https://dspace.org/

The moral duty of the banking sector to transform

Phillips, John Christian Arthur

2009-01-20T11:52:34Z
http://hdl.handle.net/10539/5951

Downloaded from a DSpace repository. https://dspace.org/

THE MORAL DUTY OF THE BANKING SECTOR TO TRANSFORM

John Christian Arthur Phillips

A thesis submitted to the Faculty of Humanities, University of the Witwatersrand, Johannesburg, in fulfilment of the requirements for the degree of Master of Arts in Applied Ethics.

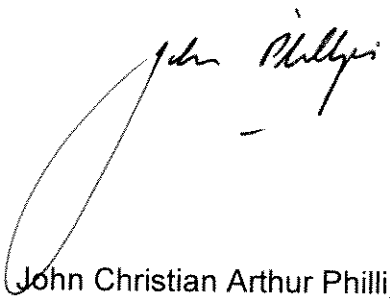
Johannesburg, 2006

Abstract

The major theme of the thesis is to argue that the banking sector has a moral duty to sacrifice a certain portion of its profits for the upliftment of the underclass in society. The transformation of the economy and society can occur within the guidelines and parameters provided by the Financial Sector Charter. The thesis introduces a utilitarian argument in favor of banking sector transformation, which argues that banks have this special responsibility to sacrifice a certain portion of their profits, because it is within their power and make-up to make a difference in society. In other words, they must because they can. Utilitarian theory advocates that something is morally good to the extent that it produces a greater balance of pleasure over pain for the largest number of people involved. One of the most important objections to utilitarianism is that it is unable to account for justice. Another objection is that it is asking or expecting too much of people that they be required to always act from the overriding moral premise of always generally promoting the general welfare of society. Banks have great capacity to do good while still making a legitimate profit. The moral obligation of the banking sector to assist in the upliftment of the poor must be combined with sound business sense, so as to protect the banking system from failure, which could be more damaging to society.

Declaration

I declare that this thesis is my own unaided work. It is submitted for the degree of Master of Arts in Applied Ethics in the University of the Witwatersrand, Johannesburg. It has not been submitted before any other degree or examination in any other university.



John Christian Arthur Phillips
13th day of February 2006.

Acknowledgements

1. I wish to acknowledge the kind assistance of my supervisor, Professor Thad Metz, for his constructive input and guidance.

2. I would also like to thank my employer, ABSA Bank, a truly learning organization, for their assistance and for providing me the opportunity to complete this study.

Contents

		Page
1.	Parts of the thesis	
1.1	Title Page	i
1.2	Abstract	ii
1.3	Declaration	iii
1.5	Acknowledgements	iv
2.	Contents	
2.1	Introduction and thesis statement	1
2.2	Transformation	2
2.3	Challenges facing the banking sector	5
2.4	Utilitarian argument in favor of the thesis	7
2.5	An analysis of utilitarianism	8
2.6	Objections to utilitarianism	14
2.7	Applying utilitarianism to transformation	17
2.8	Stakeholder Theory and banking transformation	20
2.9	Objections to banking sector transformation	25
2.10	Conclusion	34
2.11	References	36

THE MORAL DUTY OF THE BANKING SECTOR TO TRANSFORM

Introduction and thesis statement

My objective is to argue that any bank in a developing country, and in particular a country with a skewed distribution of wealth as a result of past discriminatory policies which favored only a certain segment of society, has a moral duty to sacrifice a certain portion of its profits, with the objective of assisting with the transformation of that country's economy.

The structure of the research report will be as follows: First, I shall explain what transformation is, with special reference to the Financial Sector Charter, and how it applies to the banking sector, in particular. The socio-economic challenges, and their moral imperative, which currently face the banking sector will be highlighted. The moral imperative for the banking sector to transform itself within the guidelines and parameters provided by the Financial Sector Charter provides the underlying basis of argumentation. I shall then introduce a utilitarian argument in favor of the thesis, first analyzing in detail utilitarian theory, and then applying it to the context of transformation of the banking sector. I shall also address the general objections to utilitarian theory as it relates to transformation of the banking sector. This will be followed by a conclusion, which summarizes the main findings of the research report.

Transformation

Apartheid systematically and purposefully restricted the majority of South Africans from meaningful participation in the economy. The assets of millions of people were directly and indirectly destroyed and access to skills and to self-employment was racially restricted. The accumulation process under Apartheid confined the creation of wealth to a racial minority and imposed underdevelopment on black communities. The result is an economic structure that today, in essence, still excludes the vast majority of South Africans. It is crucial to understand the magnitude of what took place in our past in order to understand why we need to act together as a nation to bring about an economic transformation in the interests of, and to the benefit of all citizens.

Transformation is essentially about change. It is about acting in the best interests of South Africa as a nation. It is a process towards a goal and once that goal has been reached a notion should become normalized. In this respect, normality would mean adherence to a constitution that treats all its citizens black or white as bona fide nationals with equal rights and opportunities to prosper and to contribute to its development. It is a necessary change process for normalizing an essentially abnormal society. To provide impetus to the transformation of the South African economy, the state, in consultation with various role players, has decided to set up transformation Charters for identified key sectors within the economy (for example, mining, financial services and telecommunications), which provide the guidelines, legal framework and key targets to be achieved by

these sectors within a given time frame. After a protracted process of consultation, negotiation and compromise, the Financial Sector Charter was signed by the various role players early in 2005.

