The Pursuit of Sustainability by a Global Commercial Bank

by

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ABSTRACT

"What is Corporate Social Responsibility?" "How can it be achieved?" These questions have been central themes in business management for the last decade. In particular, protecting the global environment is now recognized as common wisdom throughout the world. In fact, many companies worldwide have initiated steps to challenge environmental issues, and various methods have been developed to measure the impact. It must be said, however, that most companies have not directed their attentions to economic and social issues, such as human rights and poverty, on which companies can exert enormous influence.

This thesis examines the next courses of action for the commercial banking industry in its efforts to pursue global sustainability. Already commercial banks have as their primary mission to circulate money in a global society. In this thesis, I explore a revolution in global banking in terms of habits of thought and action, and habitual artifacts.

First, I address current discussions among international organizations about global sustainability, including the serious impacts stemming from the current world financial crisis, and the policies and activities of commercial banks. Second, I research recent examples of multinational companies and NGOs that are striving to understand and mitigate the negative impacts to society. Finally, I explore how to design a global commercial banking system that helps commercial banks achieve their goal of sustainability.

Thesis Supervisor: Wanda J. Orlikowski
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"It is easier said than done." Global sustainability, I believe, is one issue that this proverb is exemplifies well. In particular, the commercial banking industry, which has a significant role as a circulatory organ of global society, is a strong contributor to the issue. However, the industry is now at the root of the financial crisis that has exerted tremendous negative impacts on global society today.

Although the discussion in this thesis is conceptual, I also think it is well timed to draw a new picture for the future. The global economy is beginning to recover, and the commercial banking industry can be expected to be a full participant in such a discussion.

I would like to express my heartfelt thanks to my thesis advisor, Professor Wanda J. Orlikowski. Despite her busy schedule, she always found time to have meetings with me. Her encouragement and thoughtful suggestions helped me to remain strongly motivated while writing this thesis over the last five months.

I am also deeply grateful to MIT Senior Lecturer Peter Senge. He kindly gave me suggestions as to the latest discussions on the role of financial corporations. Furthermore, in a class at the Leadership Lab at MIT's Sloan School of Management, I learned from Peter and Wanda what leaders ought to do to tackle complex issues. This learning experience is now one of the biggest events in my life.

I also want to say thanks to Cherie Potts for her editing. She devoted considerable time to offer me helpful suggestions on formatting and expression.

Finally, I very much appreciate my wife Miwako and son Yuto. Miwako spends countless hours devoted to Yuto, who has congenital diseases, while at the same time providing me the best environment to conduct my research. Yuto, who is four years old and speaks only Japanese, started in a special class at the local preschool. I know it is hard for him, but he has made steady adjustments and improvements and has almost completed that big challenge! I am enormously proud of him!!

Taking a leaf from his efforts, I have pledged to myself that I will do my best to achieve solutions to the challenging and complicated issues that humans need to resolve in the near future.

Katsunori Yokomaku
Cambridge, Massachusetts
May 2010

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List of Acronyms

ASRF	Asymptotic Single Risk Factor
BIS	Bank for International Settlements
BoA	Bank of America
CDO(s)	Collateralized Debt Obligation(s)
CSR	Corporate Social Responsibility
Citi	Citigroup
EAD	Exposure At Default
EL	Expected Losses
FED	Federal Reserve System
GRI	Global Reporting Initiative
HSBC	HSBC Holdings
IFC	International Finance Corporation
IMF	International Monetary Fund
IRB	Internal Rating-Based (Approach)
JPMS	JP Morgan Chase
LGD	Loss Given Default
MDGs	Millennium Development Goals
MNE(s), MNC(s)	Multinational Enterprise(s), Multinational Corporation(s)
MUFG	Mitsubishi UFJ Financial Group
NGO	Nongovernmental Organization
PD	Provability of loss
PRI	Principles for Responsible Investment
PSD	Private Sector Development
UKFSA	UK Financial Services Authority
UL	Unexpected Losses
UN	United Nations
UNDP	United Nations Development Programme
UNEPFI	United Nations Environment Program Finance Initiative
UNGC	United Nations Global Compact
VaR	Value-at-Risk
WB	World Bank

CHAPTER 1
INTRODUCTION

Undertaking radical challenges to achieve global sustainability, that is, to enhance the positive effects and/or mitigate the negative effects on social and economic issues, is extremely difficult for most private companies, including commercial banks. Indeed, to date it is unprecedented. However, long discussions about the challenges show that it is imperative for the future, and people are waiting in anticipation for solutions to achieve this goal. Panelists at numerous conferences say it is time for global leaders to create a new system instead of merely treating the symptoms.

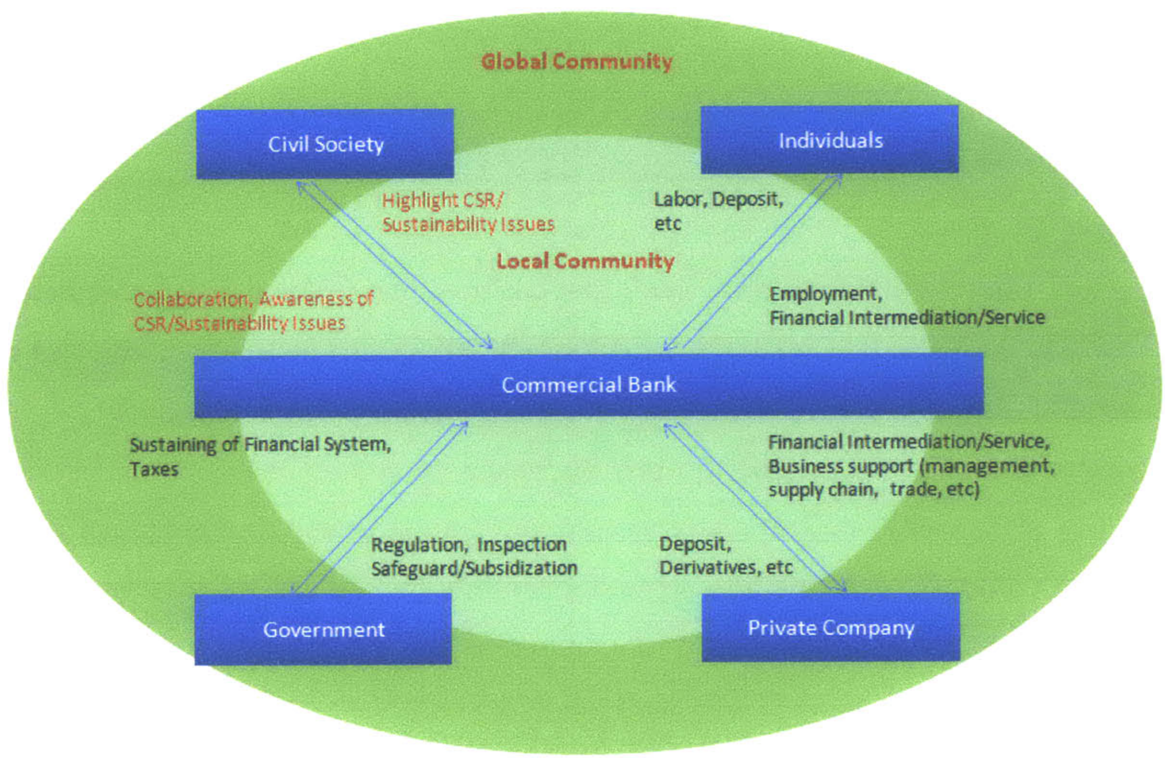
Many leaders ask: What can we do to achieve global sustainability? While they can identify ideal strategies, the method for executing those strategies is often unclear. And even if they define concrete methods for carrying out an idea, uncertainties about the effect of the idea may cause them to hesitate in making a decision. Senge et al. (2008) state:

> The real artistry of leadership comes not from creative tension alone but from understanding and working with its inevitable companion, emotional tension. Dealing with fear, anxiety, stress, anger, sadness, resignation, and even despair is an inescapable aspect of leadership because such emotions naturally arise when we face the gap between our visions and reality. *When you consider the enormous size of the challenges related to food and water, energy and climate change, waste and toxicity, and the growing gaps between rich and poor, you would not be human if you did not experience emotional tension.* [emphasis added] (pp. 295-296)

It appears to be true that considering unprecedented ideas from the perspective of existing measures is difficult. It is a serious challenge to change a conventional system, but bringing forward leading-edge propositions is a necessity.

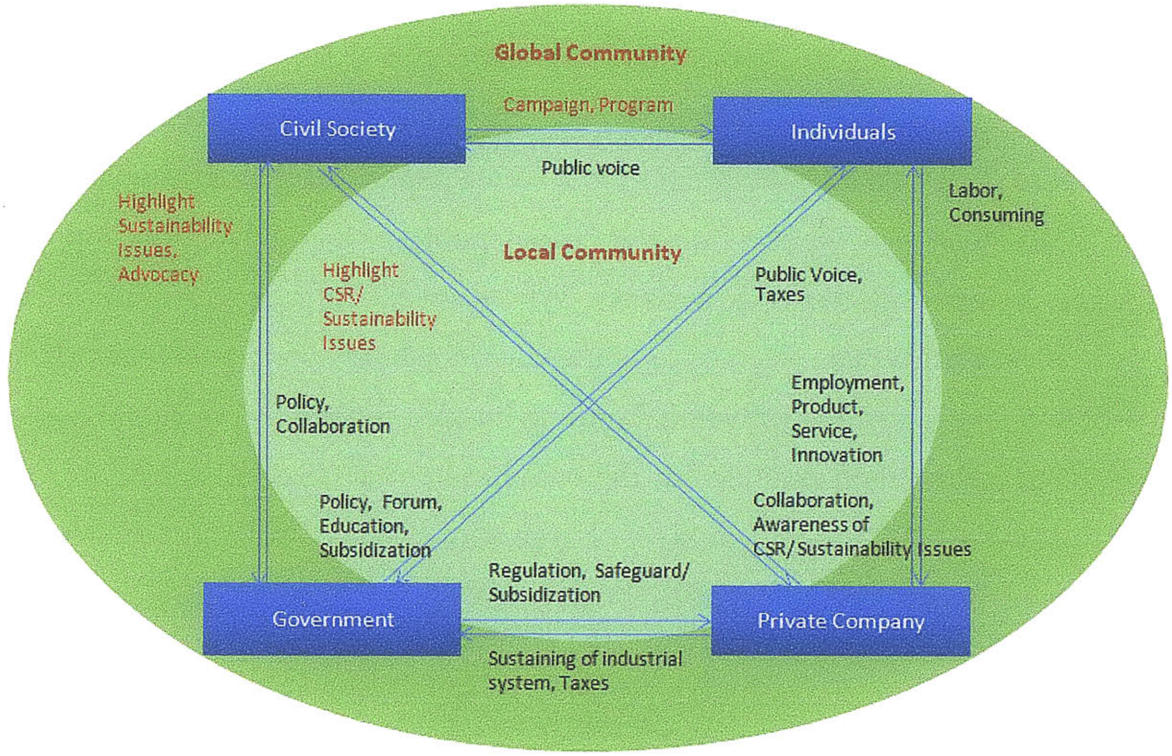
It is difficult to advocate, reach agreement, and bring out new proposals in transparent, reliable, and practical ways. An effective leader is one who has the ability to manage the tension between the vision and current reality, and that skill is critical to achieving the ultimate goal in which a new social system is developed.

In this thesis, I explore how to change habits of thought, action, and artifacts in the commercial banking business. When considering change, examining the dynamics of the social system is fundamental. Moreover, close involvement with the people in the system is essential. Defining current relationships with stakeholders and recognizing their opinions in the broad system are crucial (see Figure 1). The relationships between stakeholders of commercial banks hints at the direction of discussion (see Figure 2).



Source: Author

Fig. 1: Relationships between commercial banks and their stakeholders



Source: Author

Fig. 2: Relationships between the stakeholders of commercial bank

With these two figures, I will first address international organizations such as the United Nations (UN) and World Bank (WB), which shape prevailing and expert opinion through research, in order to highlight issues of global sustainability. These organizations advocate for the private sector, including the commercial banking industry, and also address government functions. Current thoughts and actions in such organizations are helpful for understanding the discussion in civil society.

Next, the CSR philosophy of commercial banks is discussed, as well as actions taken to date. To support my research, I developed in-depth case studies of four multinational companies and NGOs. Information from these case studies is useful for understanding current situations and global sustainability trends.

Finally, I discuss how a new system should be designed, and what commercial banks should do to change their systems.

The challenge in this thesis is to elucidate habitual thoughts, actions, and artifacts in the commercial banking industry. In particular, I specifically address international commercial banks in view of the magnitude of their impact on society.

I must confess I was one of the people who endorsed Japanese banks' expanding investments into securitized products such as collateralized debt obligations (CDOs), which I believe are one of the main culprits in today's financial crisis. Now my desire is to address the financial crisis by considering a different role for commercial banks.

Readers may doubt the practicality of the revolution that I call for in this thesis. But such a revolution depends on each leader's firm faith and resourcefulness. I believe that to date, only the smallest steps have been taken to pursue sustainability in social and economic aspects.

As to my research method, I considered insightful discussions among specialists and organizations wherever possible, analyzed core principles of the commercial banking industry, and organized the points at issue based on my personal experience.

Just as I began working on this thesis, I was fortunate to participate in and complete an on-site project at MIT which supported an NGO. That NGO is now designing a new methodology, which will enable private companies to contribute to reducing negative social impacts. As part of the project, I was given opportunities to interview the NGO's stakeholders, including clients, competitors, consultants, and internal personnel. I successfully presented a strategy to implement the methodology.

At the same time, I was also in charge of strategic management at a Japanese bank, and often discussed the challenges of sustainability with the Corporate Social Responsibility (CSR) Office, which was located in an area behind my desk. During my thesis research, I incorporated some of the insights I had obtained from the project and my experiences in a real business field.

Corporation 20/20 (2010), an international initiative, has formulated new principles of corporate design, as follows:

- The purpose of the corporation is to harness private interests to serve the public interest.
- Corporations shall accrue fair returns for shareholders, but not at the expense of the legitimate interests of other stakeholders.
- Corporations shall operate sustainably, meeting the needs of the present generation without compromising the ability of future generations to meet their needs.
- Corporations shall distribute their wealth equitably among those who contribute to its creation.
- Corporations shall be governed in a manner that is participatory, transparent, ethical, and accountable.
- Corporations shall not infringe on the right of natural persons to govern themselves, nor infringe on other universal human rights.[1]

Based on my experiences and my intuitions behind them, I agree with these principles. Commercial banks are also corporations. Therefore I will examine these principles, and use them to explore new designs for the commercial banking system.

