but being an outspoken leader for proper allocations of capital."

Others see an opportunity for banks to play a more focused role in creating social value. Thought leaders mention opportunities to influence public policy, fund clean energy, manage funds with environmental, social, and governance criteria, and extend financial services to the unbanked.

"There is an opportunity to provide insurance, capital, and basic services globally. Financial inclusion is not just a developing country issue," explains David Blood, Co-Founder and Senior Partner of Generation Investment Management. "It's an extraordinary challenge. It may not be profitable in our existing models. We need new models and we need to maximize the enabling aspects of finance and minimize challenges."

Interviewees mention a variety of opportunities in emerging markets, and also indicate that banks have a different role there than in developed countries. "If you look at banks in developing countries, they must not be seen purely as a lender, as a financial intermediary," explains Dr. Mohd Azmi Omar, Dean of the Institute of Islamic Banking and Finance. "Banks must be seen to be actively involved in economic development, meaning products must bring value to society as well as the country… [The] role of banks is to be an active partner in development."

Doubtless, different institutions will take different positions on this issue, depending on their unique competencies and the universe of stakeholders with whom they engage. The following section addresses the diverse stakeholder relationships that financial institutions must navigate, and the means available to them for doing so.

*"Purely financial activity may deliver some social benefit, but if the benefit is unsustainable, it's not very helpful."*

# WHO MATTERS? THE FINANCIAL SECTOR'S STAKEHOLDER CONSTITUENCIES



## Key Findings:

- Many thought leaders suggest that, like other industries that have faced reputational challenges, the financial sector could benefit from a new approach to engaging with its stakeholders, including:
- ***Employees***—corporate culture is viewed as a contributing factor to the financial crisis and a key channel for engaging employees and creating norms that lead to responsible behavior.
- ***Customers***—varying levels of sophistication among financial services customers imply differing approaches to engagement with them. Thought leaders see benefits of greater transparency with all customers as well as a need for stronger protection for consumers in particular.
- ***Regulators***–many thought leaders advocate moving from an antagonistic to a more collaborative relationship between banks and regulators, and agree that increased disclosure as well as better resources for regulators are imperative.
- ***Civil society***—thought leaders are divided in their view of the extent to which the financial sector should engage civil society, particularly when it is critical of the sector. Those who do advocate engagement note that it can carry benefits besides defusing criticism.

The financial sector faces more challenges from more sources now than perhaps at any time since World War II. Popular protest movements worldwide have used banks to symbolize unfairness and inequality. Litigation over mortgage lending and structured products in the run-up to the financial crisis of 2008 has cost banks hundreds of millions of dollars. Some banks are losing market share to non-banks in new consumer markets, and nearly all banks face challenges navigating regulatory uncertainty. Furthermore, new technologies, an increasingly globalized financial services sector, and increased competition have created new challenges that will define the sector for decades to come. Thought leaders express concern that if banks are to continue to thrive, they will need to re-envision how they shape a productive operating environment.

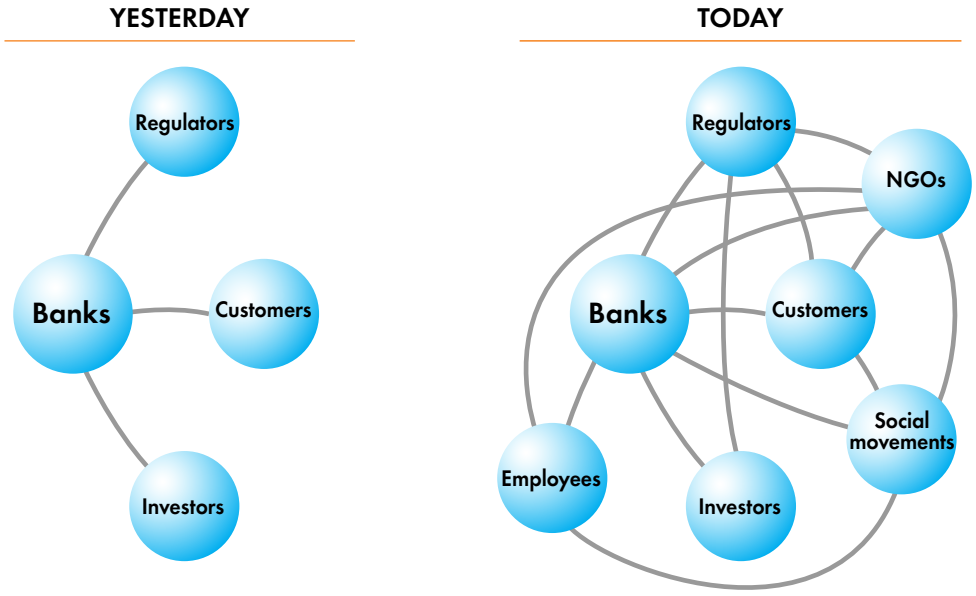



*Figure 1: Banks and other financial institutions have historically been used to interacting with a limited set of core stakeholders in a relatively controlled and static fashion. With the increasing influence of non-traditional stakeholders in a highly interconnected world, it is important to understand and engage with a larger and more complex set of constituencies.*

One mechanism for future-proofing against these challenges, according to experts, is to take a more expansive and inclusive view of which stakeholders can have a material impact on the financial sector. Many of the thought leaders we spoke to believe that financial institutions have understood their stakeholder universe too narrowly and should look to engage more broadly with stakeholders in the future. Engaging more meaningfully with stakeholders can provide financial institutions with opportunities to meet business objectives—including creating new products, accessing new markets, and attracting talent—and to secure their license to operate by creating social value.

"I believe any company that wants to do well in the medium and long term cannot afford not to take into account the interests of its major stakeholders," explains Dr. Leonard Cheng, Dean of the School of Business and Management at the Hong Kong University of Science and Technology.

Thought leaders' perspectives on financial sector stakeholders allow us to map and characterize the range of audiences that financial institutions engage, the level of responsibility that the sector has toward each group, and the types of engagement that are appropriate.

## Employees

The core group of stakeholders for any industry is its employees, whose engagement and inspiration may be the single most important factor in delivering business success. Thought leaders repeatedly highlight the crucial role that a healthy corporate culture, driven by effective leadership and creating motivated employees, plays in the success of financial institutions. It is clear from our interviews that both effective leadership and a strong culture are needed to create the mix of cultural norms and financial incentives that produce successful, dynamic, and profitable firms.

"Success starts in the banks with the people who run the banks," explains Jonathan McMahon, Director of Financial Institutions at the Central Bank of Ireland. "It's about making sure you have the right people and the right set of values and the right incentive structures. Incentives are key because you get what you pay for. If banks aren't set up properly, no system of regulation will be sufficient."

Culture is responsible for many aspects of a financial institution's success. It contributes to attracting and retaining talent, managing risk, and establishing reputation. When identifying banks that weathered the financial crisis of 2008, stakeholders repeatedly point out that those with strong cultures of responsibility performed well and effectively managed downside risk. Conversely, they identify the lack of such a culture in many banks as a driver of the 2008 financial crisis.

Geoff Burnand, CEO and co-founder of Investing for Good, highlights the importance of culture within a bank. "I think that there is great potential for financial services organizations to engender a different kind of

### The value of stakeholder engagement: the biotechnology sector

The biotechnology sector's struggles to gain acceptance for genetically modified crops show the imperative of stakeholder engagement—even when critics seem misguided.

Genetically modified crops have seen enormous success in North America, now accounting for more than 60 percent of cultivated land across five major crop categories. However, early mistakes in stakeholder engagement have meant that the potential of this technology remains largely unrealized in many other markets.

In the 1990s, the biotechnology sector moved quickly to introduce genetically modified crops into new markets soon after their development. It was confident in its product, the technology behind it, and the benefits to society. However, this confidence meant that the sector failed to acknowledge critics and skeptics, leading to organized resistance that has cost billions in potential revenue in the European Union and emerging markets.

In the years since, biotechnology companies have come to acknowledge that their approach to engaging stakeholders was short-sighted. Monsanto's then-CEO Bob Shapiro admitted in a 1999 meeting with Greenpeace that the company had "forgotten to listen" to its critics and had seen them as "wrong or at best misguided."