An overriding principle and objective of the Financial Sector Charter is the growth and development of the financial sector, which is central to the successful implementation of black economic empowerment. This means that targets must be achieved consistent with sound business practice. It provides for increased access to financial services for poor households and communities, and aims to direct billions of Rands of investment into transformational infrastructure, agricultural development, low-income housing and small and medium black business. The main objectives of the Financial Sector Charter are the following:

- to facilitate black ownership in the banking sector. (The Financial Sector Charter has set a target of 25% by 2010.)
- to promote a diversity of institutions that extends access to financial services to the under-banked and the un-banked on a sustainable basis;
- to encourage greater competition in the financial sector as a whole;
- to protect consumers, especially those not financially literate, from exploitation and abuse.

(Absa Group Strategy internal document, p 10).

The Financial Sector Charter has identified the following challenges for the banking sector:

- "it is characterized by the presence of a few large institutions. Many of the smaller and foreign institutions have exited the market in recent years;
- there has been an inadequate response by the sector to the increasing demand for access to financial services;
- there are low levels of black participation, especially of black women, in meaningful ownership, control, management and high-level skilled positions in the sector. There are low levels of black participation, especially of black women, in meaningful ownership, control, management and high-level skilled positions in the sector;
- the sector has not effectively provided credit to entrepreneurs, particularly black businesses; the national level of savings and investment is inadequate to support sustained economic growth and individual financial security;
- there has been an inadequate response by the sector to the increasing demand for access to banking services;
- there is insufficient investment of the savings pool under the control of the sector into targeted investments of national priority;
- a large pool of funds circulates outside the formal financial system, including but not limited to funds held by stokvels *(community savings societies)*, informal traders and in other forms of short-term savings;

- there has been limited support for new black firms in the financial sector by Government and the private sector; and
- they need to find meaningful ways to support the Proudly South African campaign."

(Financial Sector Charter 2005, p 5).

By addressing the abovementioned objectives, the banking sector could make a significant contribution towards economic growth, development, empowerment and reduction of inequalities and poverty in our society, which, I shall argue, should be a moral imperative as well.

Challenges facing the banking sector

In most economies the banking sector plays a central role in enhancing growth and development. The South African banking sector is generally regarded as world class in terms of its skilled workforce, adequate capital resources, infrastructure and technology, as well as a conducive operating, regulatory and supervisory environment. However, the banking sector is confronted with a number of challenges which relate more specifically to the socio-economic transformation of the economy, as specified in the Financial Sector Charter.

The above challenges also highlight the moral imperative facing the banking sector. The combined savings deposits pool of the lower income group of the population makes a significant contribution to the funding of banks, in other

words, the liabilities side of the balance sheet (note that loans advanced forms the primary assets in a bank's balance sheet). It is a cheap form of funding for banks, which in turn have to provide the depositors with a margin income net of costs. In other words, poor folk upon whom banks rely as a source of funding are charged a fee by the banks for providing a safe deposit service for their own money! This funding is then advanced as relatively low risk loans to the more affluent groups in society. The Financial Sector Charter has highlighted various moral dilemmas currently facing the banking sector. These have rightly become complex and heated points of discussion in the formulation of particular bank strategy, which is normally formulated at board level. For the first time in South African banking sector history, the interests of various role players and stakeholders have to be taken into account. Most banks have made strong strides in achieving transformation of the respective board of directors, as required by the Financial Sector Charter. The morality of banking decisions and actions has featured prominently (and will continue to feature prominently in the future) in the public debate. This is a new playing field for the banking sector and has caused much discomfort.

Note that discussion of banking ethics does not form part of the scope of the research report. However, the moral reasoning or justification of certain actions, which forms the basis of the ethical theories referred to in the research report, is clearly based on the principle of ethics. I will offer a practical definition of ethics: Ethics is values, norms and rules that constitute the base for individual and social

relationships, from a perspective that requires treating others well. A professional ethic regulates the relations between individuals within a professional group and their relations with the community whereas an organizational ethic defines the code of conduct in an organization.

Utilitarian argument in favor of the thesis

I will argue that, from a utilitarian perspective, banks have this special responsibility to sacrifice profits for the sake of transforming the economy because it is within their power and make-up to make a difference, in other words, 'they must because they can'. Specifically, banks have an obligation to produce as much happiness as possible in society. Conversely, actions which produce the reverse of happiness, in other words, unhappiness, are immoral. As key institutions of society, banks share in this moral obligation by virtue of their function as financial intermediaries (i.e. accepting money from depositors, rich and poor, at a fee and then lending to borrowers at a fee which includes a margin for profit). There are very few institutions, outside government, that are so well placed to influence the transformation of the economy, by virtue of their actions, and without necessarily following a socialist or welfare agenda. It seems somewhat irresponsible and immoral for banks in a developing and skewed economy to ignore the pleas of the poor, especially when it is in their power to make a difference, without necessarily placing themselves and the entire banking system at risk.