[1] Corporation 20/20 website: http://www.corporation2020.org/

CHAPTER 2

GLOBAL SUSTAINABILITY IN THE FINANCIAL SECTOR

In this chapter, I address current discussions in global organizations that generate insightful opinions about global sustainability and the role of the financial sector. This will enable me to identify what will be next anticipated from the sector.

2.1 What is Corporate Social Responsibility?

The International Finance Corporation (IFC) defines CSR this way:

> Corporate social responsibility is the commitment of business to contribute to sustainable economic development by working with employees, their families, the local community and society at large to improve their lives in ways that are good for business and for development.[2]

The United Nations Development Programme (UNDP) describes CSR as:

> . . . a spectrum of business activities ranging from philanthropy on one end via strategic social investments to how business processes can become more sustainable and contribute more effectively to equitable development.[3]

Taken together, CSR can be defined as the commitment and creation of business designed to support a sustainable world for all constituents.

In order to translate CSR concepts into action, many major companies apply the United Nations Global Compact (UNGC). UNGC describes the Compact as follows:

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[2] IFC website: http://www.ifc.org/ifcext/economics.nsf/context/csr-intropage

[3] UNDP website: http://www.undp.org/partners/business/corporate_social_responsibility.shtml

> . . . a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of *human rights, labour, environment and anti-corruption*. By doing so, business, as a primary agent driving globalization, can help ensure that markets, commerce, technology and finance advance in ways that benefit economies and societies everywhere. [emphasis added] [4] (see Appendix 1)

The UNGC, which has been applied by more than 7,700 enterprises from 130+ countries, is a broad initiative to encourage corporate citizenship and sustainability worldwide. It proposes multi-stakeholder partnerships, alignment of the international community and the business, in order to respond to social, political, and economic challenges, including Millennium Development Goals (MDGs) (see Appendix 2). In this context, the role of private enterprises is becoming more important.

In fact, CSR has become one of the most carefully deliberated issues in private companies during the last decade. UNDP indicates:

> Stakeholders ranging from investors, consumers, communities, employees and government officials are increasingly demanding that companies behave responsibly and look at how their positive impact on society can be maximized.[5]

Many companies establish their corporate philosophies from a CSR standpoint and publish disclosures such as a "CSR Report" or "Sustainability Report." Observing the number of such reports, it is obvious that private company efforts to take on environmental challenges are making great strides forward.

However, CSR includes other issues too. In particular, human rights issues are often not detailed in reports from private companies, so it is difficult to obtain a comprehensive picture of each enterprise's contributions to global sustainability and their value. For instance, Barclays PLC (2008) identifies material sustainability issues

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[4] UNGC website: http://www.unglobalcompact.org/AboutTheGC/index.html

[5] UNDP website: http://www.undp.org/partners/business/corporate_social_responsibility.shtml

as the following:

- Responsible products and services
- Customer and client support
- Social, ethical, and environmental impact of investments
- Climate change
- Human rights
- Financial crime
- Corporate governance and shareholder activism
- Financial inclusion and microfinance
- Employee welfare
- Community investment
- Compliance and policy formulation
- Economic impact (p.8)

Barclays says these items were selected for their relevance to global banking. However, the precise meaning of "human rights" was not clearly conveyed.

Mitsubishi UFJ Financial Group (MUFG) (2009), the largest commercial bank in Japan, determined key issues for society and priority themes from global business, including the following:

- Key Global Issues
  - Global environmental issues, as symbolized by the advancing state of global warming and climate change.
  - Poverty and related issues (for example, hunger, labor, human rights and education).
- Group CSR Priority Themes
  - Addressing Global Environmental Issues: Address global warming, climate change and other global environmental issues which are becoming increasingly serious.
  - Nurturing Society's Next Generation: Nurture society's next generation that will address issues like global environmental problems and poverty on a global scale . . . . (p.5)

In its CSR report, MUFG stated that human rights is related to poverty. The bank attached a Content Index indicating items required to report by the Sustainability Report Guidance which Global Reporting Initiative (GRI) provides. In pages related to human rights, management policies are identified but quantitative results in a fiscal year are not reported. It appears to be a subject for future consideration. In short, it is unclear what large commercial banks should do in the context of human rights.

How should commercial banks recognize human rights? What concrete actions should they take? These core questions go to the heart of fulfilling a business's corporate social responsibilities.

2.2 What are Human Rights?

The United Nations Environment Program Finance Initiative (UNEPFI) defines human rights as:

> . . . basic rights that form the foundation for *freedom, justice and peace* and which apply equally and universally in all countries. The internationally agreed definition is contained within the Universal Declaration of Human Rights proclaimed in 1948 by the United Nations General Assembly. [emphasis added][6] (see Appendix 3)

Government has a major role to play in advocating for human rights and providing a general framework for society. According to the OECD (2008):

> . . . links among economic, social, and environmental progress are a key means for furthering the goal of sustainable development. On a related issue, while promoting and upholding human rights is primarily the responsibility of governments, where corporate conduct and human rights intersect enterprises do play a role, and thus MNEs are encouraged to respect human rights, not only in their dealings with employees, but also with respect to others affected by their activities, in a manner that is consistent with host governments' international obligations and commitments. The Universal Declaration of Human Rights and other human rights obligations of the government concerned are of particular relevance in this regard. (pp. 39-40)

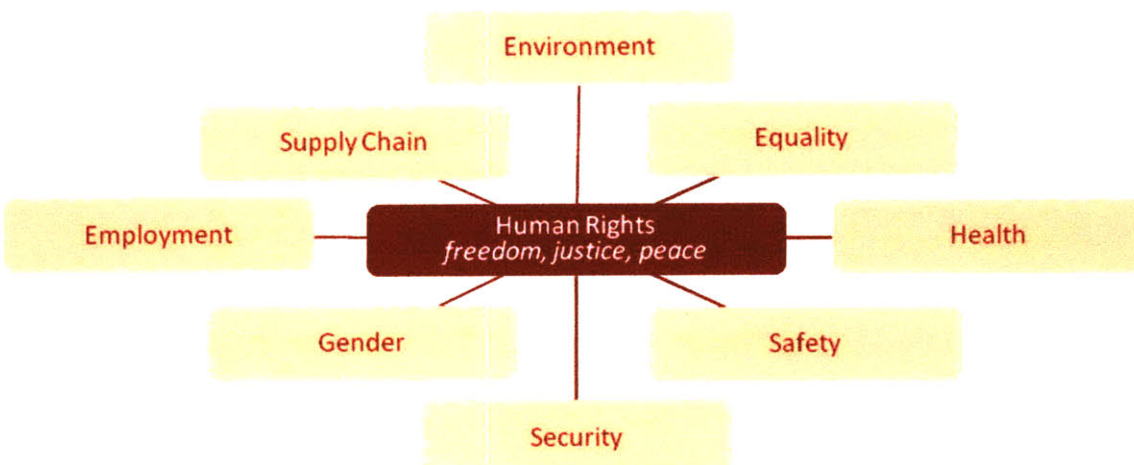
However, today private companies in all industries need to find ways to

[6] UNEPFI website: http://www.unepfi.org/humanrightstoolkit/what.php

support these rights creatively rather than merely complying with them as a general philosophy. UNEPFI suggests that human rights should reach other areas such as:

- employment practices
- health and environment
- safety and security
- labor relations in the supply chain
- respect for disadvantaged groups and minorities[7]

Based on these premises, private companies, including commercial banks, should take into consideration factors such as the environment, equality, health, safety, security, gender, employment, and the supply chain when addressing human rights (see Figure 3).



Source: Author, based on discussions by the UNEPFI and OECD

Fig. 3: Human rights

The next consideration is how commercial banks contribute to each factor. For example, nowadays there are several metrics with which banks can measure their operational impact on the environment. These metrics set a series of targets to

[7] UNEPFI website: http://www.unepfi.org/humanrightstoolkit/business.php

reduce carbon emissions and enforce expansion of the emissions trading market. In addition, banks usually provide employee healthcare, as well as provide financial services that help the healthcare industry to expand. Furthermore, maintaining the safety and security of the financial system and customers' privacy are primary responsibilities of commercial banks, while diversification by nationality and gender is also specifically promoted.

However, how much real contribution the commercial banks make toward equality and optimization of the supply chain is exceptionally complex. Identifying a system that supports these aspects is a key to enabling every bank to make a meaningful contribution to human rights. Before discussing such a system, I will first consider the principles that shape private sector development (PSD).

2.3 Major International Organizations' Approaches to Private-Sector Development

It is axiomatic that PSD has a beneficial influence on existing private sectors in both developed and developing countries. Hence, a major international organization's approach to PSD is a compass that gives direction to a company's strategy, including commercial banks.

The UNDP (2007) identifies its approach to PSD as a creation of inclusive markets:

> . . . UNDP will base its future approach to the private sector on the concept of facilitating the development of "Inclusive Markets." The overall aim will be to ensure that markets work better for the poor as entrepreneurs, wage employees and consumers. (p. 4)

It mentions five primary issues:

1. Policy advisory support will be provided to governments that wish to establish legal and regulatory frameworks for rule-based and non-discriminatory markets,

including robust and transparent market institutions that promote fair competition whilst safeguarding the rights of producers, employees and consumers and *ensuring the inclusion of the poor.*

2. *Assistance will be provided for the development of integrated value chains* in market sectors that offer the prospect of sustainable growth and transition to higher valued added and better remunerated forms of employment. *Priority will be given to commodity product and services markets that are characterised by high labour intensity.*
3. Building on existing programmes in the area of pro-poor investment, further research on 'bottom of the pyramid' investment opportunities and sustainable business models will be undertaken in order to support countries to identify and facilitate the development of market sectors for key basic goods and services. Where appropriate, *further support will be provided for the development of innovative pro-poor business models and the implementation of public private partnerships in sustainable local infrastructure provision.*
4. Renewed efforts will be made to promote entrepreneurship for the poor, in keeping with the objectives of the 2004 'Unleashing Entrepreneurship' Report. To this effect, UNDP in conjunction with other development partners and the private sector, will support *the design and delivery of new best-practice-based entrepreneurship development initiatives* that are tailored to address local market realities. Specific efforts will be made to promote women's entrepreneurship.
5. *Continued efforts will be made to advocate for the use and alignment of private sector CSR resources* in ways that contribute to the development of inclusive markets. Corporate partners will be encouraged to align their CSR activities more closely to the achievement priorities 1-4 (above) as well as to the achievement of the MDGs and the UN's development mandate more broadly. [emphasis added] (UNDP, 2007, pp. 4-5)

The WB and IFC focus on three core areas for PSD, including financial sector development:

1. Creating an institutional foundation for effective markets (example: poverty rights, collateral systems, corporate governance, financial market infrastructure.
2. Promoting open and competitive markets (example: opening up entry, access to finance for promising firms, deeper and more liquid financial markets, and exit for failing firms).
3. Supporting social safety nets with market-based instruments (examples: financial market-based instruments and risk management for pensions and insurance systems as well as low-income housing). [8]

Furthermore, the WB concentrates on financial market integrity (e.g., anti-money laundering, combating the financing of terrorism), global capital markets (e.g., securities market development, non-bank financial institutions, corporate governance), and financial systems (e.g., financial policy development, prudent oversight, systemic stability).

Based on these examples, commercial banks should commit to the core areas of poverty, labor, supply chain, entrepreneurship, and assistance with building a stable financial system.

[8] IFC website: http://www.ifc.org/ifcext/economics.nsf/Content/Home.

2.4 Challenges to Human Rights

2.4.1 A System Dynamics Approach

Commercial banks need to understand the impact of their business on equality and on poverty. In the case of commercial banks, the impact goes further than normal banking activities like lending, to a more complex system. Banks need to be sensitive to forces arising from larger social systems that interconnect business, equality, and poverty.

Figure 4 is a causal loop diagram that helps understand the relationships between the banking business, equality, and the poor. In the figure, there are five reinforcing loops (R-Loops). They illustrate how the bank's actions lead to improved "Equality", which is one of the most crucial material factors leading to greater protection for human rights (refer back to Figure 3), via "Standard of Living", "Solvency in poor", or "Nation's pursuit of equality". The loops work together in the following manner:

1. Enhancement of the financial system (R-Loop 1)
   - The bank's business development and support for creating a local financial system, in conjunction with international commercial banks, will improve solvency in the poor country.
2. Community capacity building (R-Loop 2)
   - Developing and conducting new business in poor countries, in conjunction with the local community, generates employment which increases national income.
3. Engagement with private companies (R-Loop 3)
   - With the commercial bank's collaboration and oversight, private companies in developed countries are urged to create new business in the poor country, which helps expand the local economy.
4. Development of the financial system to support new ventures (R-Loop 4)

- Expansion of the financial system causes new financial functions to invest in entrepreneurs in the poor country.