The loss of revenue to the biotechnology industry and the costs to societies around the world as a result of this failure to adopt a potentially beneficial technology are immense. This shows that seemingly non-strategic stakeholders who may not fully understand the industry and technology can still have a material impact on the business. Investing in engagement with a broader array of stakeholders can assist banks in anticipatory issues management and, ultimately, in implementing corporate strategy.

culture consistent with a more ethical, more honest approach to the use of money... I think banks need to work harder to align employees with their culture, and not just pay lip service to the importance of culture amongst their employees with the business of managing money."

*"[Employees] understand that there's a deal between them and the institution—what the institution will do for them and what their responsibility is."*

Thought leaders articulate two specific cultural characteristics of successful banks. First, a sense of respect for the institution among employees: banks that retain a "long-term ethical business culture" elicit behavior from employees that is consistent with the institution's stability.

Jonathan McMahon stresses that the culture in many successful banks gives employees "a clear sense that they're in an old institution and they need to be around for a long time in the future. They understand that there's a deal between them and the institution—what the institution will do for them and what their responsibility is."

Second, successful banks create a culture of collaboration and teamwork, and they align short-term performance incentives with what's best for the institution in the long term.

"I think there are some cultures out there where it's every person for themselves and each is their own profit center, as opposed to what's best for the institutions," explains Carmine DiSibio, Vice Chair and Managing Partner, Financial Services at Ernst & Young. "Incentives to create culture around teaming and around the institution are important to the well-being of the institution and the system."

A banking industry executive sums up the importance of creating and maintaining culture that contributes to institutional success.

"Culture is very hard to create and manage, [but] having respect for the institution and a sense of history will help avoid repeating the mistakes of the past."

## Financial services customers

Customers are another key stakeholder group for the financial services sector, and there is an opportunity to re-engage with them more productively moving forward. Mortgage borrowers, retail banking customers, and institutional investors have all seen their relationships with banks suffer since the 2008 crisis, resulting in lawsuits against banks, low levels of trust among consumers, and a deterioration in the reputation of the industry. Thought leaders make the case that engagement with customers needs to be re-envisioned.

Thought leaders identify a hierarchy of sophistication among the customers for financial services that implies financial institutions have varying levels of responsibility toward them. Individual consumers are the least sophisticated, while clients like banks, large funds, and large corporations are the most sophisticated.

Given these varying levels of sophistication, consumers are identified as the most vulnerable customer segment. Relative to other financial

services customers, consumers tend to be the least informed and least financially literate. Low levels of financial literacy are readily acknowledged to be an issue globally, and were mentioned as a driver of the 2008 financial crisis. A heavy onus is placed on banks to make sure that consumers truly understand the products they are purchasing. Thought leaders suggest that consumers need plain-language information about financial products, and that banks need to do more to advise against products inappropriate to a client's situation.

"It is more difficult for a retail financial services consumer to understand a financial contract than a car purchase," says Christopher Steane, Global Head of Structured Finance for ING. "Our dealings with customers should be open and fair and include an element of responsibility that people are properly advised."

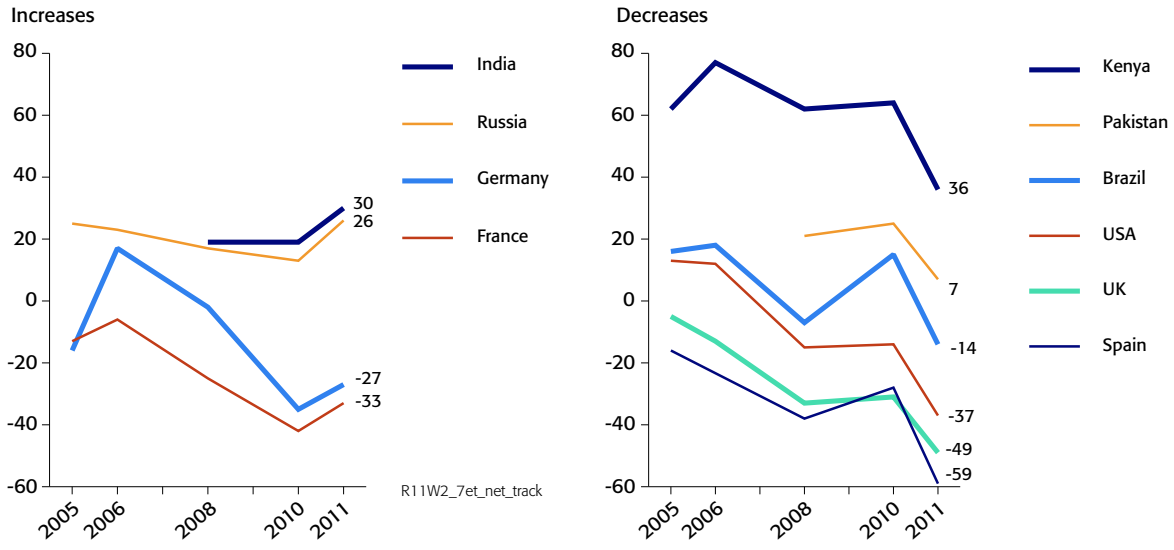
Scott Mullin, Vice President of Community Affairs at TD Bank Group, described a rule of thumb TD has used to gauge whether a product is appropriate for a consumer. "Early on our CEO took a position that if he couldn't explain a product to his mother, we wouldn't sell it. This has meant that we only take risks that we understand and this approach has served us well." Consumers themselves have taken a markedly more negative attitude toward the financial sector in the wake of the financial crisis, although it has taken until 2011 for the full extent of the reputational damage to become evident (Figure 2). Consumers in the United States, the UK, and Spain are particularly critical of the sector, although the change is not restricted to developed markets: Kenya, Pakistan and Brazil have all seen steep declines.

The path to rebuilding public reputation would appear to be demonstrating trustworthiness to

*Figure 2:*

**Respect for Banks / Financial Services Companies**

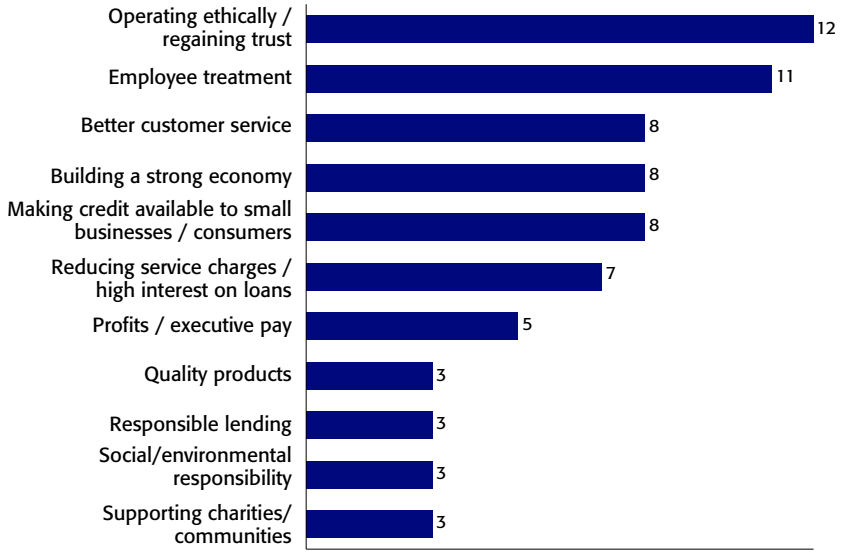
Net Respect,* Trends: 2005–2011




*5+4 minus 1+2 on a scale from 1 to 5 where 1 is "No respect at all" and 5 is "A lot of respect."

*Figure 3:*

**Most Important Issue the Banks / Financial Services Industry Needs to Address**
Unprompted, Average of 20 Countries, 2011




consumers: research shows that consumers wish to see the industry focus on rebuilding trust and operating ethically (Figure 3). They also call for the industry to do what it can to build a strong economy and increase access to credit. Ethics and trustworthiness are particularly salient issues in North America and Europe, whereas those in Africa and Latin America prioritize the industry's treatment of employees. Consumers in Asia call first for better customer service, then for greater access to credit.