An analysis of utilitarianism

Modern ethical theory has focused on determining the ethical character of actions. This has resulted in the development of two competing ethical theories. (White, p 4). The one theory argues that actions have no intrinsic ethical character, but acquire their moral status from the consequences that they produce. This is referred to as a *teleological* approach to ethical reasoning. The other theory argues that some actions are inherently right (for example, telling the truth) or wrong (for example, lying or stealing). This is referred to as a *deontological* approach to ethical reasoning. I shall focus on the teleological approach to ethical reasoning, which forms the basis for a utilitarian theory.

Teleology is also known as consequentialism. A consequentialist theory of ethical reasoning concentrates on the consequences of human actions, and all actions are evaluated in terms of the extent to which they achieve desirable results. Such theories are evaluated in terms of extent to which they achieve desirable results: teleology is derived from the Greek word *telos*, which means end or purpose. (Donaldson, p 4). According to teleological consequentialist theories, the concepts of right wrong, and duty are subordinated to the concept of the long-term effects of the action.

There are two types of consequentialist theory. The first, which is advocated by only a few philosophers, is called ethical egoism. It defines right action as "action whose consequences, considered among all the alternatives, maximizes *my*

"good", that is, actions which benefits *me* the most or harms *me* the least." (Donaldson, p 4). The second type, which is advocated by most consequentialists, "denies that right action concerns only *me*. Rather, right action must maximize the overall common good (or minimize bad) from the standpoint of the entire human community", and is termed 'utilitarianism'. The principle of utility states that an action is right, if it produces the greatest balance of pleasure or happiness and unhappiness in the light of alternative actions. (Donaldson, p 5). Note that, in maximizing the common good, one must be concerned only with maximizing pleasure. Other things, such as maximizing knowledge, moral maturity, and friendship are good merely as a means to pleasure or perhaps preference satisfaction. Philosophers have also adapted utilitarianism to modern methods of economic theory, by developing "preference utilitarianism", which interprets right action as that which is optimal among alternatives in terms of everyone's preferences.

Essentially, utilitarianism was developed by the Jeremy Bentham and further refined by John Stuart Mill. (White, p 4). Bentham noted the following two putatively self-evident observations, which provides the foundation of utilitarianism:

1. pleasure and pain govern our lives, and;
2. the former makes life happier and therefore the better, while the latter makes life unhappier and therefore worse.

Utilitarianism (therefore) advocates that something is morally good to the extent that it produces a greater balance of pleasure over pain for the largest number of people involved. It is popularly described as 'the greatest good of the greatest number." (White, p 5). According to Bentham, pleasure is the ultimate standard of morality. The main objective of all human action should be to create or provide the greatest happiness to all those peoples whose interests will be affected by our actions. Therefore, all that is required for determining whether or not an action is morally defensible is careful, thorough and fair examination of whom the action helps or hurts and in what ways. In other words, we generally ought to help others, especially those who are less privileged, because in doing so, the greatest social benefits accrue. The action the consequence of which promises the most happiness is the right action.

How does one apply the traditional principle of utility? Firstly, one's race, religion, social status, or condition of birth is considered irrelevant in determining one's ultimate worth. Each person counts for "one", and no more than "one". Second, an important guiding principle in evaluating "happiness" requires one to take into account the happiness, not only of present generations, but also of future generations. Thirdly, to strive for individual pleasure or "happiness" is not reduced to the idea that "one ought to do what makes the most persons happy". (Donaldson, p 5). Utilitarianism does not therefore necessarily subjugate individual interests in favor of majority interests. It also considers the long-term consequences (of short-term actions) for single individuals. Finally, according to

many utilitarians (such as Mill), some pleasures are qualitatively better than others. For example, intellectual pleasure is deemed to be superior to physical pleasure.

Utilitarianism acknowledges that there are often "unequivocal cases of conflicting obligation", in determining moral responsibility. For instance, how do banks decide whom in a certain sector of society should receive assistance? Mill offers the view that, whilst, "unequivocal cases of conflicting obligations" do often arise and thereby provide real difficulties for an individual in terms of his personal conscience and conduct, in following or being guided an ethical standard, "they are overcome practically, with greater or with less success, according to the intellect or virtue of the individual." (Sher, p 307). If utilitarianism is the ethical standard being applied in determining the source of moral obligation, in those instances of deciding between conflicting rights and duties (for example, stockholders versus community interests), the principle of utility (maximization of happiness / the common good) can be applied.

Generally, utility is associated with the 'maximization of welfare' or the greater good from scarce economic resources that must be protected because they are a means to achieving this end. This is further illustrated in the following passage by Goodin: "Utilitarianism of whatever stripe is, first and foremost, a standard for judging public action – action which, whether performed by private individuals or public officials, affects various other people besides just yourself." (Singer, p

245). It is against this standard or principle that the moral duty of banks to transform and which essentially is a public action (rather than a private choice) which requires a reallocation of resources, must be considered.

I now address how the utilitarian deals with public / private issues. According to Goodin, "Ethics is a theory of social relations," and the requirement for ethical relations is to do good for people. (Singer, p 241). Something must be good, somehow, for someone. In other words, 'utility' in its most general form, means 'useful': "I do what will produce the best results." The basic utilitarian formula equates to the sum of individual utilities taken impersonally across everyone affected. Utilitarian theory acknowledges that the calculations will often lead us to show some apparent favoritism towards our love ones, because it is easier to know what people close to us need (the underclass who are part of our society), and how best to help them. It is also easier to get the necessary aid and assistance to them efficiently, without losing too much in the process. "It makes a good deal of utilitarian sense to assign particular responsibilities for particular people and projects to other people near to hand." (Singer, p 247).