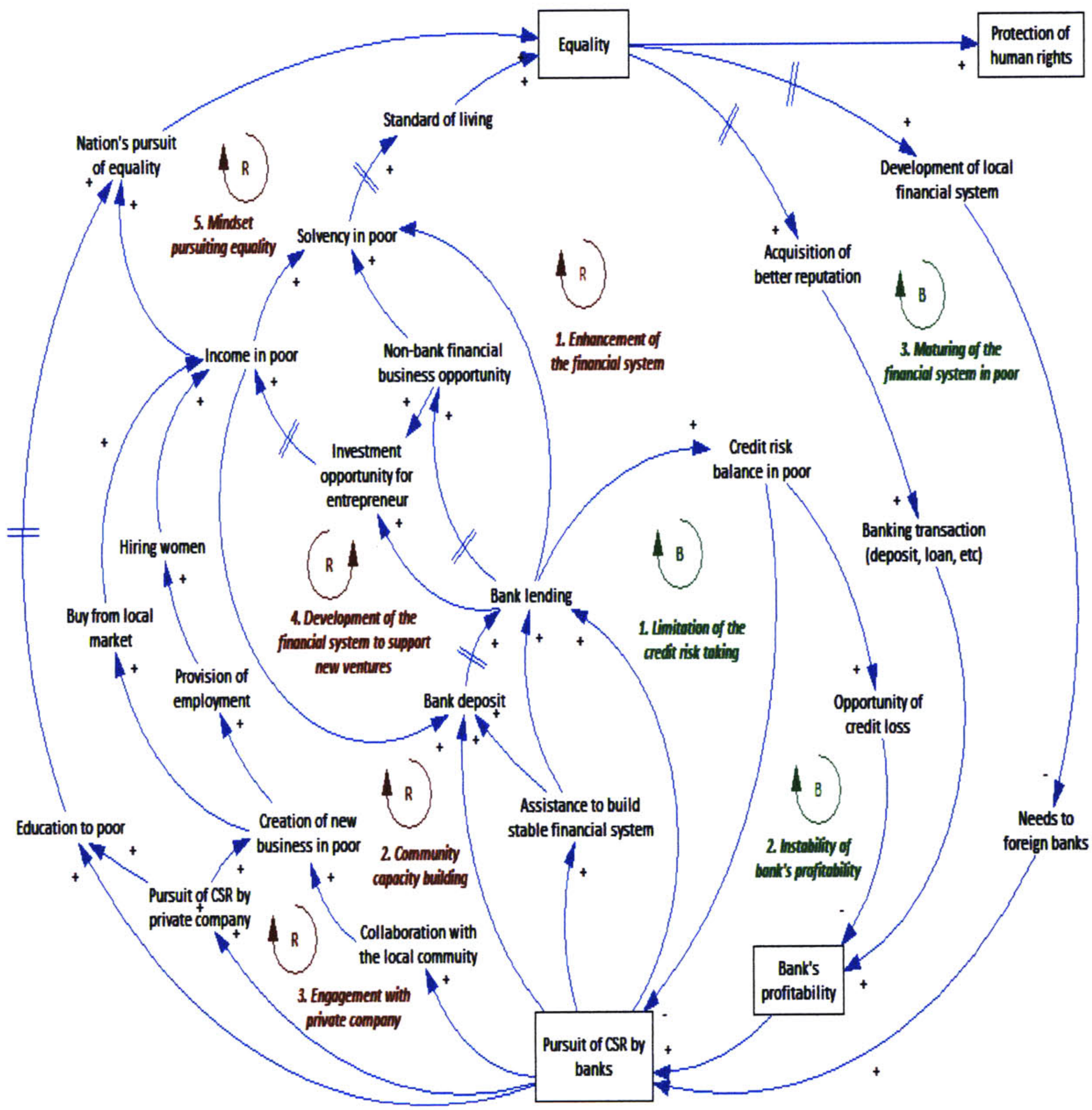
5. Mindset pursing equality (R-Loop 5)
   - Once income begins to increase, it has a positive impact on people's minds, which further improves their standard of living.

As "Equality" is improved, people in the poor country will praise the efforts of the commercial bank, which leads to increased "Bank's profitability." Taken together, all the loops illustrate that by pursuing CSR it helps the bank to realize both goals: human rights and the bank's growth.

On the other hand, there are three balancing loops (B-Loops):

1. Limitations of credit risk taking (B-Loop 1)
   - As credit exposure increases, the bank will run into a limit on how much sustainable lending it can give to the poor country.
2. Instability of the bank's profitability (B-Loop 2)
   - Through expansion of the bank's credit exposure in the poor country, there will be more likelihood that the bank will suffer credit loss.
3. Maturing of the financial system in the poor country (B-Loop 3)
   - Equality is a key factor in the local financial system, but expectations for international commercial banks will be reduced.

Due to current regulatory requirements for capital adequacy, the volume of credit risk which the bank can take on is limited. Moreover, the possibility of new credit losses may reduce future profitability. Yes, "Maturing of the financial system in poor" should be recognized as perhaps the best result for foreign commercial banks. However, before that, those banks become afraid to increase their credit assets which should be covered by capital adequacy and also may provide negative opportunities result in lowering their profitability.



R: Reinforcing Loops (R-Loops), B: Balancing Loops (B-Loops)

Source: Author

Fig. 4: Causal loop diagram:

Seeking human rights, equality, and business advantages for the bank

This brings us back to the question: How can commercial banks tackle poverty? It is a crucial question, which I will address in Chapter 6. In general, banks have difficulty achieving poverty reduction in a dynamic system, but if they are successful, it also brings enormous pride in the achievement.

2.4.2 Measuring Poverty

The UN *Handbook on Poverty Statistics* (2005) describes poverty this way:

> Poverty is multifaceted, manifested by conditions that include malnutrition, inadequate shelter, unsanitary living conditions, unsatisfactory and insufficient suppliers of clean water, poor solid waste disposal, low educational achievement and the absence of quality schooling, chronic ill health, and widespread common crime. . . However, because it is not easy to define or measure, monitoring poverty in its broad manifestations is a complex task conceptually and empirically. (p.6)

Clarifying the typical aspects of poverty and determining how to undertake statistical analysis is of paramount urgency. The UN (2005) also offers guidance on this issue:

> Despite the breadth of concerns, social scientists still find it useful to focus on poverty as *a lack of money*—measured either as low income or as inadequate expenditures. . . . The 2004-5 survey by UNSD showed that of 84 countries that responded to the question, almost half base their poverty calculations on expenditure data, about 30 percent base the calculations on income data only, and 12 percent use both. . . .
>
> The usual next step is to identify a poverty line. A poverty line typically specifies the income (or level of spending) required to purchase a bundle of essential goods (typically *food, clothing, shelter, water, electricity, schooling, and reliable healthcare*). [emphasis added] (pp. 29-31)

The headcount index, poverty gap, and squared poverty gap are recommended methods for measuring poverty.

This guidance seems suitable for country-level analysis. However, such a macro perspective is not applicable when attempting to value a private company's activity. I researched various methodologies developed by NGOs, indices, and consultants, and found very little worth considering. A private company's range can be very broad, and all the business factors—promotion, labor market, supply chain—are becoming more and more diverse due to globalization.

According to the UNDP (2008):

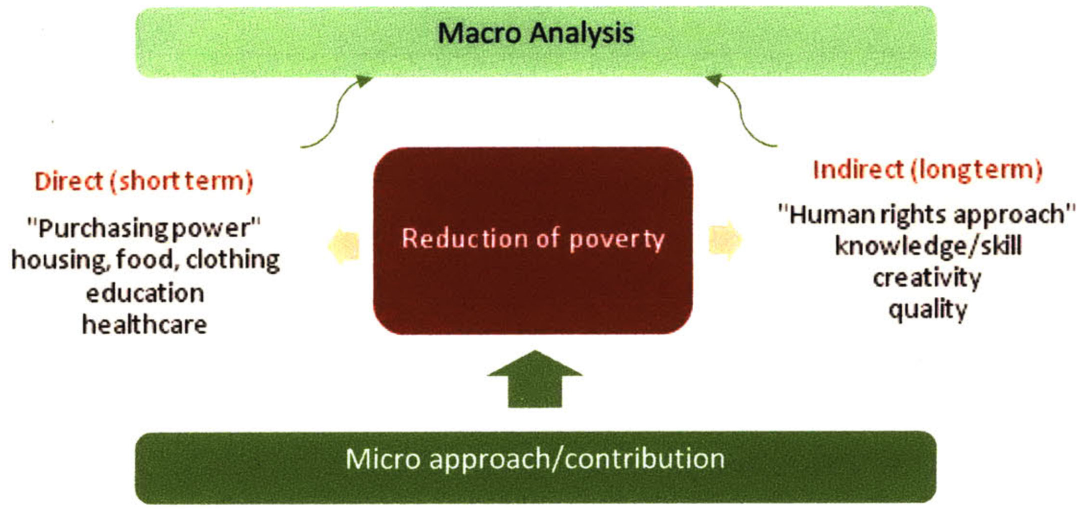
> Poverty is traditionally defined as a lack of income or ability to consume. But the human development approach goes beyond what it sees as a limited definition of income and consumption. The *human development approach* makes people the ends rather than the means of development, so that increased income and consumption are valuable only insofar as they improve people's lives. Human development is two-sided. It involves forming people's capabilities through *improved health, knowledge and skills.* It also involves using these capabilities to achieve what is valued. The approach also places more emphasis on *the quality and distribution of growth* than conventional measures like GDP. The underlining objective of human development is to enable people to enjoy *long, healthy and creative lives.* [emphasis added] (p. 25)

Formulating a strategy as to how a private company's contribution will improve poverty is difficult. However, two factors should be considered (see Figure 5):

- Direct impact to develop purchasing power;
- Indirect impact to accumulate intangible assets.

The first factor is measured in the short term; the latter varies over the long term.

Developing techniques to measure poverty is a constant challenge. The idea of linkage between macro figures and an individual company's contribution should be taken into account, but nevertheless the challenge is exceedingly difficult.



Source: Author

Fig. 5: Reducing poverty: How can it be measured?

2.4.3 Reporting

A dependable reporting system is indispensable for both internal and external business purposes. Prior to taking various management decisions in a company, qualitative and quantitative analyses of relevant facts need to be carried out. External stakeholders may ask the company to deliver a report in order to discuss with or evaluate the company. The reporting system may have been improved considerably, but it is likely inadequate for some areas within CSR, such as poverty. The OECD concludes: "The emergence of private initiatives for corporate responsibility—including the development of codes of conduct, management systems for improving compliance with these codes and non-financial reporting standards—has been an important trend in international business over the last 25 years." [9]

In particular, UNEPFI (2006) cites the excellent work done by GRI:

[9] OECD website: http://www.oecd.org/department/0,3555,en_2649_33765_1_1_1_1_1,00/html.

> At the global level we have the GRI reporting guidelines, strengthened by the recent release of the new G3 reporting framework, and this is certainly the best practice approach that any institution can strive towards. The critical issue, however, is that a financial institution begins on the journey of sustainability reporting in a manner that makes sense to them, their clients, broader stakeholders and the environment. A steady progression from the earliest of reports covering basic internal environmental issues right up to fully GRI-compliant reports creates learning inside an organisation which is invaluable in every respect: performance; staff attitude; reputation; and a connectivity to the broader community which enables institutions to understand their clients needs more fully and identify new markets more readily. (p. 1)

UNGC and GRI (2009) also found:

> Stakeholders—customers, civil society organizations, communities, governments, investors, employees—increasingly expect appropriate management of business activities to avoid negative impacts. There is also a growing expectation that companies should take steps towards positive societal impacts, including in the area of human rights, and develop robust public reporting of how they are performing in these areas.
>
> Sustainability reporting supports the deeper integration of human rights into business practices, by establishing an external accountability mechanism as well as stimulating companies to improve their internal management systems as part of the process of developing reports. However, many businesses still struggle with defining how to embrace human rights concerns and embed these into their business practices and public reporting. While a growing number of tools related to human rights and business provide useful guidance for companies, most do not provide detailed information on human rights reporting. (p. 5)

Both organizations (2009) listed current trends as follows:

- Notable progress, strengths, and innovations
  - Stakeholder inclusion
  - Implementation reporting

- Positive contribution to human right

- Continued challenges and weaknesses
  - Equating community with philanthropy
  - Lack of performance reporting and impact reporting
  - Lack of balance
  - Significant gaps in reporting content
  - A gap in reporting on sustainability context
  - Absence of human rights from assurance
- Area for further discussion and research
  - Placement and highlighting of human rights issues in reporting
  - Reporting on human rights outside of sustainability reports

The gaps between ideal goals and realities have been recognized. Many consultants and NGOs struggle to bridge the gaps through collaborative studies with private companies. Commercial banks, however, have enormous amounts of data about their clients, i.e., private companies. The banks may need to develop ways to contribute to poverty issues through suitable uses of their accumulated data.

2.5 What Can be Anticipated from the Financial Sector?

2.5.1 Human Rights Approach

Considering human rights is important for risk management and effective business development. According to the UNEPFI:

> Recognition is growing amongst many businesses that awareness of their own human rights impacts and public and political expectations of corporate behaviour, nationally and internationally, is an important component in managing risk and securing and maintaining a license to operate. Respect for human rights may in some markets enhance the

competitive edge of a company as consumers value ethical behaviour. [10]

The UNEPFI also produced a report that specifies core ideas relative to the private sector:

- in addition to compliance with national laws, the baseline responsibility of companies is *to respect human rights;*
- the corporate responsibility to respect exists independently of States duties;
- a company *cannot compensate for human rights harm* by performing good deeds elsewhere;
- to discharge the responsibility t*o respect requires due diligence.* [emphasis added] [11]

Private companies, including commercial banks, are required to frame a policy outlining their policies with respect to human rights, and then show how their performance measures up in terms of protecting human rights. This is the metric that commercial banks need to develop and make operational.

2.5.2 Building a Financial System in Poor Countries

The WB believes that for enhancement of business attractiveness in developing countries, they should:

- Build capacity - strengthen their governments and educate their government officials.
- Create infrastructure - implement legal and judicial systems that encourage business protect individual and property rights, and honor contracts.
- *Develop financial systems* - robust enough to support endeavors from micro credit to financing larger corporate ventures.
- Combat corruption - or there is not much that can be done that is effective.

[10] UNEPFI website: http://www.unepfi.org/humanrightstoolkit/business.php.

[11] UNEPFI website: http://www.unepfi.org/humanrightstoolkit/specialrep.php

[emphasis added][12]

"Develop financial systems" is a theme that commercial banks need to adopt. In general, adequate liquidity in financial markets and smooth settlement operations enable a financial system to be stable. Once stability has been achieved, the system begins to earn trust which encourages more participants to enter into the market. In this situation, the positive spiral encourages money flows to expand steadily, which increases income and expenses.

What are commercial banks expected to do? Regarding the development of a financial system in developing countries, the UN (2008) states:

> The development of a sound and broad-based financial sector is central to the mobilization of domestic financial resources and should be an important component of national development strategies. We will strive for diversified, well-regulated, inclusive financial systems that promote savings and channel them to sound growth generating projects. We will further refine, as appropriate, the supervisory and regulatory mechanisms to enhance the transparency and accountability of the financial sector. We will aim to increase the domestic supply of long-term capital and promote the development of domestic capital markets, including through multilateral, regional, subregional and national development banks.
>
> To achieve equitable development and foster a vibrant economy, it is vital to have a financial infrastructure that provides access to a variety of sustainable products and services for micro-, small- and medium-sized businesses, with particular emphasis on women, rural populations and the poor. We will make sure that the benefits of growth reach all people by empowering individuals and communities and by improving access to services in the fields of finance and credit. (p. 5)

In this context, commercial banks have various options for contributing to the construction of a financial system, such as development of products, construction of

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[12] WB website: http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,contentMDK:20040565~menuPK: 1696892~pagePK:51123644~piPK:329829~theSitePK:29708,00.html.

a broader network, instruction on general banking operations, employment, financial education, and so on. Such contributions will have a positive influence on creating an effective financial system.