Thought leaders do not assign the same standards of protection to institutional investors as to mainstream consumers. As long as banks have disclosed all relevant information about a financial product to an institutional investor, they are not considered to be accountable for judging the suitability of the product in the same was as they would be for a consumer product. For counterparties in trading transactions, the bank's obligation to ensure suitability is viewed to be even more limited. Both sides of a trade are expected to take a "buyer beware" approach and to do their own due diligence.

Institutional investors are perceived to be more sophisticated in their ability to make judgments about the suitability of the products they buy, despite the huge losses they suffered after buying AAA-rated mortgage products in the run-up to the 2008 financial crisis. Because of their sophistication and sheer size, institutional investors are also perceived to have the ability to influence banks.

Some thought leaders wish to see institutional investors make greater use of their potential influence over banks and regulators to advocate for industry and regulatory action that both addresses the practices that led them to huge losses in 2008 and helps them add more social and environmental value with their funds. "When institutional investors get really angry, they have an incredible amount of power. The question is, do they have the motivation to use the power they have?" asks one respondent. "In most cases they're very difficult to get angry. Institutional investors have to be more easily provoked."

## Regulators

Given the substantial influence that regulation has on how the financial sector is able to do business, the sector's relations with government and regulators are critical. Thought leaders suggest that positive outcomes on regulation are largely dependent on the manner in which the sector engages with its regulators and the other stakeholders surrounding the regulatory process. In particular, a number of thought leaders stress that the process should be collaborative and constructive instead of antagonistic, as it has been in many countries, particularly the UK and the US.

### Deepening responsibility for product impacts: the food sector

***The evolution of the food industry's response to the obesity crisis may contain lessons for the financial sector.***

Nearly a decade ago, the food industry came under intense scrutiny over the health impacts of its products. Since then, obesity and other chronic health issues have worsened, and the food industry has found itself in the middle of a full-fledged public policy debate.

With growing consumer activism, legislative initiatives, and threats for more regulation, health and wellness has become a major competitive issue that directly impacts financial success. Companies including Campbell's, Coca-Cola, Danone, Kraft, McDonald's, Nestlé, PepsiCo, and Unilever have responded and made significant changes to their products' ingredients, labelling, and marketing. Reputation at the brand and sector level has subsequently improved.

The implication for banks is that there is an increasing expectation for companies to take responsibility for the social and economic impacts of their products. As norms and expectations develop to hold banks accountable for the social impacts of over-indebtedness, foreclosures, and economic well-being, it will be in the industry's best interest to take a more proactive and well-publicized approach to helping consumers and other customers make good financial decisions. Whether through education programs, a different approach to marketing, or redesigned products, such efforts could create an advantage at the corporate brand level.

Most bank executives interviewed recall negative experiences with regulators or auditors. One points out that the tone of conversation between banks and regulators varies across countries, and the balance of power in the relationship often seems to stem from broader cultural and institutional factors that may not be within banks' power to change. These factors include legal frameworks around banking and national norms of risk-taking.

Opinion leaders cite various perspectives on how to move to a more collaborative approach to regulation, including more information sharing, and co-development of regulation in areas of financial innovation.

Julie Monaco, Managing Director and North America head of Citi's Global Transaction Services, explains that, "More so in the last couple of years, the industry has embraced the need for productive dialogue." She identifies opportunities for regulatory collaboration in emerging innovations like mobile payments. Because banks play a central role in facilitating payment in mobile money platforms, they are well positioned to take a leadership role in designing the relevant regulation.

Stakeholders express hope that collaboration will yield regulation that is flexible. Technology is rapidly driving innovation, so regulations written today will likely need to change ten years from now.

There is broad consensus that information disclosure will be important to develop platforms for more effective regulation. Thought leaders stress that disclosure—which can be either voluntary or regulated—and the ability to interpret large amounts of data are more important for successfully regulating banks than creating new regulations. The ultimate goal of disclosure is to increase the level of transparency in bank operations. Transparency can help regulators anticipate needs in regulation and contribute to regulatory flexibility.

## Civil society

Opinion leaders are divided on the extent to which banks should take into account external stakeholders beyond their customers, shareholders, and regulators. Those who see little value in engaging civil society stakeholders perceive them to have limited relevance to banks' operations and limited influence over their actions. They cite banks' lack of interest in those stakeholders as evidence of their lack of influence.

*"When institutional investors get really angry, they have an incredible amount of power. The question is, do they have the motivation to use the power they have?"*

"Society can't really have a role except through regulators," says one thought leader. "Take the example of mortgages and consumer credit. It's hard for any private group to create enough pressure to stop things from occurring. For any one individual, it's not enough to push against. Factors that would be considered egregious in the aggregate are not addressed because they only have a small impact on individuals."

Many thought leaders, however, identify a growing role for a wider group of stakeholders in influencing financial institutions—and an increasing payoff for those institutions that engage these stakeholders strategically. Thought leaders argue that NGOs play an important role representing the interests

of groups that might not otherwise have a voice in public debate.

Engaging with NGOs may create opportunities for banks to enter new markets and access new customers. In developing countries, and to a smaller extent in developed countries, NGOs play a prominent role in shaping the development of the banking sector.

When describing the opportunity to engage NGOs, respondents mention their expertise in developing financial infrastructure (international development banks), acting as intermediaries to reach underserved populations (microfinance experts), or providing proof-of-concept for new products and services, as explained by the IFC's Peer Stein:

"In sustainable energy finance we have seen that donors have played a key role in providing proof of concept. They have helped banks at the outset with support and risk sharing that allowed the banks to test the waters before they were fully ramping up. Further, a supportive government and regulator can be critical to boost the development of this sector, whether for energy-efficient businesses and buildings, or for renewable energy."

## Addressing sector challenges: the International Council on Mining and Metals

***The mining industry has shown how collective leadership can effectively address common challenges.***

In the 1990s, the mining industry faced serious challenges, including environmental degradation, limited access to resources, and declining employee and investor confidence. Spurred by public scrutiny before the World Summit on Sustainable Development, nine of the world's largest mining companies launched the Global Mining Initiative (GMI). Shortly thereafter, the metals industry's representation organization broadened its mandate to create the International Council on Mining and Metals (ICMM). ICMM member companies committed the organization to engage in constructive dialogue with key stakeholders on the industry's major challenges, with the intention of improving performance in social and environmental areas.

ICMM has led the industry's participation in developing approaches to its most important environmental and social challenges. It is now regarded by stakeholders as a leadership group, moving its members toward sustainable business practices and making a significant contribution to raising overall industry standards.

Recent years have exposed common challenges for many companies across the global financial services sector. It may be strategic to address civil society pressure through a similar global organization, designed to engage stakeholders in constructive dialogue. Such an organization could resolve important issues, raise the standards of its members and the sector overall, and improve the reputation of the industry. This could be achieved through existing organizations such as the Equator Principles Association or a new initiative.

Bob Annibale, Head of Global Microfinance for Citi, and other bank executives interviewed perceive relationships with NGOs to be strategic investments that will help position financial institutions to take advantage of opportunities, especially in emerging markets. Annibale explains:

"Although Citi has a local presence in over 100 countries, we often have a limited branch footprint in terms of reaching many underserved consumers in rural and urban areas. However, we do have relationships with partners, non-profits, and for-profit institutions, that have a presence that may extend 'the last mile,' and by combining our resources we can expand and accelerate financial inclusion."

If financial institutions are to realize these opportunities, they will need to address a perceived gap between their current level of engagement with civil society and what many thought leaders regard as the optimum level for the future. Thought leaders indicate two possible explanations for this gap.

First, some thought leaders suggest that financial institutions have historically prioritized only those with a direct stake in their enterprise: employees, customers, and shareholders.

Carmine DiSibio ventures that "Banks are still figuring out how to engage stakeholders. In terms of the importance of employees and customers, they've got it. In terms of communities, lots of retail banks are getting a sense of how to do it. In terms of the environment, I'm not sure it's top of mind,"

Another explanation is that increased pressure on the banking sector due to its contentious role in the financial crisis and competing stakeholder agendas makes engagement difficult. "Banks have a fundamental role to play," explains Catharine French, Retail and Business Banking Chief of Staff and Corporate Affairs Director at Barclays. "Equally, it's a very tricky role—balancing the needs of a number of different stakeholders—shareholders, customers, government. There isn't alignment between what is expected of a bank... In every business there are going to be shades of grey, but in banking particularly at the moment, there's a starkness in the different agendas of the stakeholders."