We can distinguish between two groups of utilitarians, namely act utilitarians and rule utilitarians. (Donaldson, p 6). An act utilitarian believes that the principle of utility should be applied to individual acts. Therefore, one measures the consequences of each individual action according to whether it maximizes

"good". An act utilitarian would analyze a problem from the viewpoint of the individual and the situation he confronts at a given time.

A rule utilitarian, on the other hand, believes that instead of considering the results of specific actions, one must weigh the consequence of adopting a general rule exemplified by that action. According to the rule utilitarian, one should act according to a general rule which, if adopted by most in society, would maximize the "common good". The focus is on the general rule and not on the individual act. An example of a general rule could be the following: "Never decide on an action to be taken by your organization in a manner which may lower the self-respect or dignity of a given class of citizens in a society." For instance, if banks were to insist on providing separate and inferior banking facilities for a certain sector of society, say the lower income group, they would be lowering the self-respect and dignity of that class of society. If everyone followed the rule of not lowering people's self-respect, then happiness would be maximized more than the rule that lowers self-respect.

The following case illustrates the difference between act and rule utilitarianism: Suppose a bank client is experiencing financial distress due to his own negligence, for example poor discipline and financial mismanagement, and as a result is in default of his loan terms and covenants. The bank is faced with the situation to either call-up the facilities, liquidate the securities and recover whatever loss that it can. This would lead to the loss of job opportunities and the

resultant negative economic externality. The act utilitarian would argue that the bank has a moral duty to determine which action would produce the best results for all parties involved. The appropriate action might be to give the client a break to help him try to save the business. This can be done by for instance, by appointing a mentor or consultant to the business to improve the financial management, thereby reducing or eliminating the total anticipated loss. The client does not want to lose his business and the bank does not want to lose the client and its money net after the liquidation of collateral and legal costs.

The rule utilitarian would argue not to make an exception of the client, who is in default through his own negligence, by giving him the above assistance. If the defaulting client were to receive assistance from the bank, it would follow that, in terms of the rule utilitarian definition, all negligent and hence defaulting clients would have to receive assistance or lenient treatment from the bank. And if that were to happen, then clients would feel not an obligation to honor their loan obligations and this would undermine the fabric of lending between bank and counterparty. Cleary, this situation would be untenable for the banking industry and would eventually undermine the entire banking system, at great cost to society. I will appeal to rule utilitarianism in this essay.

Objections to utilitarianism

Utilitarianism is criticized for the "impersonal summation of utilities (which) renders it insensitive to the distribution of people", which may lead to the

concentration of wealth in the hands of a few people (the leftist argument), or it could lead to the sanctioning of a radical redistribution of private property (the objection from the right). The utilitarian response to this objection is the economic law of 'diminishing marginal utility', which states that, the utility that you derive from the first unit of a good (for example food or money) is higher than that you derive from the second, and so on. Therefore, utilitarians would be reluctant to radically redistribute property and wealth for "empirically contingent reasons", because they recognize the value of stability and security in planning their own lives and in anticipating the ways that the life plans of other citizens would affect their own.

One of the most serious objections to utilitarianism is that it is unable to account for justice. Because the utilitarian concentrates on the consequences of an action for a majority, the employment of the principle of utility can be argued to allow injustice for a small minority. For example, if the overall "common good" were maximized in the long run by legally enslaving say two percent of the population, utilitarianism on the face of it, is seemingly forced to condone slavery, which of course is clearly unjust. The obvious utilitarian response is that slavery will not, as a matter of empirical fact, maximize the "common good". Rule utilitarians would argue that society should embrace the general rule, "never to enslave others", because in adopting this principle, the common "good would be maximized in the long term.

Another objection to utilitarianism is that it is asking or expecting too much of people that they be required to always act from the overriding moral premise of always generally promoting the general welfare of society. In reply Mill argues that thus is "to mistake the very meaning of a standard of morals and confound the rule of action with the motive of it." (Sher, p 303). Although it is the objective of ethics to highlight and identify our moral obligations and therefore obliging us to observe certain moral duties, ethics does not require from us that the sole objective of all of our actions should be motivated by a sense of obligation or duty. "The vast majority of our actions is performed with other motives in mind, and is morally acceptable if the rule of duty does not condemn them. The motive has nothing to do with the morality of the action, though much with the worth of the agent." ((Sher, p 304). Utilitarianism does not require individuals to perform actions with the sole motive of complying with the utilitarian principle and thereby primarily benefiting society. Most of the actions of individuals in society are intended for their own benefit (private utility) and collectively they serve the common good (public utility). It is, therefore, morally acceptable in terms of utilitarian philosophy.

Furthermore, the ability of an individual to be a "public benefactor" is generally very limited. But, surely, in those instances where an individual is in a position to make a significant contribution to the welfare of society, he is morally obliged or duty bound to follow those actions. If we consider the role that banks perform in society and their relative size, and hence their inherent ability to assist in the

social and economic transformation of society, then surely they have a moral duty to take certain actions which are for the benefit of society. Just what these actions should be and the priority and extent of these actions over and above their mission statements and stockholder requirements, is something I address below.