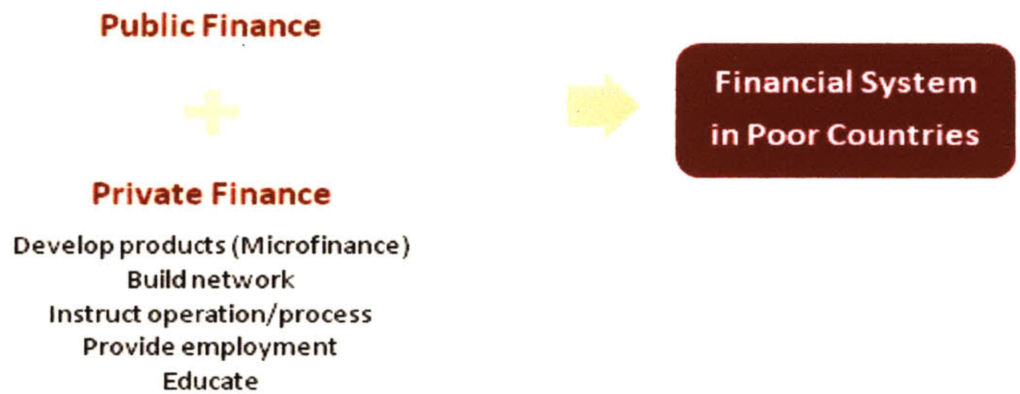
The IFC (2000) has similar expectations of private financial institutions:

> Financial institutions and capital markets play a special role in development and poverty reduction by mobilizing savings, including the savings of poor persons themselves, and by allocating resources. In this sector, too, most sustainable and sustained expansion is by private financial institutions.
>
> Microfinance institutions empower poor individuals; they often provide the means to accumulate very small-scale capital, which is absolutely crucial to making possible economic and social mobility. Some microfinance institutions also offer a safe repository for savings for people who would not use formal banks, thereby reducing insecurity. Larger and more sophisticated financial institutions make similar benefits available on a much wider scale, creating channels for resource mobilization and allocation and for bringing information to bear on economic processes. (p. 19)

The OECD (2007) talks about the collaboration between public and private finance in the Local Economic and Employment Development (LEED) Programme:

> Financing local development is not simply a question of finding the public money required to invest in a local productive base, or wider economic development opportunities. How local development is financed plays a key part in defining what the goals of local development may be, and the extent to which the outcomes will be sustainable in both financial and economic terms. Financing local development involves both public and private finance, including philanthropic financing, and the mix of these varies very broadly throughout OECD Member Countries. It also concerns multiple actors and the banking sector is one of these. The mutual benefit and credit co-operative sector represents an important part of the banking sector but its contribution to the funding of local development has not yet been studied sufficiently. If, as a general rule, an area's economic development is influenced by the actions and strategies of the banks operating there, certain of them, such as the mutual benefit and co-

operative banks, have a specific vocation to support local development as this corresponds to their statutory mission. (p. 1)



Source: Author

Fig. 6: Creation of a financial system in poor countries

Although public finance now helps to develop the financial system in developing countries, I believe that resources and knowledge of private finance will be conducive to a stable financial system and diverse economic circulations (see Figure 6).

2.5.3 Supply Chain

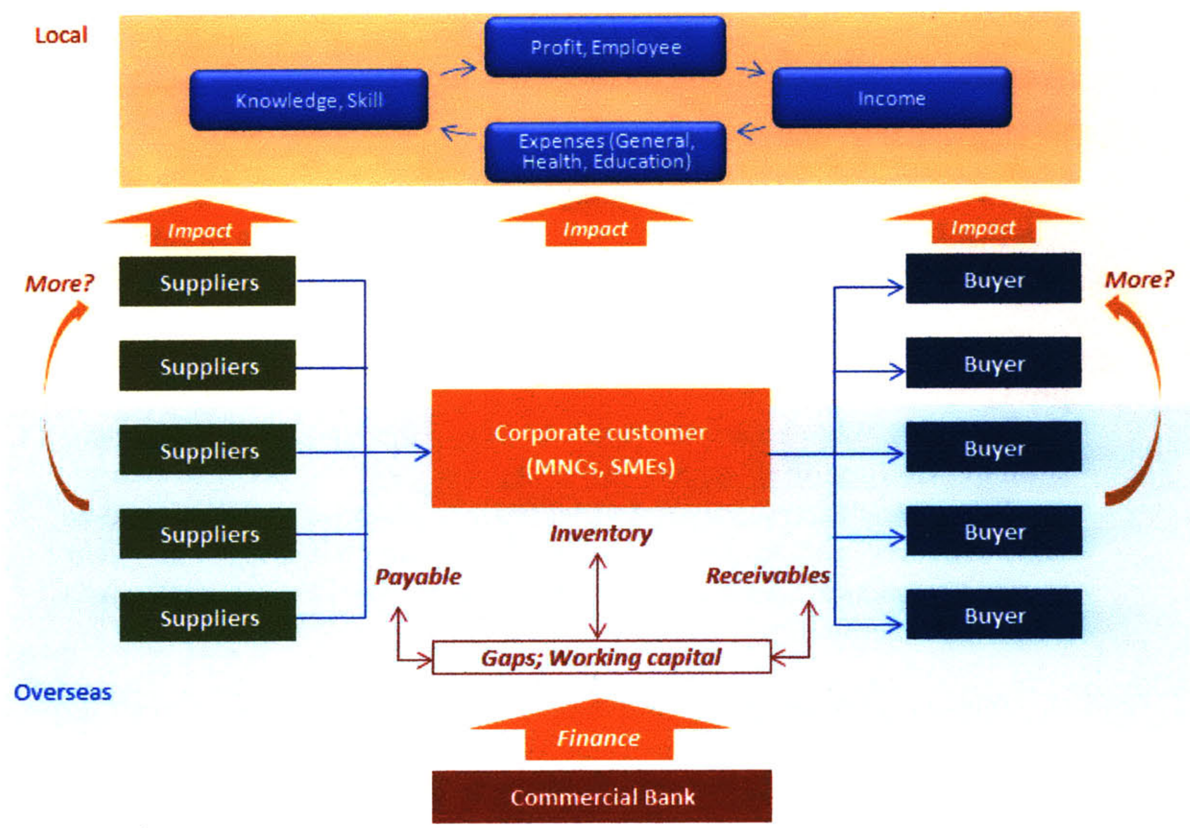
The IFC advocates:

Recent research on business models that target the 'Bottom of the Pyramid', the vast untapped potential market made up of the world's poorest people, has emphasized the need for multinationals to radically change their approach and to fundamentally rethink every step in their supply chains. Companies are advised to build new resources and capabilities, to implement multiple strategies concomitantly, and to partner with multiple constituencies that often have different strategic objectives. The complexities and potential costs involved in these recommendations, we believe, constitute severe hurdles to executive decision making and to realizing the financial returns that would justify such investments. (Seelos, 2007, p. 1)

On the other hand, the UNDP (2008) addresses the issue of trade this way:

The current trade architecture and protectionist policies in most developed countries in sectors of particular interest to developing countries are regarded as a significant obstacle for developing export productive capacity in emerging economies. Starting from these basic notions, the inter-linkages between human development and trade can be mapped using a step-by-step process as outlined in Figure 3.1 [see Appendix 4]. . . .

The dimensions of human development are often interlinked. Box 3.5 [see Appendix 4] highlights a possible strategy - fair trade - for linking sustainable trade with gender empowerment. (pp. 31-39)



Source: Author

Fig. 7: Example of finance scheme and human development (Working capital and impact on local community)

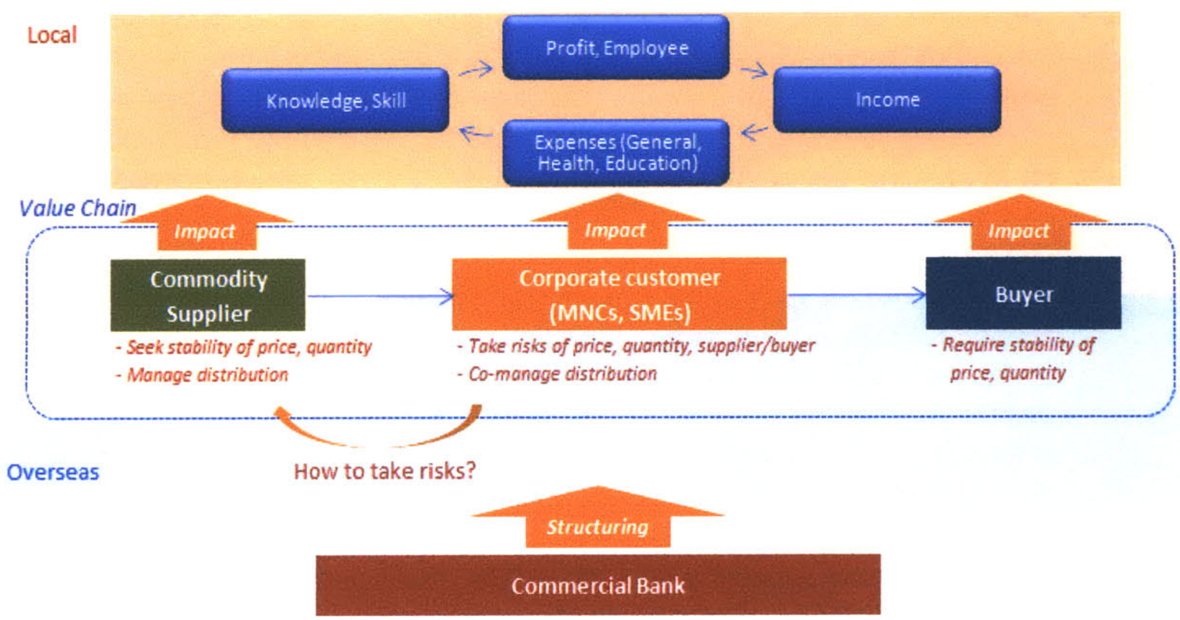
In fact, commercial banks have considerable information about the supply chain and trade business of their corporate customers. The most fundamental product offered by commercial banks is financing working capital for its customers (see Figure 7). Banks usually collect detailed information about names of suppliers and buyers, payables and receivables, and inventory costs. The bank clarifies the business condition from its customers and monitors warehouse levels. The bank also provides key trade instruments, such as letters of credit. Bankers may sometimes contact a customer's supplier and/or buyer as well. Thus, the banker needs keen judgment and the ability to recognize and adopt an appropriate scheme that matches the customer's business. In particular, banks need to pay attention to the immense potential for creating employment and wealth when financing a business in a developing country.

Within the category of trade finances, it is worth noting commodity finance as well. The UNDP (2009) notes:

> Primary commodities, including agricultural and mineral commodities, are the major source of income and employment for a number of developing countries and least developed countries. . . .
>
> For a more equitable distribution of benefits from commodities production and trade there is a need to address supply side and value chain issues, which are essential to any commodity development strategy. Commodity - dependent countries need the necessary factor conditions, such as resources and additional financial aid, to capitalize on their natural endowments through diversification of their economies which would result in greater economic growth and poverty reduction. . . .
>
> Institutions such as banks and trade associations are key players in implementing governmental policies, such as prioritizing specific commodity related action, through pricing mechanisms, providing safety nets through appropriate financing schemes and easing credit crunches in times of volatility. Dynamic enterprises and cooperatives are also increasingly viewed as the engine that powers growth and development by linking the local supply capacities to the global value

> chain. Another significant factor in developing a coherent global initiative for commodities is the supporting role that needs to be played by regional policy makers in integrating regional production clusters which promote industrial growth, thus providing opportunities for exports and creating jobs. (pp. 1-3)

Applied commodities vary considerably, including items such as wheat, corn, soybean, oil, natural gas, coal, iron ore, so bankers must compete to offer custom-made schemes that support commodity finance. For example, Deutsche Bank created its own commodity index (Geman, 2005). Some investment bankers, such as Goldman Sachs, hold their own commodities, such as crude oil. Commodity derivatives transactions are prevalent worldwide, and banks handling them contribute to market stability. On the other hand, it is also true that investment in commodities as an asset class is widespread. What could happen if speculative transactions accumulate rapidly? The thought of it is troubling.



Source: Author

Fig. 8: Example of finance scheme and human development (Commodity finance and impact on local community)

In addition to comprehensive research into how commodity-related transactions contribute to human rights, there is an expectation that commercial banks will adopt broader strategies for the direct and indirect social impacts of their activities (see Figure 8).

2.5.4 Oversight of Corporate Customers

As mentioned earlier, commercial banks retain huge quantities of detailed information about their corporate customers. However, they have not put it to use to assess corporate customers in terms of CSR. In fact, no specific requirement for such an assessment has been imposed on banks by any regulatory authority. One suggestion for private financial institutions is to assume responsibility for possible outcomes from financing. It should be a central part of each bank's own CSR objectives. The UNEPFI says:

> Many of the direct human rights risks and issues faced by the finance sector are generic to all businesses, such as those relating to the treatment of employees, or to the development and communication of new products, or to labour relations in the supply chain when purchasing goods and services. A business can promote human rights by specifying contractual standards in these areas which ensure that human rights are met.
>
> However, when providing funding or financial advice to a business client, a financial institution can be exposed to the human rights concerns which relate to that business and its sector. This is due to the provision of support being construed as an endorsement of the activities of the client, as well as facilitating the continuation and development of the business.
>
> Although a bank does not have the same degree of influence and control over client activities as it has over its own workforce and suppliers, there is a risk it can be linked indirectly with human rights violations perpetrated by a client. [13]

[13] UNEPFI website: http://www.unepfi.org/humanrightstoolkit/finance.php.

Along the same lines, the IFC (2008) has reported:

> As much as banks have traditionally looked after the financial performance of its borrowers, they may also be well served to pay attention to their governance practices. Indeed, assessing, improving, and monitoring the corporate governance practices of their clients may not only help minimize their portfolio risk but also add value to their client's business.
>
> Results indicate that a significant majority of banks (58%) do not include an evaluation of their clients' corporate governance practices. (p.67)

The OECD also has policies that commercial banks, I think, should refer to in order to oversee their corporate customers (see Appendix 5).

It might seem radical to suggest that commercial banks should govern the CSR of its corporate customers. Many will question how commercial banks can assume responsibility for its corporate customers without breaching human rights issues. And at some point, not only monitoring but also responding to negative cases will be required for the bank. In section 6.3, I will examine how a commercial bank can take on this duty.

2.5.5 Governance

With regard to governance, the UNEPFI says:

> Financial institutions are under closer scrutiny than ever before. Investors and regulators are increasingly asking challenging questions about corporate governance, the social and environmental impacts of operations and investments and how financial institutions support their local communities. Answering these questions is not easy and requires institutions to change policies and practices. This may seem a daunting task. [14]

[14] UNEPFI website: http://www.unepfi.org/benefits/index.html

A financial institution ought to regulate its business activities with strong governance. In that sense, it confers some type of oversight on its clients through their financing activities. Originally, commercial banks might be entitled to lead the evolution of current common sense.