# THE BIGGEST CHALLENGE: REGULATING THE FINANCIAL SECTOR



## Key Findings:

- While concurring with many of the reforms already widely identified for global financial regulation (e.g., higher capital requirements), thought leaders particularly advocate for greater consumer protection, the management of systemic risk, and global coordination of regulation.
- Thought leaders are concerned that regulatory action has been slow and somewhat indecisive since 2008—and not always directed at the most important drivers of the financial crisis.
- Many acknowledge that increased regulation may stifle innovation and reduce lending, although they also note that unchecked innovation is not an unqualified good.
- Global financial services companies could play an important role in assisting emerging markets in creating needed financial regulation structures.

The fact that regulatory reforms enacted in response to the 2008 financial crisis are still not complete in many countries attests to the challenge of effectively regulating the banking sector. Recent reports and investigations by the Wall Street Journal,[1] the Financial Times,[2] and McKinsey & Company have all dealt with the range of questions that still surrounds financial regulation. Needless to say, the key regulatory issues are well known, and our interviews with thought leaders show that financial sector stakeholders and commentators are grappling with many of the same questions. The Wall Street Journal, for instance, asked participants in a recent study to rank 20 priorities for rebuilding the financial system in the US. The top priorities were to raise capital requirements, empower the Financial Stability Board, promote risk management in banks, and improve regulator resources—all themes that also emerged from our interviews.

[1] Future of Finance, 2011, The Wall Street Journal, 10 Nov. 2011, < http://online.wsj.com/public/page/future-of-finance.html>

[2] Future of Banking, "An FT investigation into whether the global banking system and the regulatory regimes designed to protect the world from further shocks are any safer three years after the crisis broke," September 2011; accessed from http://www.ft.com/indepth/future-of-banking

However, the diversity of financial sector stakeholder perspectives represented here also brings to light themes that have not come through in other reports. Thought leaders say that protecting consumers should be a particular priority; they also advocate for management of systemic risks and global coordination of regulation. Several also note that banks have a role to play in shaping regulation and institutions to facilitate economic growth in developing countries.

## Consumer protection, managing systemic risk, and global coordination

Thought leaders identify three priorities for financial regulation: protecting consumers, managing systemic risk, and coordinating global regulation. Consumer protection is mentioned by stakeholders with experience both inside and outside the banking sector. Consumers, including mortgage borrowers, are perceived to be the most vulnerable to exploitation. They are widely seen to have borne the worst losses in the 2008 financial crisis, and are perceived to have limited financial literacy and means for recourse, especially poorer segments of the population.

"I don't think consumers are able to protect themselves against large institutions like banks. Regulation is absolutely required to make sure there's symmetry of information. There's incredible asymmetry between a bank and an account holder," says one thought leader from a multilateral organization.

Some respondents also mention that consumers are more likely than other customer groups to be targeted for products that, though they might be suitable, could have long-term negative consequences, specifically unsustainable debt. Experts mention products including credit cards, bank accounts with hidden fees, and mortgages with variable rates.

"Many times important information is contained in the fine print and is not communicated directly to consumers unless regulators require banks to do so. People really need to understand what they're buying, not through hundred pages of small print, but through clear instructions," explains Jeroo Billimoria, Managing Director of Child and Youth Finance International and Vice Chair of Aflatoun, an organization promoting financial literacy.

This sentiment is reflected by many of the opinion leaders interviewed—helping consumers make good financial choices will be an important step in creating a more robust consumer finance sector. There is also consensus that consumer protection is best achieved through a mix of regulatory action and increased transparency that facilitates standard consumer practices like comparison shopping—the norm when purchasing TV service, a mobile phone, or a car.

*"Regulation is absolutely required to make sure there's symmetry of information. There's incredible asymmetry between a bank and an account holder..."*

But whose role is it to protect consumers? Interviewees mention mechanisms for protecting and educating consumers that range from new regulatory agencies, to mandatory labelling of financial products and services, to financial education in school similar to drivers' education. Despite the recent creation of the Consumer Financial Protection Bureau in the US, most thought leaders are ambivalent

about whether effective regulatory options exist to protect consumers.

The second regulatory priority emerging from our thought leader interviews is the management of systemic risk to promote economic stability. "The first objective in regulation has to be stability," explains one NGO leader. "Banking over hundreds of years has been volatile and prone to bubbles and crashes, which is destructive for the real economy."

*"The fact is that we now live in this global world. It's not like one country can just move forward and say, 'we're going to do it this way.'"*

Though there is disagreement about whether crises are an inherent feature of the economic system, there is consensus that financial crises similar to that of 2008 are avoidable; however, many respondents both inside and outside the financial sector lack confidence in the ability of regulators, politicians, and the financial services industry to address issues of systemic risk and avoid future crises.

Frustration at the lack of regulatory progress since 2008 exists, especially in the US; for example, despite their supposedly central role in precipitating the financial crisis, systemically important financial institutions (SIFIs) have yet to be clearly defined.

Executives and regulators express concern that some of the conditions contributing to systemic risk—like high concentrations of capital in a small number of large banks—have persisted and in some cases worsened: capital has in fact been re-concentrated among a smaller number of surviving banks.

These concerns highlight the need for effective regulation to address systemic risk, but to date the regulatory process has seen a lack of focus. "I think that the US as a country never really fully put our arms around what happened in the financial crisis," says one bank executive. "The result is that we have thrown together regulation which isn't necessarily looking in the right places, and because we haven't developed a consensus as to why the crisis happened, we have ended up in a place now where there's an attempt to defund pieces of the regulatory structure that would go after looking at the things that happened."

As a third priority, thought leaders cite global coordination of financial regulation. With the globalization of financial services and the proliferation of technology in banking, disparate parts of the world's financial system will continue to be more and more closely linked. Consistent global regulation will be key to preventing the migration of high-risk activities to less-regulated geographies, and to avoiding penalizing countries that introduce more regulation. Michael Klowden, President and CEO of the Milken Institute explains: "If you try to regulate in too much detail, you tend to… make it difficult for the competitive landscape worldwide, which leads to what [US] Treasury Secretary Timothy Geithner has been talking about, which is that you need to have a much more synchronized approach to financial regulation. If you don't have a level playing field, you're going to get a lot of financial forum shopping."

Some respondents doubt that regulatory arbitrage is likely, but tend to agree that global coordination is important. Alec Morley, Senior Vice President for

Small Business Banking at TD Bank Group, sums up many thought leaders' sentiments. "The fact is that we now live in this global world. It's not like one country can just move forward and say, 'we're going to do it this way.'"

## Challenges with regulation

Thought leaders identify three key challenges potentially arising from regulation. Several bank executives interviewed fear increased regulation will stifle innovation and lead to lower profitability. Some worry that regulatory uncertainty will slow investment and economic growth. Others allude to equity issues in regulation, expressing concern that new regulation will decrease the availability of credit for higher-risk customers and clients.

Concern around regulation stifling innovation and reducing profitability is heightened by the fact that regulation can be a blunt instrument, affecting institutions whether or not they have exhibited bad practices or been bailed out with public funds. As Tomás Conde Salazar, Director of Sustainability at BBVA, puts it, "It means it will be more difficult to make new businesses. It penalizes those banks and institutions who were doing their homework, who didn't get a penny from the public sector. The rest did, but now the extra regulation will affect them too."

While regulation may place a drag on innovation, Dr. Mohd Azmi Omar notes that innovation is neither good nor bad per se, but should be judged by its outcomes:

"Regulation can stifle innovation and potentially prevent the introduction of new products that meet specific needs of clients. But we have to look at this in the context of the greater good. Innovation may benefit a specific part of the market, but not be good for society at large. We have to have innovation that's going to create value and benefit society."

Perhaps more damaging to the financial sector than restrictive regulation itself is uncertainty around the development and implementation of new regulations. Regulators and bank executives acknowledge that economic and regulatory uncertainty have led banks to scale back certain operations, and corporations have kept more cash on their balance sheets. Many thought leaders agree that regulations should be written and implemented quickly to ease uncertainty.