Conversely, it is morally required of individuals to avoid personal actions, despite the motivation of private utility, which ultimately harms society. For instance, it is wrong to litter the countryside because you are too lazy to make the effort of disposing of the litter when it is more convenient to yourself. Following from this, whilst it may be desirous of banks to always act in their own best interests, and therefore to choose to ignore taking actions which do not maximize profits, they may in fact be acting immorally, because paradoxically their actions could in fact be harming society in the long-run. This harm is manifest in the perpetuation of a skewed economy, sub-optimization of resources, loss of business opportunity and the tacit contribution to maintaining social instability. On the basis of moral obligation it would appear, on the face of it, that abstinence by banks from actions aimed at transforming society, and motivated purely from shareholder considerations, could be immoral.

Applying utilitarianism to transformation

Within the South African context, the issue of corporate social responsibility ["CSR"] is of particular importance due to our apartheid history and the

perception that the South African banking system was, to a greater or lesser extent, in cahoots with the government of the day, and if not willing participants, and at worst, beneficiaries of that socio-political system. From this premise, it can be argued that South African banks should share the burden of eradication of inequalities, in other words, it is their moral duty and not mere compliance with legislation, which is a utilitarian idea. Banks cannot separate themselves from certain sectors of the economy and occupy the moral high ground by claiming that they have a duty and right to their shareholders only.

The welfare or happiness of poor people is no less important than that of other people in society. Poor people also deserve or have a right to be happy. This happiness is generally directly linked to their personal wellbeing. Banks are also members of a community of persons, and for them to ignore to assist poor people would be wrong and therefore immoral, especially if it was within their means to do so. The morality or otherwise of corporate social responsibility will have to be examined in greater depth.

There exists a strong moral argument, as evidenced in the various policy debates regarding the Financial Sector Charter, that banks have this moral responsibility to actively engage in the socio-economic transformation of South African society, because of their special role in the economy, and also because they have benefited financially (by growing their wealth as evidenced in their respective balance sheets and share prices) and otherwise, from past discriminatory

economic policies. For instance, they did not invest or lend to those perceived 'high risk' segments of the population, with the result that very little development (residential or business) occurred in those communities. This, despite the fact that banks have been quite prepared to accept deposits from these communities, which are significant in monetary terms, when considering the volume of deposits made by individuals. There must be a *quid pro quo*, if financial and social stability (included in the definition of the role of banks in the economy) is to be achieved. The 'sacrifice of profits (capital)' by earmarking investments or amending lending policies to advancing these funds to disadvantaged communities in a way that they still make business (and banking) sense and not just becoming a handout or wastage of what is essentially the shareholders' money, does also have potentially positive spin-offs for banks, in that new untapped markets can be identified and developed. In this scenario, shareholders and investors will eventually benefit, in that new wealth is created.

There are many ways in which banks could sacrifice a portion of their profits for the greater common good. For example, banks may offer broad based ownership to previously disadvantaged groups in preference share transaction deals, which effectively provide such groups with board representation, where they can influence the policy and strategic direction of the particular bank. Banks could also introduce mentorship support programs for black entrepreneurs involved in start-up businesses. The proposed funding of mortgages for the lower housing market (designed on a similar basis as the Fanny Mae bonds in the United

States) by means of bonds which can be taken up by the investor community, and which is a joint initiative between the state and the banking sector, in which the state will share in the financial risk of default and provide certain limited guarantees to banks, is an excellent example of how banks can sacrifice a portion of their profits in the short term, but still likely leverage from the benefits of this action in the future. The argument is that these communities will be in a position to acquire an asset (home) which will provide security for future lending. The introduction of state guarantees to cover the identified monetary portion of the advance at risk (in other words, the unsecured portion of the advance), as a creative form of collateral, in mitigating the risk, is a further example of sound partnership.

Stakeholder Theory and Banking Transformation

My utilitarian argument entails a form of stakeholder theory of corporate social responsibility. In terms of stakeholder theory, management has a moral obligation to advance the interests of all stakeholders in the business in other words, the stockholders, management, workers, government, suppliers and the broader community in its actions. This suggests that rule utilitarianism favors stakeholder theory, that a rule that would most benefit society if routinely followed would be one instructing firms to help all stakeholders. Stockholder theory conversely, claims that management has a moral obligation to help only the owners of the business, in other words, the stockholders / shareholders.

Because stock ownership in banks (as public listed companies) is spread out among hundreds or thousands of people, ultimate authority in banks is vested in a board of directors, a group of individuals, appointed by the stockholders and responsible for seeing that the company is properly managed. Traditionally, this has been understood to mean that business is conducted so that the interests of the owners, that is, the stockholders, will be maximized. Corporations (banks) are sometimes referred to as identifiable and autonomous entities. But, are they really? Their existence is based on the principle of "delegated agency", whereby managers and employees are supposed to act in the best interests of the real owners, that is, absent and passive stockholders.

In contrast to a narrow focus on shareholders, stakeholder theory says that companies have a corporate social responsibility that requires them to promote the interests of the communities and the nation in which they are located. According to this view, combating environmental pollution, reducing formal unemployment, protecting the local economy, contributing to charity, and supporting schools and other local welfare causes are just a few of the social responsibilities companies are said to have. In terms of the stakeholder theory, corporate social responsibility is expanded to include the protection of the interests of anyone affected by corporate actions, that is, anyone who holds a stake in the outcome (Carroll, p 24). Stakeholders, therefore, include employees, suppliers, customers, the state, and members of the immediate community.