Regrettably, however, it was the financial institutions themselves that brought on the financial crisis. The combination of financial institutions and regulatory authorities has resulted in the catastrophic failure of their respective basic missions, including product development and risk management. Although a discussion of the governance of financial institution has a rich history, it has not worked well. How should a banker stand up to adversity based on habitual thinking such as short-termism? An unshakeable faith in the CSR philosophy should be retained in order to breathe life into the issue of appropriate governance.

CHAPTER 3
OVERVIEW OF THE FINANCIAL CRISIS AND GLOBAL SUSTAINABILITY

In this chapter, I will focus on the impacts which have been caused by the latest financial crisis, and discuss about anticipation of the financial sector from the context of seeking of global sustainability.

3.1 Impact on Poor Countries

Since the world financial crisis began in September 2008, there has been much research conducted on the impacts of the crisis, from various perspectives. I will defer to specialists for a comprehensive analysis. What I will discuss are the views of international organizations regarding the influence of the crisis on developing countries.

Ravallion (2009) conducted a number of analyses for the WB, both before and after the crisis. He found:

> Before the crisis, the incidence of poverty in the developing (world) was on a trend decline. The proportion of the developing world's population living under $1.25 a day in 2005 prices fell from 52 percent in 1981 to 25 percent in 2005; that implies 500 million fewer poor by this standard (from 1.9 billion in 1981 to 1.4 billion in 2005). . . .
>
> The World Bank's Development Prospects Group has made projections for average consumption at the country level after the crisis. These can be compared to the Bank's pre-crisis projections to assess the expected impact of the crisis. At the time of writing (mid-June 2009), we expect the crisis to knock almost 5 percentage points off the consumption growth rate for 2009, bringing it down to zero. The effects on growth

impacts will tend to be greater in less poor countries. (Eastern Europe and Central Asia figure prominently in this group). This pattern will help dampen the overall impact of the crisis on poverty. . . .

Applying country-specific growth projections to survey based data and aggregating them, we estimate that the crisis will increase the 2009 count of people living below $1.25 a day by 50 million. More than half of this increase is expected to be in South Asia; 10 million will be added to the poverty count in East Asia and 7 million in Sub-Saharan Africa. Another 64 million will be added to the number of people living under $2 a day. Given the current growth projections for 2010, there will be a further increase in poverty in that year, with a cumulative increase of 89 million people living under $1.25 a day and 120 million more under $2 a day by 2010. (p. 17)

The crisis has had a devastating impact on the poor. The financial sector in developed countries has accepted the fact with humility and made vigorous efforts to turn around the situation. The UN describes apprehension about the achievement of MDGs: "Progress toward the goals is now threatened by sluggish—or even negative—economic growth, diminished resources, and fewer trade opportunities for the developing countries" (Millennium Development Goals Report, 2009, p. 4).

The crisis led directly to a severe reduction of capital flows and reduced trade volume into developing countries. The UNDP (2009) reports:

One of the key channels for transmission of the crisis from developed to developing countries has been via private capital flows though the impact of this has been more severe for emerging markets than for low-income countries, which are less integrated into international private capital markets. . . .

The main channel of transmission of the crisis to exporters of manufactures and services is through *a decline in trade volumes*; while exporters of primary goods have been more affected by *declining prices*. [emphasis added] (p.2)

Contrary to expectations in the commercial banking industry, the financial crisis has had a terribly negative impact on the poor. It is no exaggeration to say that the banks abdicated their responsibility to seek global sustainability.

3.2 Causes

The WB asks: "Why do the managers of financial institutions continue making such commitments while repeatedly failing to honor them? There are two possible explanations: either they understand the risks and go ahead because it suits them, or they go ahead because they do not understand the risks" (WB and IFC, November 2009, p. 1).

I think most bankers feel that risk management based on Value-at-Risk (VaR) is limited. Put in extreme terms, when all markets collapse simultaneously, a bank's risk will increase tremendously overnight. The correlation between assets and/or liabilities, which is calculated using the most advanced mathematical logic, will disappear. All risks will move in the same direction. Eventually, total risk may be far beyond the bank's capital adequacy.

The answer to the above question is that managers of financial institutions understand the nature of risk but do not grasp the figures, or they ignore the impact on the system when a market collapse occurs.

I faced the catastrophic shrinkage of the inter-bank money market in 2008. No bank was able to borrow U.S. dollars from the inter-bank market. The margin of swap transactions was extraordinarily high. The situation exerted huge negative impacts on corporate customers. For instance, Japanese commercial banks were not able to smoothly lend in U.S. dollars to their corporate customers who operate trade businesses. The decline of corporate customers' business wrought severe damage to poor countries.

Rating and regulatory agencies have similar viewpoints in terms of risk management (WB & IFC, October, 2009). In the financial industry as a whole, there might be a certain amount of negligence in response to such risk. It is a gross deviation from what the public expects from banks in terms of CSR.

3.3 Challenges Following the Financial Crisis

Regarding regulation, the UNDP (2009) suggests:

> The magnitude of the current crisis is clearly associated with *inadequate regulation and supervision of banks and financial markets*. The new regulatory governance needs to be based on a well-functioning network of national and regional authorities and include truly international supervision of financial institutions with a global reach. There are a number of broad principles on which future financial regulation needs to be built: the first is counter -cyclicality, in order to correct the main market failure of banking and financial markets—their boom-bust nature. The second key principle for modern, effective regulation should be comprehensiveness; for regulation to be effective, the domain of the regulator has to be the same as the domain of the market to be regulated. [emphasis added] (p. 3)

A regulatory authority has the important role of maintaining and improving the financial system. What is considered is its position in society. In most nations, the regulatory authority sits at the top of the banking system. But the *raison d'être* of any regulatory authority is to define, on behalf of nations, the principles and rules that determine industrial actions. From the bank's perspective, the regulatory authority is a representative of nations. In that sense, what the bank should never forget is that it has to shoulder a much heavier responsibility.

The WB, writing about the Macro-Prudential Regulation, suggests:

> One of the main tools regulators use to do this is capital adequacy requirements. But *the current approach to capital adequacy is too narrow.* Capital adequacy levels are set on the implicit assumption that we can make the system as a whole safe by ensuring that individual banks are safe. This represents a fallacy of composition. In trying to make themselves safer, banks and other highly leveraged financial intermediaries can behave in ways that collectively undermine the system. This is in essence what differentiates macro-prudential from micro-prudential concerns. . . . *Micro-prudential regulation examines the responses of an individual bank to exogenous risks. . . .*
>
> Not all financial institutions pose systemic risks. Regulation should acknowledge that some banks are systemically important, and others less so. In each country supervisors establish *a list of systemically important institutions* that receive closer scrutiny and require greater containment of behavior. Critical factors that determine systemic importance for an institution, instrument, or trade are size of exposures, especially with respect to the core banking system and retail consumers; *degree of leverage and maturity mismatches; and correlation or interconnectivity with the financial system.* [emphasis added] (WB & IFC, July, 2009, pp.2-6)

I agree that regulatory authorities must understand the relationship between whole social systems and individual financial institutions. Risk recognition by the regulatory authority is an important key here. For instance, CDO is a well-structured investment product to help lower-income people purchase their own houses. A brief description sounds like it would be the cornerstone of the company's corporate responsibility. However, when the risk recognition is incorrect, the bank must agree that a mistake has been made, which may equal an evasion of responsibility even though it does not have adequate evidence. What regulatory authorities should do is sound an alarm while being skeptical about ways to measure volatile risks.

On the other hand, the requirement to measure risk urges frequent checks on assets and liabilities at mark-to-market value. Quarterly reporting is an example. As the result, management and all stakeholders come to look at a bank's activity in narrow and short-term ways. Actualization of invisible risks in last few years has further spurred "short-termism," and that negative spiral has accelerated.

The UNGC states:

> Recent events in global financial markets *underscore the importance of transparency, accountability, and a focus on long-term investment horizons over "short-termism."* The financial collapse also demonstrates that due to economic integration, a crisis in one part of the world can quickly spread to other regions. In the same way, many social and environmental challenges do not respect national borders, which places a premium on an expanded view of risk management that includes extra-financial issues.
>
> As rising numbers of companies from around the world are embracing corporate sustainability as a management imperative, the mainstream capital markets—including major institutional investors—*have begun ground-breaking efforts to retool their investment strategies and models to adjust to new global realities.* [15] [emphasis added]

Further, the IMF notes:

> We are definitely making progress towards creating a safer and more stable financial system—but much remains to be done. In particular, capital requirements need to be strengthened, so that they are not only larger, but also *reflect better the riskiness of bank activities.* And on compensation policy, we need to *align bankers' incentives much better with longer-term performance than with short-term profits.* [emphasis added] [16]

One intrinsic problem may be the generally held understanding of profitability. There are many examinations of "long-termism" among academics and experts. What is described here is that a bank's attitude has a great impact on changing the general understanding because it determines its activity in accordance with its own profitability as well as its corporate customers' profitability.

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[15] UNGC website: http://www.unglobalcompact.org/Issues/financial_markets/index. html

[16] IMF website: http://www.imf.org/external/np/speeches/2009/090409.htm

3.4 What Can be Anticipated from the Financial Sector?

Missions and goals that commercial banks post on their websites are, I think, sufficiently sophisticated. However, management could compete more strenuously for an alignment between the mission/goals and action. To avoid further mistakes, when banks no longer feel complete confidence to manage risk in a specific business, they may return to traditional functions, such as simple deposits and loans. In these fundamental functions, banks need absolute mastery and intellectual prowess.

The WB suggests:

> Among developed countries, some of the biggest changes may occur in the United States. The U.S. financial system was in many ways unique because of the much greater role played by institutional investors and other nonbank financial institutions and because of the extensive use of capital market instruments, including securitization. The structure of the banking system may change significantly, with greater concentration around a few mega-universal banks (to the extent that such banks are not broken up as a result of government rescue programs or stricter financial regulation), less emphasis on proprietary trading activities, the rebirth of the boutique investment banking model, and greater attention to *traditional activities such as commercial lending and retail deposit-taking*. [emphasis added] (WB and IFC, June, 2009, p. 4)

Turning down new products developed by the latest technology is another challenge for banks. There will be arguments: employee's motivation could be lost; research and development within the banking industry may stall. Allowing for error in trial-and-error activities is necessary both to sustain employee motivation and to create new products and services for customers. However, what needs to be considered is the kind of research and development required to maintain global sustainability and permissible limits for error. People expect a trustworthy bank and financial market. Even though highly advanced technology is not applied to product development, employee's motivation will be generated if they recognize that the product contributes in a significant way to society. Bank leaders have to resolve the perennial dilemma between anticipation from society and ethical confusion in the bank, and support their customer's innovation.

Rangan & Petkoski (WB, 2009) has observed:

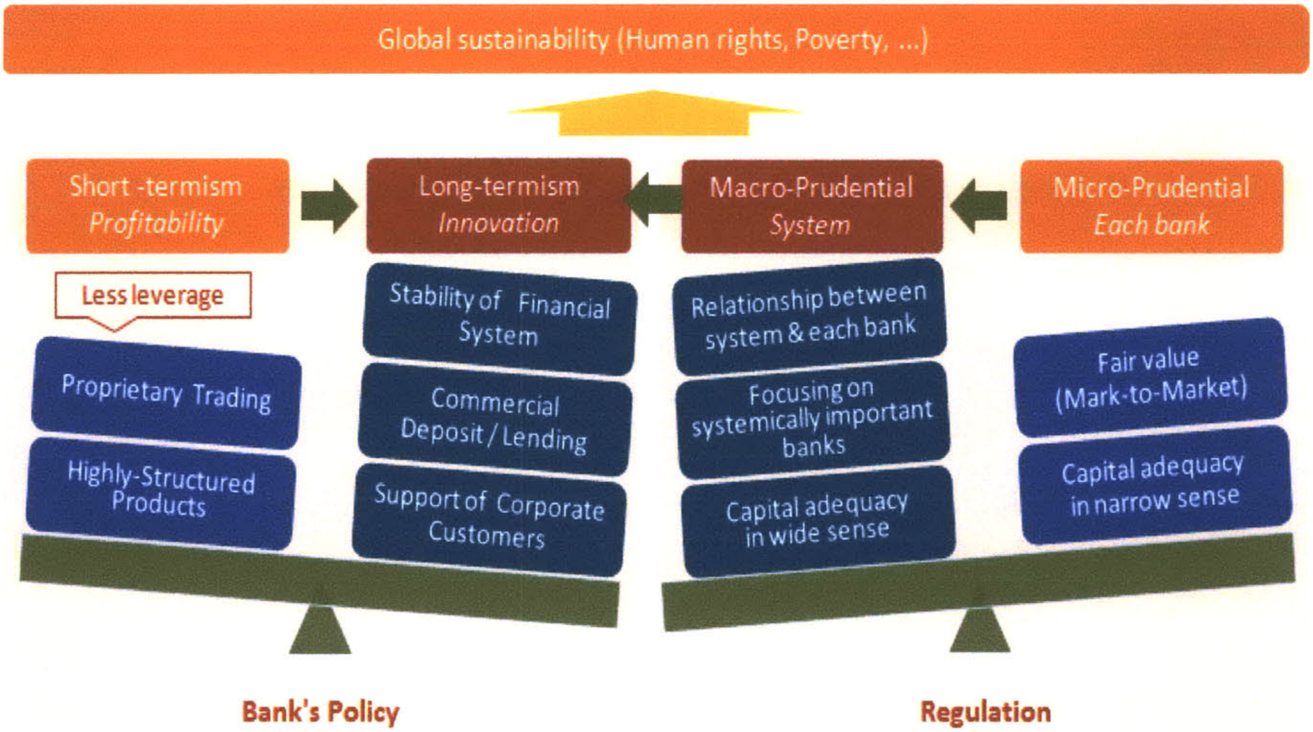
> Global GDP is forecasted to increase a modest 2.0 percent in 2010 and 3.2 percent in 2011. This will result in a very slow job recovery, and recession-like conditions will continue to prevail. Companies are employing various strategies to deal with employment issues. Some companies utilize their corporate social responsibility programs to create new jobs or preserve existing ones through temporary salary cuts and introducing shorter working hours. Some companies *use more than one business model to achieve both profitability and job creation objectives. . . .*
>
> In a recent McKinsey & Company survey more than 50 percent of the respondents said that *innovation is more important to growth now than it was before the crisis. Long-term global prosperity and stability need to be supported by expanding growth, especially among the low-income segments. . . . .*
>
> They (businesses) have given people the ability to buy healthcare and education for their children, and acquire property to improve their quality of life. They normally base their business models on a holistic assessment of how their labor policies and supply chain relationships can shape their strategy. . . .
>
> *The financial crisis creates unique opportunities for government and companies to reassess their strategies and identify innovative solutions, including creative partnerships, to tackle the new economic reality the world is facing.* Those who react quickly and forcefully will most likely be the rule makers and winners in the post-crisis world. [emphasis added] (pp. 35-36)

If every failure is a stepping stone to success, what do banks learn from the current financial crisis? How can banks make the most use of the crisis as a springboard for contributing to global sustainability?