The upshot of both greater constraints on financial services and the uncertainty around their implementation is a reduction in the services financial institutions are able to offer customers. This has implications for the economy more generally:

"We need stability, transparency, reporting, and restrictions on leverage for the economy, but overkill is a risk and a negative for everybody," says one industry executive. "It's clearly a good idea for banks to hold more capital, but if you require more and more, banks have to charge more. Loans to slightly marginal borrowers decrease, credit is less available overall, and it has a constricting effect on the whole economy."

*"It's clearly a good idea for banks to hold more capital, but if you require more and more, banks have to charge more."*

*"Regulation can stifle innovation and potentially prevent the introduction of new products that meet specific needs of clients. But we have to look at this in the context of the greater good. Innovation may benefit a specific part of the market, but not be good for society at large. We have to have innovation that's going to create value and benefit society."*

## Developing countries: Financial capacity building

Conversations with thought leaders in developing countries reveal a different perspective on the financial sector's role in regulation. The priority for these experts is for governments and regulators to develop the infrastructure to facilitate banks' productive economic role in society.

"For emerging markets, it's different," says one interviewee. "Regulation isn't to the point that it's getting in the way. More regulations are generally good, not a bad thing, and won't have negative consequences for growth."

Jeremy Hobbs, Executive Director of Oxfam International, adds: "Supporting good public policy in developing countries and creating an enabling environment in which finance can be deployed in a responsible manner would be examples of leadership in the financial sector."

Thought leaders offer a range of requirements for developing-country financial systems to progress, including building not only financial infrastructure such as credit bureaus but also legal frameworks such as enforceable contracts and property ownership rights. For countries that already have basic infrastructure thought leaders suggest a need for more sophisticated means to raise capital and encourage growth, such as bond markets.

Banks can play a role in providing the technical expertise necessary for such developments, while at the same time continuing to build a positive reputation.

# WHAT'S TO COME? PREDICTIONS AND SCENARIOS



## Key Findings:

Key findings:

- The financial sector faces major challenges ahead, in particular, remaining profitable in a tighter regulatory environment; adapting to changes wrought by technology and new actors entering financial services; and heightened demands from society for responsible finance.
- Three broad scenarios emerge:
    - Risky business as usual–regulation and industry behavior do not change substantively, industry-society relations remain challenging and the risk of future economic shocks remains high.
    - Back to boring–significant regulatory tightening restricts financial services to a "utility" role and it becomes less vibrant and profitable, but more stable.
    - Inclusive innovation–industry resets relations with regulators, other stakeholders and society, by seeking growth with shared return. A collaborative approach to regulation, and innovative financial products and services with societal benefits, results in minimal antagonism between industry and its critics, and a path to renewed growth.

## Thought Leaders' predictions

As we publish this study in fall 2011, the immediate future of the financial services industry is uncertain and beset by challenges. Regulatory changes including Basel III, Dodd-Frank, and the recommendations of the UK's Independent Commission on Banking have not been fully implemented, and despite a couple of profitable years for the sector, a recent McKinsey report[4] suggests that US and European banks "will need to transform their business models in ways more radical than many have contemplated to date" if they are to continue to prosper sustainably. The same report projects that emerging markets will represent 60 percent of global revenue growth in banking over the coming decade.

Many thought leaders we interviewed agree that the financial sector's profitability will be limited due to stricter capital requirements and tougher consumer protection laws. In the short term, respondents predict that changes to the sector will largely be governed by the specifics of incoming regulations: in retail, banks' ability to extract fees and charges from consumers is likely to be curtailed, leading them to seek other profit drivers, while in investment banking, regulation aimed at reducing conflicts of interest could lead to firms breaking up or focusing only on one aspect of deal making (e.g., splitting underwriting from financing).

Looking into the medium term, further consolidation of the industry at a global level is widely expected, as is a shift in the overall balance of financial activity and growth towards emerging markets, particularly in the Asia-Pacific region. Technology is expected to continue to transform models for service delivery in retail banking, including means of payment such as M-PESA in Kenya and Google Wallet.

Several thought leaders, including those currently working at financial institutions, expect some change to be driven by new entrants into the market for financial services, particularly in lending to consumers and small businesses. A rise in peer-to-peer lending is predicted—with multiple channels and new actors involved. One example is Starbucks' Create Jobs for USA partnership with the Opportunity Finance Network of CDFIs (Community Development Financial Institutions)[5]. A new take on efforts already undertaken by banks like Goldman Sachs with their 10,000 Small Businesses initiative, it shows how non-financial companies see an opportunity to make a social impact and improve their standing with consumers by supporting small-scale lending.

Some stakeholders predict that in response to competitive, social, and governmental demands, the banking sector may begin to play a more proactive social role, putting financial tools to use in driving economic development and inclusion, and spurring environmental innovation. We may also see enhanced communications on responsibility, transparency, and integrity, just as other industries from automotives to extractives have started to showcase their environmental and social responsibilities in their corporate communications and branding.

[4]The state of global banking—in search of a sustainable model, McKinsey & Company, September 2011

[5] "We Can All Become Job Creators" by Joe Nocera, New York Times, October 17th 2011: http://www.nytimes.com/2011/10/18/opinion/nocera-we-can-all-become-job-creators.html

Overall, our discussions with thought leaders point toward three broad scenarios for the future of the financial sector, based on its relations with regulators, stakeholders, and the rest of society:

- Risky business as usual
- Back to boring
- Inclusive innovation

The future is likely to consist of some elements from each of these, with different banks' actions taking them toward different scenarios. The following section outlines each scenario, the challenges and opportunities associated with it, and the roles that industry actors, governments, and others will play in bringing each one about.

## Scenarios for the future of the financial sector

### *Risky business as usual: the dangerous status quo*

Perhaps the most likely outcome is a future environment broadly similar to what we see today. In part this is due to governments making slow and incremental reforms to address serious problems in the banking sector rather than taking on larger scale, systemic changes. Political divisions, due to deep partisanship in the US and differing national priorities across Europe, are slowing efforts to reform regulation. This, coupled with the banking sector's traditionally robust ability to influence lawmakers, may result in relatively minor changes to financial regulation, and things could remain much as before.

As one thought leader notes, the changes enacted in the immediate aftermath of the crisis addressed some "easy targets," such as overdraft fees, that had little or no bearing on the causes of the crisis:

"Legislation on overdraft fees in the US was done very quickly, even though it had a huge impact on banks' bottom line and had nothing to do with the financial crisis. It seemed to occupy a lot of the oxygen around regulatory reform. Anti-money-laundering regulations have also been a strong focus, but it doesn't address the financial crisis, it's not connected. There's only so much mind share, and regulators may be going after the wrong things, not going after the root causes of financial crisis."

Such a lack of regulatory priority setting makes for an additional drag on reform, and increases the likelihood that regulations remain broadly similar to their current state.

So how would this "business as usual" scenario play out? As seen in the current Occupy Wall Street movement, public perceptions of the financial sector are at a low. GlobeScan's global public opinion tracking shows a steep drop in respect for the sector in the United States, the UK, Spain, and other countries. Incremental change from the government and industry to reform the financial sector would do little to curb this dissatisfaction, and an antagonistic relationship between financial institutions, regulators, and large parts of society would continue.

This low-trust environment will not be conducive either to producing appropriate regulations in the future or to government assistance to the sector in times of crisis. New service models and other innovations may be treated with skepticism by consumers, making it difficult for banks to adjust their methods of service delivery and reduce costs.

Michael Klowden outlines the trade-offs involved in maintaining the status quo. "I worry that the US financial industry, which is so important to the economy, will shrink relative to what's going on in

the rest of the world. If their people are willing to make voluntary changes to avoid regulation and accept a more modest level of profitability, banking could remain a vibrant sector. If government comes in and makes markets less competitive, then I think we'll wind up seeing the worst of both worlds—restrictive regulation, and people taking undue risk where they can to maintain profitability."

This is why we deem this scenario "risky business." Many of the systemic issues that resulted in the 2008 crisis would go unaddressed, and banks' ability to evolve and innovate would be curtailed. With little done to address the failings that led to the previous crisis, risk in the global banking sector would remain, reducing confidence in the sector and worrying investors. Low trust among consumers may lead to continual demands for tighter regulation, further contributing to uncertainty around the sector. This uncertainty and reduced confidence could put a long-term brake on growth in the wider economy.