These groups claim an equal footing with stockholders when corporate decisions are made.

The view is not that the rights of workers and society enjoy prominence over those of stockholders, but rather that stockholders may have to agree to accept less earnings or a lower return on investment, if the interests of others are to be promoted. This does not necessarily mean that the bank decision-makers should become over-burdened by moral demands on their time, energy and resources. What it requires is for business to concern itself with the consequences of its actions. To reason that it is not appropriate for banks to concern themselves with a social agenda, and that the only moral requirement for business is to make sure that it does not harm anybody in "safeguarding the property rights of stockholders", is flawed and short-sighted. There is a distinct difference between the harmful effects that business may cause by its direct actions, and the other harm caused in other indirect ways, the adverse impact of which business could have prevented or softened.

According to Lippke (p 522), the stakeholder theory / "social niche approach" has various important moral implications for decision-makers in business. In utilizing natural resources in for instance, a mining or manufacturing process, business must be aware of the legal constraints, as required by the state, which may inhibit their actions or result in increased costs. But, not only must business be aware of the legal framework (which supports the public policy, in other words,

being representative of the democratic interests of society); it is also morally compelled to abide by it and to support it, as would be required of any good citizen. Note that such action goes beyond the narrow objective of profit maximization only. Rationalization or cost-cutting strategies which result in the closure of non-profitable bank branches (in favor of more sophisticated electronic banking channels), which are usually located in poorer areas, leading to the loss of job opportunities and other externalities, is perfectly acceptable in terms of the stockholder theory. However, it has significant moral impact in terms of the stakeholder theory ("social niche approach"), which questions its morality. There is a sense that workers and other affected members of the community "deserve better" than to be on the receiving end of unilateral action by business, in termination of the contractual relationship, simply because business cannot consider itself and / or its actions independent from the community it serves. This is an open system with many interrelationships and co-dependencies. In determining the morality of action, the reality of the situation must be taken into account.

A further adverse effect of the above actions upon workers may be of a psychological nature, in that their self-worth may be compromised through the actions of business. They have significant moral impact. In certain circumstance, workers may not be mentally fit to continue working and as a consequence their capacity to acquire wealth may be terminated. Also, they may be forced to use their acquired wealth (life savings and pensions) in a less satisfactory or optimal

manner. What does this have to do with banks? Well, for one, banks could be more tolerant of businesses in distress and especially where the failure of a firm could have far-reaching and disastrous effects on the underclass, by further contributing to unemployment and thereby perpetuating the cycle of poverty. The recent closure of various textile factories due to the influx of cheaper Chinese clothing apparel is an example of a distressed industry. Banks in co-operation with the state could protect these jobs, through a 'rescue action' where banks would have to sacrifice certain profits / capital (for example through lower interest rates, restructure of the advance / loan, taking up equity in the distressed business, or by advancing an interest moratorium or 'holiday' for the distressed business), the idea being that the participating banks will be rewarded, not only with tax breaks in the future, but also with a 'moral reward' by saving the business and the jobs. From a moral and a business perspective, this seems sensible.

I am defending the stakeholder theory in this essay. The moral duty of the banking sector to transform assumes that something must be done to change things as they are. This can be done, for instance, by the board taking actions that not only benefit the owners of the banking business (stockholders), but also, by being courageous enough to take far-reaching decisions which will take the interests of all stakeholders into account, create greater utility and happiness for the greater society. There can be no doubt of the morality of this goal. The banking sector should be prepared (despite the legal requirements of the

Financial Sector Charter) to transform from a moral perspective and not only a legal perspective. I appeal to utilitarian theory as part of my argument. It is clearly the right and proper thing to do, because of the good and happiness this action will create for the underdeveloped majority of our society.

Objections to banking sector transformation

One of the most forceful objections raised to my rule utilitarian argument is that there is a danger that interventionist policies motivated by a moral agenda could in fact result in more harm that good, in other words, it may lead to an unintended consequence. To illustrate this point, consider the following scenario. If banks were to allocate too much capital for corporate responsibility programs at the expense of core business which requires them to price for risk, the equity base could be eroded or destroyed over time, as little profit is added to retained income or the non-distributable reserve. The protection of a bank's equity base which is also referred to as the 'capital adequacy' is critical for a bank's credit rating and solvency and hence its continued existence. From a consequentialist perspective, the quantum of profit / capital 'sacrificed', without creating a risk for the banking sector and the economy, needs to be determined. From a moral perspective, some sacrifice is called for, we just do not know how much. Banks are very sensitive to socio-economic reengineering strategies, because of the nature of their business as financial intermediaries as evidenced by the composition of their capital structure and balance sheets. The regulatory requirement for capital adequacy ratio is 10%, in other words, banks are legally

obliged to hold capital of at least 10% to their total funding. Generally, most South African banks have a capital adequacy on average of 18%. Should banks then be required to forfeit a certain percentage of their profit, they could then weaken their capital adequacy ratio to a marginal level and place the bank at risk. In the event of bank distress and / or failure, not only the shareholders would suffer, but also the depositors and other stakeholders, such as communities and government (reduced revenue from reduced or no taxes).