The Principles for Responsible Investment (PRI) (2009), which are developed by the UN, discuss the banks' perceptions of environment, social, and governance (ESG), stating:

> Signatories were asked if the recent global financial market turmoil caused them to change their approach to the consideration of ESG factors or active ownership. The most common response was that the financial market turmoil has had no impact on their approach. Many signatories commented that they were dedicated to RI (responsible investment) long before the emergence of the global financial crisis and that, if anything, the market turmoil has reaffirmed their (and, in some cases, their clients') belief that ESG issues are important. A number of signatories did indicate that new budget constraints may slow down some planned RI activity. (p. 8)

Yes, people really do hope that commercial banks will achieve their targets regarding ESG issues. However, banks are expected to do so visibly. Banks should make their plans for the long term distinctly clear. I believe careful consideration should be given to direct/indirect contributions to the financial system, taking deposits, lending, and supporting corporate customers' business (see Figure 9).



Source: Author

Fig. 9: Summary: Long-term innovation and the macro-prudential regulation

CHAPTER 4

COMMERCIAL BANKS AND REGULATORY AUTHORITY

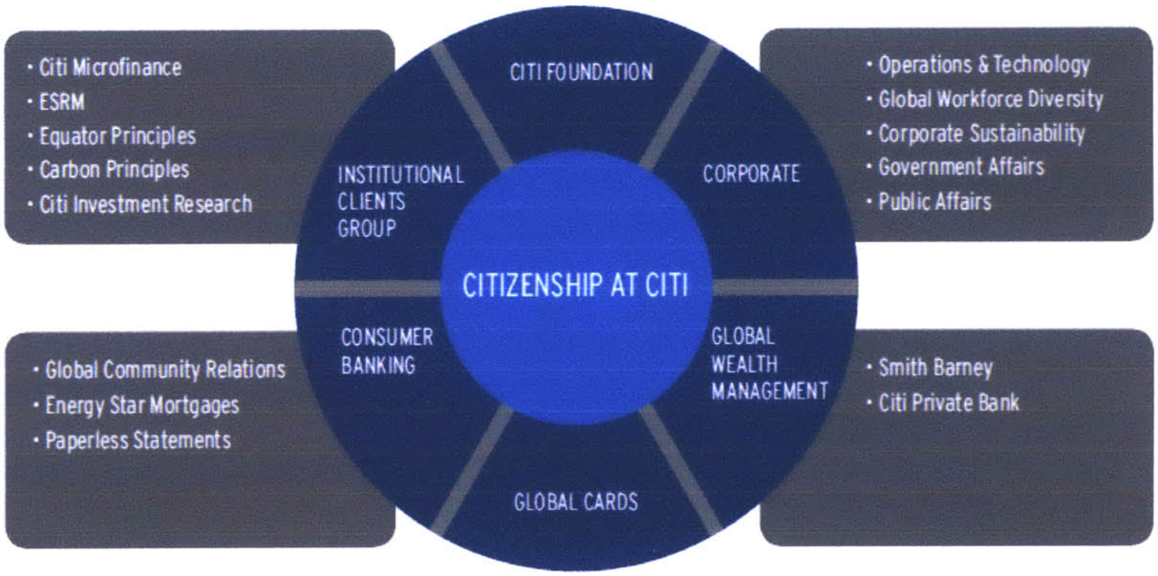
In this chapter I research the thoughts, actions, and artifacts by which major banks in the U.S., Europe, and Japan deal with sustainability issues. In addition, I will discuss the outcome when I approached a regulatory authority that is known for tackling sustainability issues as part of its mission.

4.1 Commercial Banks

4.1.1 U.S. Banks

Since 2001, **Citigroup (Citi)** has annually published its "Citizenship Report." In the eighth report (2008), Citi presented eight goals and their performance results (see Appendix 6). Typically, when recovering from a financial crisis, help given to homeowners for loan modifications is put at the top of the performance highlights, followed by financial education and microfinancing. Other items such as environment, risk management, diversity, employees, and foundations are touted, in common with other private companies. Citi has adopted the GRI G3 Sustainability Guidelines, and pertinent information about the guidelines is indexed in the Report.

Citi has a Public Affairs Committee in its Board of Directors to supervise Citi's policy and citizenship activities; also a Director of Corporate Citizenship reinforces Citi's CSR efforts with environmental, social, and economic issues (see Figure 10).



Source: Citigroup. *Citizenship Report*, 2008

Fig. 10: Citizenship at Citigroup

One area deserving special mention is microfinance. Citi has provided its services to more than 100 microfinance institutions in over 35 countries. Citi provides local currency funding, credit, savings, insurance, remittance products, innovations with partners, corporate finance, capital market solutions, and a risk assessment framework. Furthermore, through ties with the WB and IFC, Citi has contributed to creating best practices and new schemes to support lending in developing countries, while also discerning potential microfinance risks.

I believe Citi is one of the top banks in terms of direct contributions to poor countries. There are many things that multinational banks can learn from Citi's Institutional Clients Group (refer back to Figure 10). On the other hand, I think Citi will be expected to design new applications to indirect contributions for the future.

Its Corporate Group identifies operations, technology, diversity, corporate sustainability, government affairs, and public affairs as its priorities. However, people may expect that Citi will also develop more long-term practices. For instance, creating a methodology for innovative oversight that encourages its corporate clients to contribute to poor countries would be a complete revolution in the global financial industry.

In addition to Citi, **Bank of America (BoA)** focuses mainly on the U.S. domestic market, and is committed to the stabilization of housing and ownership, education, and medical support for low-income nations. BoA also acts decisively on environmental issues (BoA, 2008).

JP Morgan Chase (JPMC) commits mortgage money to low and moderate-income and minority nations, lends to small businesses, engages in community development (e.g., providing facilities for housing companies, low-interest lending to manufacturing companies for job creations), and offers microfinance. JPMC reports its financial transactions in great detail to clarify its environmental impact on society (JPMC, 2008).

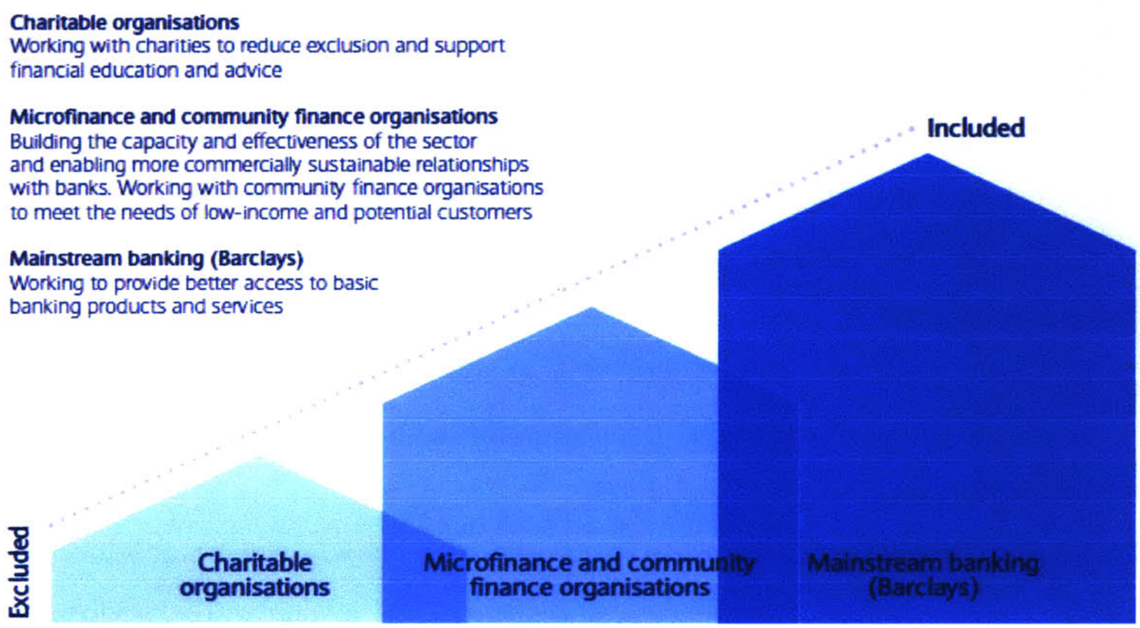
4.1.2 European Banks

HSBC Holdings (HSBC) puts a priority on global economy, customer relationships, retaining and developing top talent, climate change, future social opportunities (innovation, enterprise, and microfinance), and sustainable use of natural resources. It uses a unique series of quantitative measurements, including benchmarks from the Dow Johns Sustainability Index, and/or FTSE4Good, to monitor the progress of each of its commitments, and the report is vetted by PricewaterhouseCoopers (HSBC, 2008).

HSBC requires its suppliers to comply with HSBC's code of conduct on labor rights, environmental issues, etc., and a third party evaluates the performance of each supplier. In the future, it may ask something similar of its corporate clients. I believe that reporting HSBC's impacts on society and the economy by its lending to the supply chains of its corporate client will also be expected. HSBC has one of the broadest networks worldwide, and its creativity brings tremendous power to its indirect contributions as well.

Barclays Bank's strategic sustainability themes are: meeting the needs of customers and clients, inclusive banking (banking services in developing countries), environment, diversity (employee, talent development), and responsible global citizenship. The bank defines specific issues on which it will focus with Deloitte and reports the outcome and performance.

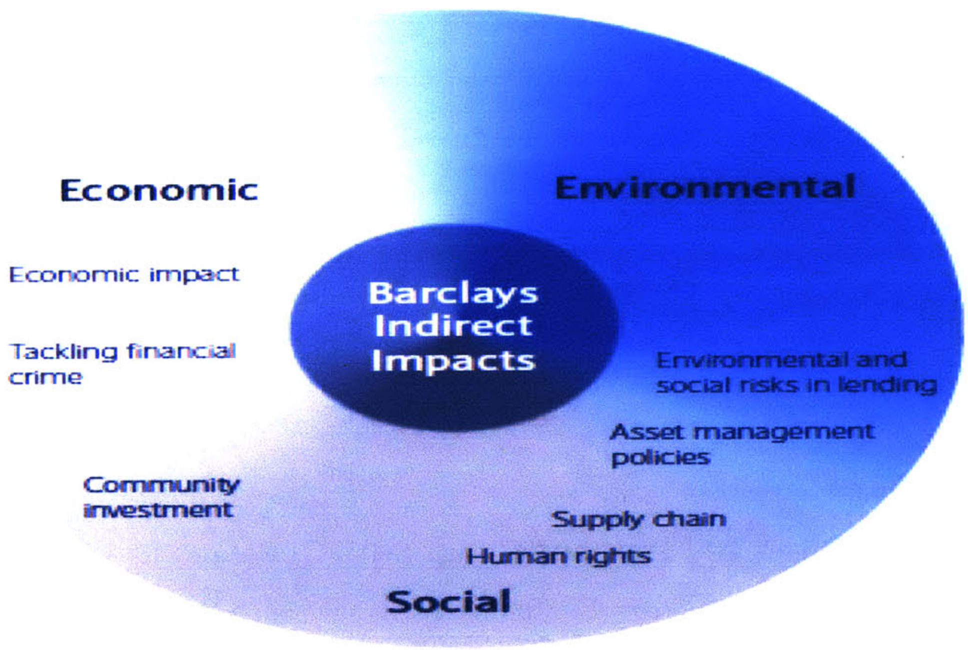
Regarding inclusive banking, Barclays has a strategy for developing financial services in line with the market situation (see Figure 11). Also key is generating positive demand to improve productivity and establish partnerships to expand service. I think this is a rational and pioneering strategy for direct contribution to developing countries (Barclays, 2008).



Source: Barclays PLC. *Sustainability Review*, 2008

Fig. 11: Barclays' financial inclusion journey

Barclays says it also has an obligation to make an indirect impact on global sustainability (see Figure 12). In particular, in the context of its supply chain management, the bank's policy is to review suppliers' data on its activities before engaging them as suppliers. Moreover, direct engagement with suppliers to reduce negative influences on sustainability seems to be practiced regularly.



Source: Barclays PLC. *Sustainability Review,* 2008

Fig. 12: Barclays' indirect impacts

Rabobank Group (Rabo) is a Netherlands-based bank with 152 independent local banks in more than 40 countries. The bank continually acquires partner banks in developing countries, mainly in Africa, and then helps those banks provide credit for small agricultural companies and individuals.

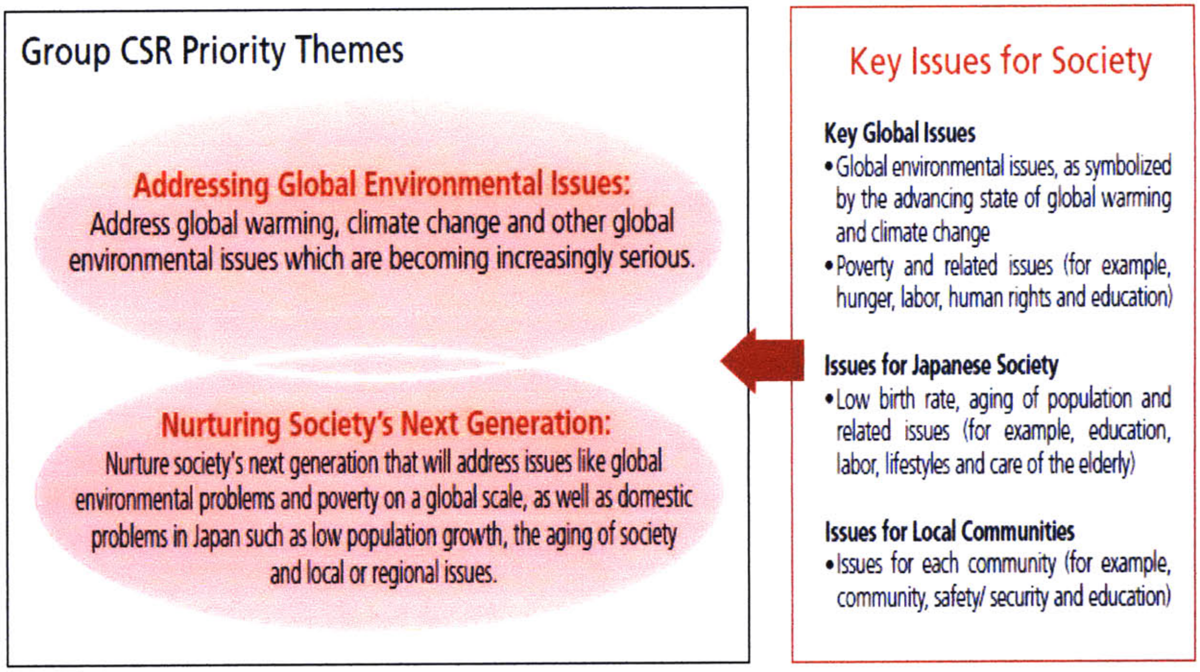
Rabo's main strategy is to sustain the food and agri businesses. It has five Food & Agribusiness Principles: (1) sufficient and safe food production; (2) responsible use of natural resources; (3) cultivating a responsible society in order to promote welfare; (4) responsible treatment of animals; and (5) raising awareness among consumers and citizens. Its research arm focuses on the whole foods chain including production, sales, supply chain management, branding, and environmental issues. Based on its research, Rabo offers advisory services to its clients. [17]

Rabo's perspective is long-term, concentrating on crucial issues: people, food, and the planet. Food is usually an important income source for developing countries, which means that fluctuation of food prices inflicts serious damage on a country's economy. It is apparent that as the global population increase, this issue will be a major theme in politics, diplomacy, and business. Addressing the food chain itself will bolster confidence to develop some innovative financial services and oversee the bank's pursuit of global sustainability.