### *Back to boring: a financial utility*

The traditional image of banking and financial services is very different from how it is perceived today. Where once the industry was seen to be staid, conservative, and relatively low-key, today it is vibrant and innovative, if beset by challenges. Some opinion leaders argue that financial services companies should revert to something akin to their earlier role, that of a pure intermediary between savings and investments, their activities heavily circumscribed by regulation. In this scenario, the innovation and risk-taking that contributed to the systemic crisis in 2008 would be curtailed. Trust in the sector might begin to be restored. However, this is the "boring" scenario for the sector: many avenues to further profitability would be cut off and the sector would become less attractive to the more ambitious and driven recruits it has attracted over the past couple of decades.

José María Lamamié de Clairac, Director of the Financial Institutions Department of the Bank of Spain highlights the financial downside to the "boring" scenario. "We'll probably see banks that are less profitable than they were before. Basel III will require a larger amount of capital for banks. The amount of capital will probably affect profitability for banks and for investors." Recruiting and retaining talented employees could also be a problem. "I'd be surprised if after what happened there's not a generation of bankers that emerges that has a value set different from their predecessors and an awareness that the business they do is a utility-type business and not at the cutting edge of entrepreneurial capitalism," notes Jonathan McMahon.

This scenario could come about in the event that pressure from regulators and the public increases substantially, overcoming political gridlock. With financial institutions' capacity to innovate limited, entrepreneurial actors in other sectors such as information technology and mobile communications may become known as the centers for financial innovation.

### *Inclusive innovation: growth with shared return*

The final scenario that emerges from our research sees the financial sector taking a more proactive role in shaping its relationship to customers, regulators, other stakeholders, and society in general. In this scenario, banks take collective and individual action to ensure that their activities, while continuing to deliver profits for themselves and their investors, also benefit society more broadly. This represents an evolved perspective on corporate responsibility, informed by recent views from a range of leading

thinkers, including Michael Porter, The Economist, McKinsey, and others.[6]

Contemporary corporate responsibility strategists encourage companies to move away from the combination of "do no harm" and corporate philanthropy that previously characterized corporate social responsibility initiatives, and to seek opportunities to grow in ways that have direct or indirect social benefits. Value is created both for the business and for its stakeholders.

| | Drivers | Challenges | Opportunities |
|---|---|---|---|
| **Risky business as usual** | Political gridlock | High likelihood of future crises and specter of draconian regulations | Continued innovation |
| | Anti-reform lobbying | Poor industry-society relations | Periods of rapid growth and profits |
| | Emergent regulatory regimes in developing countries | | |
| **Back to boring** | Public pressure | Lower economic growth | Greater stability |
| | Regulatory overreach | Lower profits | Less confrontation |
| | Further crises | Tougher recruiting environment | |
| **Inclusive innovation** | Improved stakeholder relations / reputation management | Greater demands on change management to drive cultural shift | More innovation |
| | Increased competition from other sectors | Fewer opportunities with competitive risk/return profile | Higher ability to attract and retain talent |
| | | Higher expectations around transparency | Improved societal relations, reputation, ability to shape regulatory agenda |
| | | | Stronger positioning in emerging markets |

[6] See:

Michael E. Porter and Mark R. Kramer, "Creating Shared Value," Harvard Business Review, January 2011

Sheila Bonini, Timothy M. Koller, and Philip H. Mirvis, "Valuing social responsibility programs," McKinsey Quarterly, July 2009

Ian Davis, "The biggest contract," The Economist, May 26th 2005

Our interviews with financial sector experts bring to the surface the best opportunities currently available to the sector for creating such shared returns. While several such opportunities, including microfinance, are already well known, the discussions reveal numerous promising additional business practice areas. Moreover, recognizing the central role that banking plays in the economy, thought leaders emphasize that the opportunities for banks and other financial institutions to make a significant social impact are greater than for many other industries.

Under this scenario, relations between the financial sector, its regulators, customers, clients, and other stakeholders are collaborative as opposed to antagonistic, and the sector's centrality to economic life is more visible and appreciated by all stakeholders. Stakeholders see the opportunity for this maximization of benefits across interested parties, as greater mutual trust would lead to more open collaboration on regulation, shared accountability and less criticism in challenging times. Financial institutions would also see numerous side benefits, as discussed below.

# WHAT WORKS? AN INCLUSIVE INNOVATION FUTURE



## Key Findings:

- Inclusive innovation can deliver financial returns and further positive outcomes for the industry:
  - Human capital—enhanced ability to attract and retain talent.
  - Reputation and brand management—a more convincing commitment to responsible finance.
  - Innovation and new products—meeting customers' appetite for financial products with a shared return.
  - Market access—entry to and growth in emerging markets may be dependent on demonstrating the social value the business can deliver.
- Thought leaders identify three key paths to inclusive innovation:
  - Leveraging financial sector competencies, products and services for positive social and environmental outcomes—financial sector skills can be used to address many pressing social and environmental needs.
  - Improving financial inclusion—banking the unbanked in both developed and emerging markets—a driver of economic growth and new business for banks.
  - Motivating action by others—leading companies can influence other industry actors by creating norms and standards, and also advocate for positive public policy changes.

## Benefits of inclusive innovation

An inclusive innovation approach to relations between banks and society confers multiple benefits. It is rooted in driving both social and business value, which means that programs can have clear financial metrics for assessing their outcomes, scale naturally, and contribute directly to the mainstream of the business. Inclusive innovation is a crucible for new products and services, matching new ideas with unique social needs.

Additional benefits to human capital management, reputation and brand, innovation and new products, and market access can also contribute to banks' profitability.

### *Human capital*

Many thought leaders believe the next generation of bankers will be driven to make a positive impact on society. Recruiters across industries are increasingly finding that graduates seek out information on how socially responsible potential employers are, and prefer to find roles in which they feel they will be able to make a difference in society. Several of the thought leaders interviewed acknowledge growing evidence that their companies' efforts in corporate responsibility motivate employees. Bob Annibale explains how Citi has benefited:

"In finance, particularly, developing businesses that combine social and financial objectives can be hard

### Inclusive innovation in action: Nestlé's "Creating Shared Value"

***Nestlé's shared value strategy creates value for itself and in the communities it works.***

In April 2009, Nestlé unveiled a new approach to corporate responsibility, replacing its earlier corporate philanthropy, community relations, and traditional corporate responsibility programs. The concept, "Creating Shared Value," demonstrates that Nestlé believes its own success rests on creating value for all of its stakeholders.

Nestlé works to generate shared value in three focus areas of nutrition, water, and rural development. Co-created with input from stakeholders and experts, the program is intentionally consultative and iterative, and relies on regular open forums to review progress against program targets and obtain further input from stakeholders.

One initiative under the Creating Shared Value concept is the Nescafé Plan. It unifies the company's plan to optimize its coffee supply chain with its plan to meet social development goals. Nestlé targets business goals in coffee farming, production, and consumption while implementing social programs–like community agricultural education–that also contribute to those goals.

Nestle's Creating Shared Value is a model of modern corporate social engagement. Its strong alignment of social change with business value exemplifies a new approach that companies, including those in the banking sector, can take to uncover value. Given the fundamental role of the financial sector in human wellbeing, many banks are in a good position to adopt a shared value model.

to achieve, yet many colleagues are very engaged in our work. Most people want to 'do the right thing,' personally and professionally. We get many inquiries from students and professionals about career advice and opportunities for working in the sector. I always suggest that they consider the wide range of community needs that they can support through their expertise and skills. What could be better than doing what you enjoy and are trained for professionally, and knowing that it has social merit and contributes to broader public objectives?"

### *Reputation & brand management*

"A bank's reputation is very important. And they're concerned about their reputation potentially more than other types of companies," says one thought leader. It is well established that activities that create value for a company's stakeholders contribute to a company's overall image, but exploiting these activities for reputational enhancement is a delicate act. Companies that have embraced creating social value as part of their core businesses have been able to communicate in a more credible way about their social achievements than those relying on pure philanthropy, or programs not related to their core competencies. For example, XacBank in Mongolia started as a microfinance institution with a unique service delivery model. The bank developed a strong business built on lending to the under-banked and expanded into other services, becoming one of the largest banks in Mongolia while retaining their mission of providing inclusive financial services. In such cases, the sustainability of the intervention comes across naturally, and the profit motive dispels the notion that the intervention is purely for image enhancement. High-profile examples of corporate brands built around business initiatives making a social impact include GE's "ecomagination," Marks and Spencer's "Plan A," Starbucks' "Shared Planet," Unilever's "Sustainable Living Plan" and IBM's "Smarter Planet."