There is the danger that banks begin to take on the social responsibility of the state, and that the fabric of the financial system could be undermined, as the economic system ultimately becomes more and more socialist. Certainly, the prevailing legislation, the level of taxes paid and their individual and collective financial strength / health in relation to their international counterparts would indicate to what extent banks operate in a socialist system.

The most apparent solution to this dilemma is to get the balance right between the respective roles and responsibilities of the private and public sector. As previously stated, the activities of the state and business cannot be clearly separated. The provision of services by security firms and private postal services are examples where business has taken on what was previously regarded the duty and function of the state, to the benefit of all. The state cannot provide public goods and services as efficiently as the private or business sector. By acknowledging this fact and by establishing public-private sector partnerships or

by providing certain tax breaks for compliance with a transformation agenda, this could be a win-win for both parties as well as the broader civil society. If all banks and without exception followed the rule of implementing a corporate social responsibility program this would obviously be to the common good and create a great deal of happiness. Banks have far greater skill in delivering efficient services than the state. The cost of any corporate social responsibility program is in any event a cost to banks, albeit relatively small in relation to the cost of total banking business, and therefore it is tax deductible. In other words, these activities which aim is to uplift the poor are funded indirectly by tax revenue which is forfeited by the state. In allowing such tax deductions, the state acknowledges the role of the private sector in sharing in the burden of poverty alleviation and socio-economic transformation, through the provision of efficient and effective service assistance to the poor. This does not suggest that the only reason why banks have a social responsibility program is that it is tax deductible. It should rather be considered as a very necessary service to one of its stakeholders, in other words, the greater community, upon whom banks are reliant for their existence.

There is of course a monetary limit to the extent of bank involvement in corporate social responsibility programs, without which the economy could be seriously damaged. This level is not very difficult to determine and in any case, corporate social responsibility program advocates accept that it is not a primary function of business and generally are very modest in determining the total amount

budgeted as a percentage of the total business operations. The indirect benefits of a corporate social responsibility strategy, could include, reduced cost structure, better supplier relationships (BEE, Black Economic Empowerment), greater staff pride, brand and customer loyalty. Moral considerations have indicated that is about the common good (for example, social development and poverty alleviation) which is created in a society and the resultant happiness which inevitably follows.

But does a bank's moral obligation and self-interest coincide? Should banks be prepared to lose their profits / capital and not to rely on ever recovering same? I believe that the answer to this is affirmative (yes), as this should just be 'business as usual' in the risk assessment process which is the core business function of any bank. In the business of lending, there is no certainty or guarantee. To argue that lending and investment policies which have a social agenda are without (or carry unacceptable) risk, and are therefore mutually exclusive, is false. There are many ways to mitigate (although not eradicate) the level of risk within the risk appetite parameter and credit risk profile set by the board of directors.

The risk of lending to the poor who have limited or no collateral, and consequently have a high loan default probability, can be mitigated in many ways, for instance, through the utilization of state guarantees (for example the existing Khula guarantee scheme, which is a State guarantee which underwrites 80% of the total advance to the SMME, Small Micro and Medium Enterprises,

sector), and through the implementation of a franchise (where the franchisor supports the franchisee in various ways, for instance, a financial control and reporting system) and mentor support system for emerging black entrepreneurs. Furthermore, there are many empirical examples of successful social upliftment programs funded directly or indirectly by banks. Examples include, learnership training programs, accelerated management training programs for employment equity candidates, the construction of medical clinics and schools in rural areas, financial support for feeding programs, the installation of auto tellers and mobile self-contained banks in rural areas and in townships, and the provision dedicated financial and skills support for BEE businesses. These examples obviously require a sacrifice of distributable profits, the cost of which is normally approved by the board of directors when the corporate social responsibility strategy and accompanying budget is set and reviewed on an annual basis.

A further solution could be for the state and banks to form 'public / private sector partnerships' in pursuing the goal of social and economic change in a developing country. It cannot just be the responsibility of the state, mainly because of the limitations in the delivery mechanism of the state to effect and implement development policy. The state must also make certain concessions, in pursuing this agenda, by for instance providing certain tax breaks for banks who invest and lend to 'high risk' communities.

The model which calls for a distinct separation of the duties and responsibilities between business and the state is outdated and is in my view no longer viable. It is too simplistic to be applied to a developing country, especially one with such skewed wealth and income distribution as we have in South Africa. The distinction between the private and the public domain has gradually eroded over time, due to the fact that there are certain things which reside in the public domain, but can be performed more efficiently and effectively by business. This does not suggest that business should now start providing welfare services on unprecedented scale, rather this view accepts the reality of interconnectivity (and hence active and creative co-operation between business and government to resolve social issues) and the need to ensure sustainability for the whole of society. The failure of government to deliver on its election mandate, and the reaction thereto by the electorate, represents a very serious threat to the social fabric and stability of society, and therefore ultimately to the survival of business and especially banks.

Whilst there may be some merit in this argument in that certain dangers (for instance the continued stability of the entire banking system) are highlighted when banks enter the public realm, these can easily be avoided through consultative action and close involvement with the community, and through clear and honest communication with all stakeholders. In any event, the primary objective is to ultimately empower the recipient. It is his / her interests which are also being served. No doubt, the cynical argument that the real reason why a

particular bank has a corporate social responsibility strategy / program, is really just to enhance its own interest, for instance, through brand positioning and image polishing. This may not detract from the positive consequences of such action for the recipient.