4.1.3 Japanese Banks

Mitsubishi UFJ Financial Group (MUFG) defines its key issues as society and CSR themes (see Figure 13). In its Corporate Social Responsibility Report, (2009) MUFG discloses the firm's performances on environmental issues, while indicating that MUFG has adopted the GRI G3 Sustainability Guidelines. MUFG has launched vaccine bonds to support the health of infants and children in more than 70 developing countries; it maintains an environmental fund that invests in companies that contribute to environmental and social issues; and it has taken the initiative on clean development mechanism projects. However, MUFG has not addressed microfinance nor has it been involved in supply chain management for global sustainability (MUFG, 2009).

[17] Rabobank website: http://www.rabobank.com/content/about_us/



Source: MUFG. *Corporate Social Responsibility Report Fourth Issue*, 2009

Fig. 13: MUFG's CSR priorities and key issues for society

Other large Japanese financial groups, such as **Mizuho Financial Group (Mizuho)** and **Sumitomo Mitsui Financial Group (SMFG)** address environmental issues, communication (with employees and society), financial education, and corporate governance as part of their normal business, but neither has entered into the microfinance market nor moved into supply chain management (Mizuho, 2009; SMFG, 2008).

In general, Japanese banks have more liquidity than U.S. or European banks. Indeed, some Japanese banks have acquired voting rights in certain U.S. investment banks as part of the fallout from the world financial crisis. However, Japanese banks are still sensitive to negative perceptions that may arise from the impacts of nonperforming loans due to the long recession in Japan. Therefore, they may not yet be in a position to initiate creative approaches for global sustainability.

Japanese banks have generally developed their policies from a long-term perspective. In addition, although most of their profit comes from the domestic market, regional portfolio management to expand overseas business will be required as the domestic market begins to shrink owing to a declining Japanese population and the shift of manufacturing operations and companies to overseas locations. Thus, developing a clear and comprehensive global management policy, including pursuing global sustainability from a long-term viewpoint, is now indispensable.

In sum, U.S. and European banks are seeking ways to assist poor countries with direct measures such as microfinance, and European banks are looking for ways to handle supply chain management. European banks historically have been strong enough to handle the trade business, so those banks will be in a position to be first movers in this area.

Japanese banks now face a critical time for implementing new strategies based on their current strengths of liquidity and long-term commitment.

4.2 Regulatory Authority

Among financial authorities, a good example is the UK Financial Services Authority (UKFSA), which has addressed sustainability issues as one of its primary responsibilities.

The UKFSA publishes reports on its CSR efforts (UKFSA, 2009). Its key themes are workplace (helping retail consumers; promoting efficient, orderly and fair markets; improving business capability and effectiveness), environment, community (local and wider community), and people (employee). In its 2008-09 Corporate Responsibility report, it states:

> Like commercial companies, we believe that embedding CR (corporate responsibility) into operational practices will make us a more efficient organization by achieving reduced operation costs, enhancing risk

> management, creating a more engaged workforce, and developing closer links with the local community. (p.3)

Although UKFSA is sensitive to local markets, its attention to wider community demonstrates that it recognizes the need to address the global community. The report is unique, and allows this public authority to keep an eye on sustainability issues. Accordingly, UKFSA may achieve better regulation in the future.

In the case of the U.S., it may be difficult and highly complex to clearly identify the corporate responsibility of federal regulators, even though they understand the importance of CSR. If integration of regulators is achieved under some macro-prudential policy—as is currently being discussed among some U.S. specialists—I believe a new push for global sustainability will arise.

None of the authorities directly specify any bank's responsibility for global sustainability issues; however, corporate governance is stipulated in the regulations as a matter of course. Regulation is basically formulated to ensure the stability, safety, fairness, and efficiency of the domestic market. Therefore I think strict regulation of complex global issues by a domestic authority is not reasonable from the standpoints of politics, diplomacy, and business. Rather, keys questions could be: "How should individual banks take action?" and "How should a global framework be established?"

Christian Noyer (2008), Governor of the Bank of France, said:

> CSR is a concept whereby companies and financial institutions not only consider their profitability and growth, but also the interest of society and the environment by taking responsibility for the impact of their activities on stake holders, employees shareholders, customers, suppliers, and civil society represented by NGOs. Companies (including banks) must take on new responsibilities that go beyond a simple policy of "paternalism" vis-à-vis their suppliers, customers and employees, such as that practiced up until recent times. (p.1)

He asked three questions:

- Is CSR a stable concept or one that is still evolving?
- Will the concept of CSR, whose global spread has been promoted by globalization, result in new forms of managerial responsibility?
- Can CSR give rise to an alternative or complementary regulatory approach that could reinforce global regulation policies?

I strongly believe that CSR should continue to evolve as the world itself changes. As globalization makes more progress, banks will need to recognize their own responsibilities, as well as the need for closer collaboration between domestic regulators and global organizations.

CHAPTER 5
CASE STUDIES

In order to identify implications for the commercial banking industry, I researched the thoughts, actions, and artifacts which multinational corporations and NGOs recently created to achieve global sustainability.

5.1 Multinational Corporations

There is some excellent research on the subject of how multinational corporations (MNCs) create links between their businesses and assistance with poverty. In this section, I discuss two examples: Unilever and Nike.

5.1.1 Unilever: Supply Chain Research

Unilever's study of its operational impact on Indonesia is one example of excellent research (Unilever, 2005). In 2004-2005, Unilever studied its entire supply chain in Indonesia to identify positive and negative impacts on small producers, the labor market, and low-income consumers in Indonesia. Research was conducted jointly with Oxfam, an international NGO also tackling poverty issues. The sharing of insights through frank discussions between this MNC and NGO, I believe, made this research unique and meaningful.

Unilever researched five main points:

- Impact at the macro-economic level (e.g., contribution in terms of distribution of profit, shareholder dividends, taxes, balance of payments, etc.).

- Employment impacts (e.g., wages and standards, including labor contracts and gender issues).
- Value chain, from supply through distribution (e.g., supplier, raw materials producers, and distributors, including wages, job creation, living standards, finance, etc.).
- Low-income consumers in the marketplace (e.g., competition, ability of independent small producers).
- Wider impact in the community (e.g., government, business community).

In a research paper, Unilever analyzed its supply chain to determine its business impacts. Core lessons learned by Unilever were:

- The need to improve employment standards.
- Farmers are limited in their ability to develop new business models due to financial restrictions.
- Unilever's limitations on guaranteeing improvements in living standards in a poor country.
- Necessity of other resources to run a financial scheme (deposit, credit, and insurance).
- Formal research to measure economic impacts in poor societies is now conducted with INSEAD.

As a result of analyzing this research, I identified the following insights:

- Corporate collaboration with NGO expertise is fruitful.
- The responses of financial institutions to financial issues is a key to having a positive influence on a poor community. Collaboration between MNCs and financial institutions is one practical option.

- Measuring the impact is difficult but is nevertheless a worthwhile goal. Banks with much information about their clients' supply chain and the local economy can contribute to this goal.

5.1.2 Nike: Cross-Functional Team

Nike formed a Sustainable Business and Innovation Team to implement its CSR strategy (Henderson et al., 2008). There are approximately 130 people on the team, and they are responsible for several issues concurrently, such as sustainability, retail, logistics, etc.

As for its corporate responsibility strategy, Nike focuses on:

- Innovating to deliver enterprise-level sustainability solutions.
- Integrating sustainability into the heart of the NIKE business model.
- Mobilizing key constituents (i.e., society, employees, consumers, government and industry) to partner in scaling solutions.

Nike has developed several historic innovations, such as its "Considered Index," which estimates the environmental impact of a product. The Index assesses solvent use, waste, materials, garment treatments, and innovation, and the product with a score well above average is authorized as "Considered." As its next step, in 2010, Nike will disclose the details of its "Considered Index" so it can be extended for application into the industry.

Nike research also found that substantive renovation of a supply chain demands system changes that require much time. Accordingly, the company is cognizant of the need to collaborate with manufacturers and other stakeholders. Nike tries to change habitual habit of thought and action through its policy of mobilization.

Nike's strategy currently leans toward environmental issues. However, I think its approach of compiling an index and forming a cross-functional team is a good strategy, which if applied to private companies would enable them to tackle poverty issues as well.

Nike's company standards, which are based on major experience in the real business field, have the potential to become an industrial standard. The key is that continuing and substantial challenges to complicated issues can achieve creative solutions for the broader community. In that sense, commercial banks can emulate the approaches, strategies, and lessons learned from this case to search for and accumulate experiences that will work for the banks in the future.

5.2 NGOs

5.2.1 Oxfam: Launch of Methodology to Understanding the Relationship Between Business and Poverty

Oxfam is an NGO that makes outstanding contributions to resolving poverty issues. With more than 3,000 local partner organizations in over 100 countries, Oxfam works to develop long-term programs to eliminate poverty, provide assistance in emerging cases, campaign for ordinary people, advocate for policymakers, and conduct research and analysis.

In 2009, Oxfam developed the Oxfam Poverty Footprint Methodology (Oxfam, 2008) based on studies conducted with various companies, including Unilever. According to Oxfam, the purpose of the methodology is to comprehensively identify how a company exerts impacts on people through its value chain and community interactions.

The methodology investigates five factors that affect poor people:

- Value chains - policies and practices for procurement, manufacturing, and distribution.
- Macro-economy - economic contributions, including distribution of profit,

dividends, taxes, and employment.

- Institutions and policy – actions toward social institutions, policies regarding investment, procurement, distribution trade, finance, education, and health.
- Social implications of environmental practice – resilience of the value chains to environmental shocks.
- Product development and marketing – effect on cultural practices of indigenous and local communities, health, and well-being.

Through such examinations, the methodology assesses standard of living, health and well-being, diversity and gender equality, stability and security (resources for people to cope with emerging impact), and empowerment (opportunities to directly influence people's lives).

Oxfam says it provides a comprehensive dataset and, through quantitative and qualitative processes, enables a company to make decisions on how to change its business model in order to pursue better corporate citizenship.

Recently, the UN, WB, and many NGOs presented various research and measurement tools to examine the link(s) between business and poverty (see Appendix 7). Oxfam's methodology is worthwhile for producing a comprehensive grasp of an entire business case through a process of organizational learning and pursuit of accountability and transparency regarding company activities on sustainability issues. The larger issue will be how to implement this methodology and transfer it to a wider range of companies.

5.2.2 World Bank Council for Sustainable Development (WBCSD): Launch of methodology to measure business development

The WBCSD Measuring Impact Framework (2008) was developed with members in private business companies with the aim of assessing a company's impact on society. This methodology's unique aspects are:

- Grounded in what business does – built by business for business.
- Moves beyond compliance – attempts to answer questions about what business can contribute beyond traditional reporting.
- Encourages stakeholder engagement – supports open dialogue with stakeholders to create a shared understanding of business impacts and societal needs, and explores what business can and cannot do to address these needs.
- Flexible – designed for any business and/or industry at any stage in its business cycle, operating anywhere in the world.
- Complements existing tools – makes use of what is already out there (for example, the Global Reporting Initiative and IFC Performance Standards). (p.7)

By applying each step of the methodology, a company can measure both its direct and indirect impact on society, and reach better decisions by identifying opportunities and risks that will be caused by the business's impact.

This methodology is also applicable to companies in a range of industries. In particular, I support the philosophy that a company should take action toward its next step, which may go well beyond just compliance. Engagement with various stakeholders is essential in order to understand a company's business impact.

From this discussion of NGO methodologies, there are two issues that I will address here:

- How should we evaluate the bigger picture (rather than case by case) with respect to sustainable activities directed toward poverty?
- How should a company report and monitor its activities internally as well as externally?

I understand that a company's businesses may be extensive and variable, and therefore it may be a poor idea to devise a common methodology to measure the impact of its business.

Recently, there has been a flood of various methodologies. It is important to be flexible when identifying various companies' activities. However, I also believe that even if a company says that it contributes to poverty, if there is no proven track record or basis of comparison with other companies, such claims may not sit well with local people. It is clear that NGOs are aware of the requirement for reporting. Reporting is not the final goal, but the reporting system may be a halfway point. Financial institutions need to consider how to contribute to this, since they are experts on qualitatively and quantitatively analyzing companies, industries, communities, and countries.

CHAPTER 6
DIRECTION OF COMMERCIAL BANKS

Based on the discussions in previous chapters, in this chapter I will present several new ideas suggesting how the commercial bank industry should address global sustainability issues. Then I will develop a strategic design for Global Commercial Banks.

6.1 Mission of Commercial Banks

Commercial banks have a responsibility to yield returns for shareholders and depositors. Governments provide a regulatory framework, including rules and principles on behalf of depositors, mainly because most depositors have little or no expertise on how to set up, maintain, or improve a complicated financial system. Commercial banks must comply with those regulatory rules and principles as a protection to their depositors. This is the primary and popular view of how a banking system is regulated.

This leads to the next logical question: what framework is established internationally for commercial banks? At present, the major framework known as the International Convergence of Capital Measurement and Capital Standards is provided by the Basel Committee. Now a revised framework, "Basel II", is in use. It has three foundational pillars: minimum capital requirement, a supervisory review process, and market discipline, and in particular capital requirement is calculated into three categories of risk: credit, market, and operation.

I believe that measurement of capital adequacy is absolutely indispensable for securing a stable commercial banking system. In my opinion, rather than being useful for regulatory inspection or monitoring capital markets, it is necessary for supporting a bank's own business activities. In essence, calculation of required capital requires self-discipline, in addition to simply setting a target.