With non-financial companies now creating initiatives designed for positive economic impacts, financial institutions may be missing out on an opportunity to create significant positive exposure for themselves. Referring to Starbucks' Create Jobs for USA program, Michael Sadowski, Vice President at SustainAbility, says: "Why is a food and beverage company stealing the stage and running this major initiative to stimulate economic growth, why isn't a bank doing that? I think they could get a lot more creative and put more capital on the line to simply contribute to economic growth, which is obviously vital in the short term, globally."

### *Innovation and new products*

Viewing the marketplace through the lens of inclusive innovation reveals opportunities to innovate and create new products. For example, experts expect the amount of money invested seeking social as well as financial returns to increase in coming years. James Gifford, Executive Director of the UN Principles for Responsible Investment, characterizes the opportunity for banks to create products that fill the needs of those investors.

"There's a great appetite among institutional investors—particularly public sector funds and sovereign wealth funds—for investments that will provide attractive risk-return characteristics with strong social and environmental benefits… These are products that people need to develop."

### *Market access*

Demographic and economic change, particularly in the developing world, is set to create new

### An inclusive innovation: impact investing

***Impact investments aim to achieve a specific social or environmental outcome in addition to generating a financial return.***

Impact investing represents a distinct category from traditional socially responsible investing (SRI). Where the SRI approach has been to fund enterprises that simply minimize social or environmental harm, impact investing focuses on creating positive social impacts.

The targets of impact investments can range from opportunities to provide products and services to "base of the pyramid" customers, to sustainable infrastructure development. JPMorgan estimates[1] that over the coming decade there is potential for invested capital of $400bn–$1 trillion in businesses in five key sectors serving low-income populations globally, and profits of up to $667bn.

There is clearly potential to significantly expand impact investments in both developed and emerging markets in coming years. This is the archetypal case for financial services companies leveraging their core skills to achieve positive social outcomes that are aligned with business success.

[1] *"Impact Investments: An emerging asset class," JPMorgan, 29 November 2010*

opportunities for retail banking, microfinance, and other financial services. While acting as a driver of economic development in emerging markets is itself a major opportunity, gaining access to such markets may be dependent on demonstrating to government and other stakeholders the capability to deliver positive social outcomes as well as profits.

"Collaborating leads to many more people getting appropriate access to financial services, often accompanied by financial education or other services, such as insurance," explains Bob Annibale. "Partnerships, largely based on both of our institutions operating locally in the emerging market country, leverage our respective expertise, access to resources and, most importantly, our people, to deliver greater outreach, client focus, products and services to serve the end client and community."

## Paths to inclusive innovation

The opportunities that thought leaders identify for banks to grow their businesses in ways that generate a return to society fall into three broad categories: applying the sector's competencies to social and environmental challenges, striving for financial inclusion, and motivating action by others.

### *Leveraging financial sector competencies for positive social and environmental outcomes*

Many opinion leaders from outside the financial services sector think banks and financial services companies can use their core competencies to

address social and environmental problems. Experts cite a number of examples that illustrate how banks are already deploying those competencies: creating "blended return" investment products, such as those that invest in double-bottom line ventures; structuring deals that pool demand and funding for the purchase of products and services, like new vaccines, to stimulate R+D; creating investment vehicles, like funds with screens for positive environmental and social performance, to attract institutional investors with a social development mandate; and developing and supporting markets for environmental commodities like carbon.

Stakeholders representing financial institutions agree that they can play a role in these types of activities, provided they either match the risk/return profile of comparable investments, or can be considered an investment in reputation.

Scott Mullin of TD Bank Group, explains how banks' thinking has evolved. "Five to ten years ago, the environmental agenda didn't get the attention of banks. We can play a role in energy efficiency, energy strategy, and paper strategy."

Mark Tercek, himself a former Goldman Sachs banker, confirms the emerging opportunity for banks. "We believe the business community should consider more carefully environmental limits to economic growth. I've been talking to some big banks about this—their research departments could add some thought leadership on this topic carefully. In my view, they should invest some talent into the topic of resource scarcity and how investors should be smart about that."

### *Financial inclusion*

Core banking services are value generators, and banks are considered to be essential contributors to healthy economies and societies. By extension, offering appropriate banking products and services to those who do not already use them creates social value. Several thought leaders also indicate that providing access to basic financial products and services for under- or unbanked populations has social utility, especially in developing countries where it may enable individuals to enter the formal economy. However, banks will initially need to hone their business models and perfect appropriate products for these customers rather than focusing immediately on high sales volumes. Recent events in the microfinance and mortgage industries illustrate the danger of pursuing high volumes too quickly and at the expense of social and financial sustainability.

Stakeholders indicate that an inclusive innovation approach to financial inclusion focuses on the needs of the customer, identifies innovative technologies and business models for service delivery, and makes use of partner organizations with unique assets or footprints that help reach target populations.

"There's a huge missed opportunity to play an inclusive role in many economies around the world. In developing countries in particular, the financial sector is irrelevant to much of the population and to many of the businesses. They don't provide the much-needed credit and services to those groups," explains one international banking expert.

Another bank executive adds more context: "I do think creating products for and lending to emerging market economies and companies, especially those that are in position to boom, are great investments

for many banks and something that will pay off in the long term. Investment in emerging markets is very important for the viability of many banks."

Delivering financial services to under- or unbanked customers, including consumers and businesses, may require novel business models and approaches to customer acquisition and retention. It has taken the intervention of the Grameen Bank to demonstrate a successful approach to lending to people below the poverty line and with poor banking records in the US. By offering financial training, advice, and self-supporting groups of volunteers, Grameen USA has acquired more than 7,000 borrowers since January 2008, with a repayment rate of 99%.

Micro Branch, a division of Community Trust Credit Union, extends some financial services such as check cashing to low-income Americans. It charges lower rates than most check cashers and payday lenders, and offers users a path toward more standard financial products such as checking accounts. Its success to date demonstrates the necessity of tailoring services to the specific needs of low-income consumers; two years of market research informed everything from the range of products and services offered to the choices of decoration and furniture in branches.

Interviewees also highlight the value of many banks' financial literacy programs aimed at the general

## Addressing the challenge of access: the pharmaceutical sector

***With 2.5 billion adults across the world outside of the formal banking system, there may be valuable lessons for the financial sector from the pharmaceutical industry's experience in creatively developing new markets.***

The global HIV/AIDS epidemic instigated a debate on the pharmaceutical industry's role in providing medicines to those who could not afford them. In response to pressure from civil society organizations such as Doctors Without Borders, Oxfam, and the Gates Foundation, the world's leading drug companies began to experiment with new approaches to providing access to life-saving drugs to people in need.

Efforts initially focused on donating drugs and reducing prices in low-income countries, but they have evolved toward models of collaboration and investment aimed at producing long-term health gains for communities and positioning pharmaceutical companies for profitability in new markets.

Recasting access to products as a strategic objective has relevant implications for banks. Banks have a similar opportunity to re-envision their business models, investing in banking infrastructure and appropriate distribution channels that will help them serve difficult-to-reach populations. Through NGO partners, banks can gain access to new base-of-the-pyramid customers, create global governance infrastructures, and drive profitability. Global financial institutions are well placed to integrate hundreds of millions of people into the financial system, to all parties' benefit.

### Business and education: Cisco Networking Academy

***Cisco has shown how a company can deliver an education program, at scale, with clear business and societal benefits.***

Networking Academy is a set of technical education courses in building and maintaining networks, designed by Cisco, distributed across the Internet and taught by partner institutions such as schools, universities, businesses, non-profits, and government organizations. At present, there are over 9,000 partner institutions in 165 countries, and roughly 1 million students in training. The program delivers a steady stream of engineers qualified to work with Cisco's products, facilitating Cisco doing business in their countries. Over 12 years to date, more than 3 million students have completed Networking Academy courses.