A further question that arises is to what extent banks should depart from their core business, mission statement and responsibility to shareholders and stakeholders in serving the above agenda period. In terms of the stockholder theory, the primary responsibility of bank management is to serve their shareholders, the owners of the business. To depart from this fiduciary responsibility would therefore be wrong and immoral. It is the state's responsibility to uplift the poor through the execution of its socio-economic policies. Business provides the funding through taxation, and therefore does not have a further moral burden to assist the poor. The most authoritative view on this argument is offered by Friedman, in his essay, *"The social responsibility of business is to increase profits".* Friedman takes a hard and narrow line and argues against the claim that corporations (banks) have broad social responsibilities. His argument is rather that corporations (banks) are not the appropriate agencies for social assistance, for that role, the state must take responsibility for social development initiatives.

Management (board of directors) as agent of the owners (shareholders) of the bank must act in the interests of the owners and if management squanders

money on corporate social responsibility programs, they are acting in breach of their fiduciary duty to them. Banks are an integral part of society and management who are the custodians of the bank, also have moral duty towards their various stakeholders, given the interrelatedness of the various business relationships.

But, this argument assumes that the state and business operate completely independent of each other and that there is a very clear distinction in their respective objectives. This is of course not true as the activities of the state and business are in fact interrelated through the provision of certain goods and services. A good example of this is where the state is the provider of transport and energy, extracting a fee in the form of taxation to fund large scale capital intensive projects such as railway networks and electricity plants, in partnership with business. There is no particular reason why there must be such a clear distinction between their respective duties and / or division of labour. There are various examples, for instance, private education facilities, hospitals and toll roads, where state partnerships have developed to the benefit of all.

This argument also assumes that all corporate social responsibility programs are a waste and do not produce any good or benefit, which of course is untrue. The empirical evidence provided by, for instance, sponsored adult literacy programs, suggests otherwise. Furthermore, management would not be neglecting their fiduciary responsibility through involvement in corporate social responsibility

programs. It is in fact, quite the opposite. They would be enhancing their record of conduct, through their attempts to alleviate poverty which would lead to a more stable society in the long-run. This would be better for business all-round and is therefore hardly a breach of their promise to the owners of the business.

Executive management within the banking sector should not only be guided by the requirements of the Financial Sector Charter (with it socio-economic transformation agenda), but they should also accept their corporate social responsibility towards the various stakeholders, which inevitably requires certain actions which reduces the amount of money available to distribute as a dividend for the stockholders. As indicated above, banks do not operate in a vacuum and as financial intermediaries they play a critical role in the economy. They are very susceptible to adverse economic conditions and are also constantly searching for new business opportunities through which to enhance their economies of scale. Contrary to popular belief, banks do not make profits in a recession when interest rates are normally very high. Such periods or situations are usually accompanied by high rate of business failure and bad debt charge which is written off against capital. The relative health of the economy and welfare of society is as much concern to banks as it is to the state. The society in which they operate provides them with the reason or basis for their existence as banks. The sacrifice of distributable profits at an appropriate and pre-determined level makes good business sense in the medium- to long-term, although this is not the underlying motivation for a corporate social responsibility strategy or program. The forfeiture

or sacrifice of bank profits in favor of a corporate social responsibility program is outweighed, and certainly from a moral perspective, by the good created for the broader civil society.

There is a third objection that, because banks are not answerable to society in the same way that governments are, their corporate social responsibility endeavors may be viewed as paternalistic and disrespectful because the recipients do not have comparable power. Whilst there may be some merit in this argument in that certain dangers (for instance the continued stability of the entire banking system) are highlighted when banks enter the public realm, these can easily be avoided through consultative action and close involvement with the community, and through clear and honest communication with all stakeholders. In any event, the primary objective is to ultimately empower the recipient. It is his / her interests which are also being served. There is a cynical argument that the real reason why a particular bank has a corporate social responsibility strategy is really just to enhance its own interest, for instance, through brand positioning and image polishing. This does not, however, detract from the positive consequences of such action for the recipient.

Conclusion

Banks have a great capacity to do good while still making a legitimate profit. They often hold the keys to a bridge across which so many of us must pass if our dreams and aspirations are to become a reality. However, few of us will cross a

structure in which trust is wanting. In such circumstances, banks and society suffer alike. The moral obligation of banks has to be determined and their resulting moral implications have to be combined with good business sense. The failure of a bank and the resultant knock-on effect on the banking system, could ultimately cause far greater moral damage for all spheres of society. But this does not mean that banks should be freed from their moral responsibility of transforming the economy and / or helping the underclass.

REFERENCES

1. Absa Group Strategy internal document, July 2004, pp 1 – 31.

2. Donaldson, T, & Gini. Case Studies in Business Ethics. Prentice Hall, Englewood Cliffs. 1990. p 1 – 12.

3. Metz, T, Professor. Personal interview and written input to the study report.

4. The Financial Sector Charter. 2004. pp 1 – 22.

5. White, T.I. "Business Ethics – A philosophical reader." New York. Macmillan Publishing Company. 1993. pp 1 – 27.