Networking Academy is a model for how a company can use its expertise to provide educational opportunities that are aligned with its business objectives. It is unique in its scale and sustained growth, with an indefinite commitment from its parent company.

It is widely acknowledged that many consumers, even in developed countries, are not financially literate, limiting their ability to manage their own money and select appropriate financial products. Financial services companies have taken steps to address this, but may look to Cisco's example when considering how they may scale such programs for increased social and business benefit.

public, and specifically at youth. Financial institutions can also guide and educate entrepreneurs in launching and growing successful businesses. Julie Katzman, Executive Vice President at the Inter-American Development Bank outlined the mutual benefits of creating educated consumers.

"If you want to grow with that community, you're able to do this with financial literacy, entrepreneurial training, and linking with other community institutions that allow you to sell a better product. You make money doing it, but you also provide a social return that's very important to have."

*Motivating action by others*

Beyond the basic products and services they offer, banks are seen to be able to offer value by influencing other actors for positive change. Respondents see opportunity for banks to influence public policy, to provide expertise to governments in developing countries, and to collaborate with other banks to set standards for certain types of products and services.

For banking, the Equator Principles set norms and standards for international project finance and put the concept of collaboration into practice. As one thought leader says, "You can make positive things happen when there are four to five main players who take a leadership role in developing something that

can be adopted by the wider market." Other industries, including apparel and electronics, have undertaken similar projects in what is coming to be referred to as "pre-competitive collaboration."

Pushing for enlightened public policies to benefit both the societies in which banks operate and, indirectly, the banks themselves, is a recurring theme among thought leaders. "The most important thing banks can do is to have a progressive attitude toward lobbying. There's no reason banks shouldn't do what other enlightened organizations can do. Influence public policy to bring about a market where they're well positioned. If you're a banker specializing in sustainability, energy infrastructure, it's in your interest to lobby government to regulate to create those markets."

## Realizing the opportunities of inclusive innovation

In future, the financial innovations that drive economic development and change societies may not come from the financial sector—just as M-PESA, Kenya's mobile phone payment system, emerged from a telecommunications company. But thought leaders identify myriad ways in which financial sector companies could innovate products and services to drive positive social change and their business success. While a more regulated sector is likely to emerge from the ongoing round of global financial reform, we see an opportunity to refresh banks' innovative capacity, brand image, and reputation by pursuing inclusive innovation. The scale of the potential change that the financial sector could make is exemplified by the world's 2.5 billion unbanked adults, who are spread across developed and emerging economies.

There are good indications that financial institutions are devising inclusive innovations to address serious social challenges. Leading companies from across the sector already have programs designed to spur social and economic growth, increase financial inclusion and promote environmental sustainability.

Clearly the capacity in financial institutions to activate the opportunities of inclusive innovation exists: the test will be in the impact that these programs have on their institutions' core businesses. The mainstreaming of inclusive innovations will show that the financial sector is on a path to sustainable growth and a more trusting and collaborative business environment.

# APPENDIX I: THOUGHT LEADER INTERVIEWEES

**Americas**

Ellen Seidman, *Board Chair, Center for Financial Services Innovation*
Bob Annibale, *Global Director, Citi Microfinance, Citi*
Philip Brown, *Managing Director, Microfinance, Citi*
Pam Flaherty, *President and Chief Executive Officer, Citi Foundation, Citi*
Lew Kaden, *Vice Chairman, Citi*
Julie Monaco, *Managing Director and North America Head of Global Transaction Services, Citi*
Ruchi Madan-Laezza, *Chief of Staff to the CEO, Citi*
Carmine DiSibio, *Vice Chair and Managing Partner, Financial Services, Ernst & Young*
Sandra Lawson, *Senior Global Economist in the Global Markets Institute, Goldman Sachs*
Richard Ramsden, *Managing Director, Global Investment Research, Goldman Sachs*
Johan Walden, *Professor of Business, Haas School of Business, UC Berkeley*
Julie Katzman, *Executive Vice President, Inter American Development Bank*
Michael Klowden, *President and CEO, Milken Institute*
Glenn Yago, *Senior Director, Israel Center, Milken Institute*
Mark Tercek, *President and CEO, The Nature Conservancy*
Richard Bookstaber, *Senior Policy Adviser to the Director, Securities and Exchange Commission*
Michael Sadowski, *Vice President, SustainAbility*
Craig Alexander, *Senior Vice President and Chief Economist, TD Bank Group*
Alec Morley, *Senior Vice President, Small Business Banking, TD Bank Group*
Scott Mullin, *Vice President, Community Affairs, TD Bank Group*
Cherie Santos-Wuest, *Managing Director at Abundant Power Capital, TIAA-CREF*
Mike Oxley, *former Congressman from Ohio, US House of Representatives*
Robert Shiller, *Professor of Economics, Yale University*

*Responding anonymously*
4 bank executives
1 development bank representative

## APPENDIX I: THOUGHT LEADER INTERVIEWEES

### Asia/Pacific

Changyong Rhee, *Chief Economist, Asia Development Bank*
Hiroshi Amemiya, *CEO, Corporate Citizenship, Japan*
Leonard K. H. Cheng, *Dean and Chair Professor in the Department of Economics, School of Business and Management, Hong Kong University of Science and Technology*
Mohd Azmi Omar, *Dean, Institute of Islamic Banking and Finance, International Islamic University, Malaysia*
Oh-Seok Hyun, *President, Korea Development Institute*
Ulambayar Enebish, *Senior Supervisor, Mongolbank*

*Responding anonymously*
4 bank executives

### Europe/Africa

Jeroo Billimoria, *Founder and Vice Chair, Aflatoun Child Social and Financial Education*
José María Lamamié de Clairac, *Director del Departamento de Instituciones Financieras, Banco de España*
Catharine French, *Retail and Business Banking Chief of Staff and Corporate Affairs Director at Barclays*
Arif Jafferji, *Head of Marketing Effectiveness, RBB Central Marketing, Barclays*
James Strachan, *Customer Insight and Market Research, Barclaycard & Barclays RBB, Barclays*
Chris Wood, *Managing Director of Enterprise Development, Barclaycard, Barclays*
Tomas Conde Salazar, *Director of Sustainability, BBVA*
Maria Such, *Director of Brand and Reputation, BBVA*
Ignacio Villoch, *Communication and Branding: Strategy and Innovation, BBVA*
Lauren Hendricks, *Executive Director, CARE Access Africa*
Jonathan McMahon, *Director of Financial Institutions, Central Bank of Ireland*
Mauro Grande, *Director General for Financial Stability, European Central Bank*
Lisa Hehenberger, *Research Director, European Venture Philanthropy Association*
David Blood, *Co-Founder and Senior Partner, Generation Investment Management*
Jon Foster-Pedley, *Dean and Director, Henley Business School, South Africa*
Christopher Steane, *Global Head of Structured Finance, ING*
Peer Stein, *Manager, Access to Finance Advisory, International Finance Corporation*
Geoff Burnand, *CEO and Co-Founder, Investing for Good*
Jeremy Hobbs, *Executive Director, Oxfam International*
Corné Van Walbeek, *Head of Department, School of Economics, University of Cape Town*
Olaf Weber, *Export Development Chair in Environmental Finance, University of Waterloo*
James Gifford, *Executive Director, UN Principles for Responsible Investment*

*Responding anonymously*
1 bank executive

# APPENDIX II: ABOUT THE CENTER FOR RESPONSIBLE BUSINESS AND GLOBESCAN

## About the Center for Responsible Business, Haas School of Business, University of California—Berkeley:

The Center for Responsible Business at the UC Berkeley Haas School of Business is an "action-tank" that brings students, companies, and faculty together to explore issues of corporate responsibility and sustainability and inspire leaders who redefine good business.

*For more information visit:*
http://responsiblebusiness.haas.berkeley.edu/

## About GlobeScan:

GlobeScan supports leadership organizations with evidence-led strategic counsel to manage reputation, build brand value, and create effective sustainability strategy. Established in 1987, GlobeScan is an independent, management-owned company with offices in London, San Francisco, and Toronto.

*For more information visit:*
www.globescan.com