At the same time, management of financial efficiency, such as ROE management, should be taken into account. Today most financial institutions pursue higher ROE and a higher leveraged business strategy. Many financial institutions say that even though their balance sheets are leveraged, they do not have any serious problems because their risk metrics are well-calculated and fully covered by capital. However, when a market is too swollen and the bubble bursts, the ability to calculate correlation between risks no longer works and a highly leveraged operation can cause irreparable damage to society—which the last financial crisis proved.

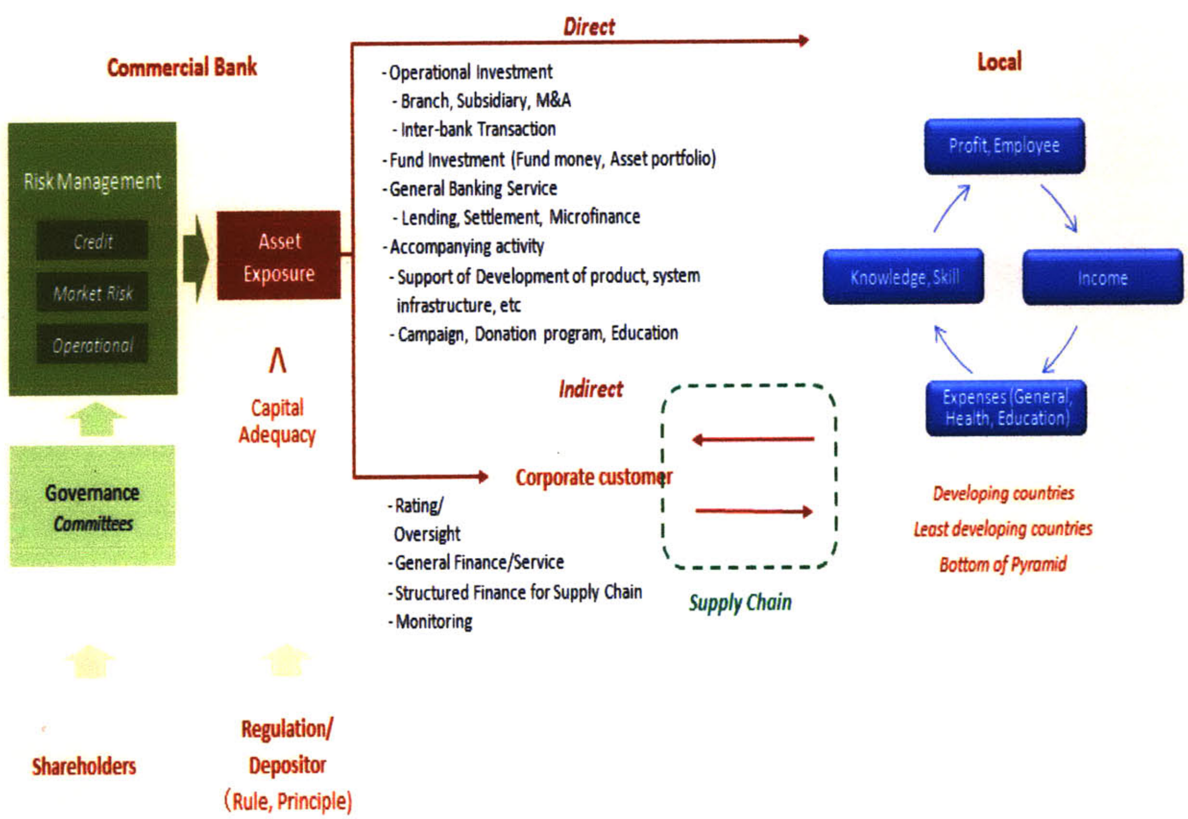
Commercial banks must now reconsider "financial efficiency" from a long-term perspective. Furthermore, regulatory authorities also need to rethink the framework in terms of greater global sustainability.

The amount of capital adequacy a commercial bank must retain determines its asset exposure for various business opportunities. On the assumption that there are both direct and indirect approaches (see Figure 14) to poor, so-called developing countries, least developed countries, or those at the bottom of pyramid, how should commercial banks allocate their capital to each type?

In the direct approach, there are four ways: operational investment, fund investment, general banking services, and accompanying activities. Among general banking services, lending on the basis of deposits, lending by carry-in capital, and settlement services are the basic products and services. Recently, U.S. and European banks also have begun to focus on microfinance.

In the indirect approach, commercial banks contribute to society through their corporate customers, which provide employment and supply chains that benefit society.

In developing countries, "real asset formation" is not adequately developed. So when a commercial bank enhances the finance business for individuals by using its own liquidity or borrowing from an inter-bank market, "capital asset formation" will be created early. Consequently, what happens if capital formation grows more quickly than real asset formation? Some believe that the level of capital formation in developing countries is extremely low, so moving quickly to lend to the poor is important. Certainly, it is effective in the short term, but I think it may likely treat only the symptoms without affecting a cure.



Source: Author

Fig. 14: Direct and indirect approaches

In the long run, commercial banks should be attentive to a balance between the direct and indirect approaches. While banks wish to support lending, they must also find ways to construct a real economy in poor countries. This is a most worthwhile mission, which commercial banks should solemnly undertake.

6.2 Capital Adequacy and a Global Commercial Bank

There is no doubt about the importance of maintaining and improving capital adequacy. Under the Basel II framework (BIS, 2004), banks must face the fact that risk-taking in poor countries requires more innovative approaches to managing the bank's capital adequacy. It is generally well-known that international banks must ensure at least an 8% BIS capital ratio. The formula for calculating the ratio can be simplified as follows:

- BIS capital ratio (%) = Adjusted Capital/Total risk-weighted assets*

---

* Total risk-weighted assets are determined by sum of three components:
    - Sum of risk-weighted assets for credit risk;
    - Amount which is divided sum of operation risk by 8%;
    - Amount which is divided sum of market risk by 8%

The point on which to focus is the "sum of risk-weighted assets for credit risk" in the denominator. To expand risk exposure in a developing country, a bank needs to decide how to measure the "risk-weighted assets for credit risk in poor countries." To begin, I will address the Basel II approaches.

To calculate the sum of risk-weighted assets, Basel II allows banks to apply two approaches: a standardized approach, and an internal rating-based (IRB) approach. The former measures credit risk using the credit assessment made by an external rating agency; the latter calculates credit risk based on the bank's own internal estimates of risk. Either way, the sum of risk-weighted asset should be calculated by methodologies defined by BIS.

If a bank adopts the standardized approach and takes AAA-rated sovereign risk, the weight is zero. When it takes a below B-rated sovereign risk, the weight is 150%. This means that while the bank does not recognize any appropriation of capital for credit risk from some developed countries, the country with the lower-rated risk demands more capital from the bank than real exposure.

Most international banks tend to apply the IRB approach, subject to their domestic regulatory authority's approval. This approach gives incentives to the banks because it usually introduces less risk-weighted assets than the standardized approach—although the banks require a higher level of skill for risk measurement.

The IRB approach begins with a simple equation:

Total Losses = expected losses (EL) + unexpected losses (UL)

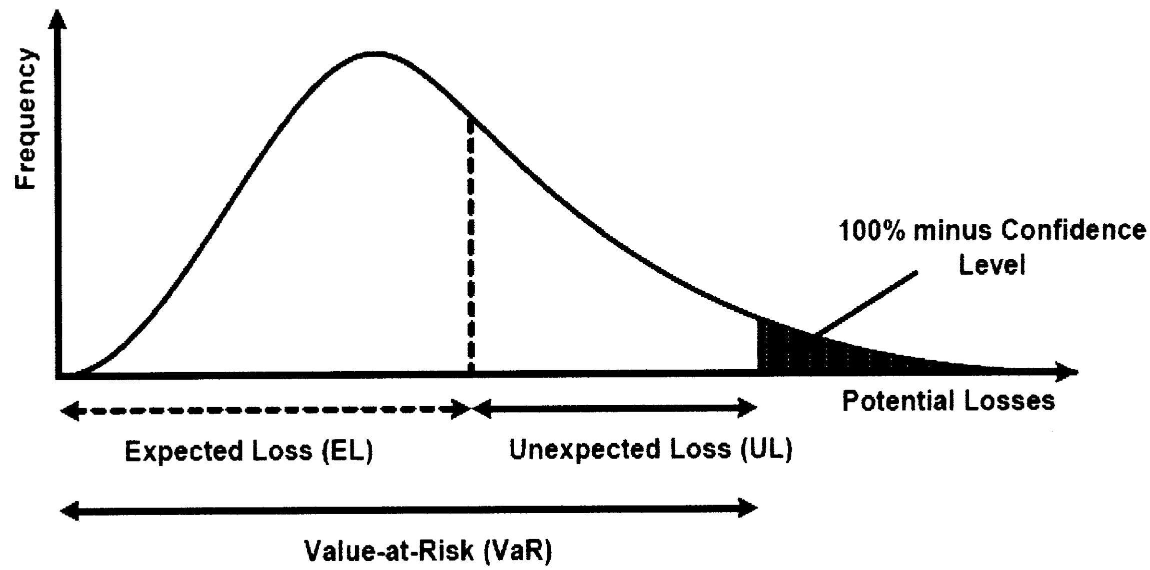
where:

EL = the cost attendant on ordinal banking business, calculated as an average level of realized credit loss that is estimated reasonably from bank's experience.

UL = is the peak loss above the expected level and is determined on the basis of the probability computed by the Asymptotic Single Risk Factor (ASRF) model developed by BIS.

BIS states that the model should be "portfolio invariant." This means that the bank has succeeded in diversifying its credit portfolio and therefore no diversification in the bank is taken into account when estimating probability. In short, the underlying assumption in this model is that the bank's portfolio has been already well-diversified with a large number of small exposures. Only systematic risks will have a large effect on the probability of credit losses; the idiosyncratic risk associated with a borrower's exposure is offset by separate exposures.

Total estimated losses are illustrated in Figure 15. In the figure, they are recognized as Value-at-Risk (VaR). BIS also fixes the confidence level at 99.9% (i.e., probability of once in a thousand years).



Source: BIS. *An Explanatory Note on the Basel II IRB Risk Weight Functions*, 2005

Fig. 15: Total estimated losses (VaR = EL + UL)

How should a bank estimate VaR, EL, and UL? To decide, key risk parameters in the IRB approach are: probability of loss (PD), loss given default (LGD), and exposure at default (EAD), each defined below:

PD : average percentage of borrowers who default. PD is estimated based on the PD of each internal rating grade. Three options for calculating PD (corporate) are: internal default experience; mapping of internal grades to external credit assessment; and statistical default prediction model (to retail, only internal default experience can be applied).

LGD: average percentage of exposure that the bank will lose depending on collateral, proceeds from workout, etc, when borrowers default. When deciding VaR, LGD should reflect an adverse economic scenario, which is called "downturn LGD."

EAD: estimated outstanding when borrowers default.

VaR, EL, and UL are defined in the formulas below. The right side of the VaR equation is called the supervisory mapping function (following the BIS ASRF model), which estimates total losses (VaR) from average PD and downturn LGD.

$$VaR = LGD \times N[(1-R)^{-0.5} \times G^1(PD) + (R/(1-R))^{0.5} \times G^2(0.999)]$$

$$EL = PD \times LGD \times EAD$$

$$UL = [VaR - EL] \times M$$

where:

N = Standard normal distribution applied to threshold and conservative value of systematic factor

G^1 = Inverse of standard normal distribution applied to PD to derive default threshold

G^2 = Inverse of standard normal distribution applied to confidence level to derive conservative value of systematic factor

R = Asset correlation between individual borrower and systematic risk factor

M = Maturity adjustment for risk from long-term credit which is usually more risky

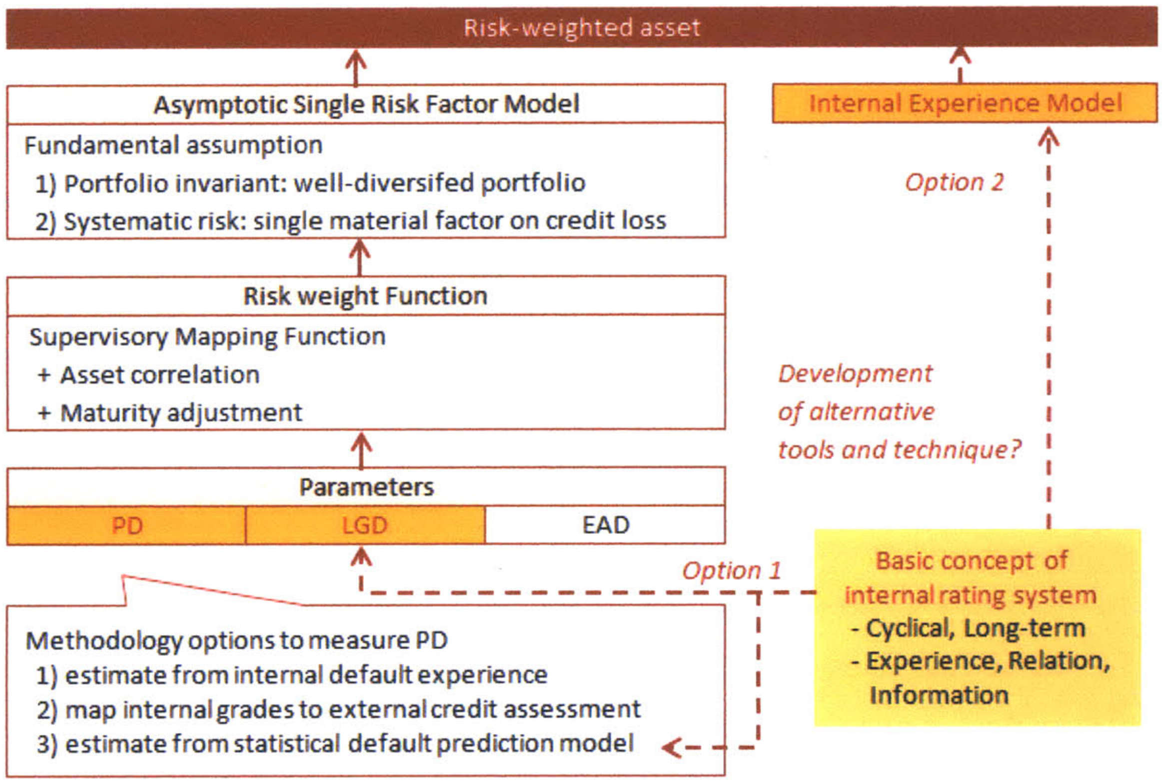
How should banks cover these risks? EL is a cost of average realized loss, so banks should manage it with price and provision. On the other hand, banks can neither estimate the time when UL is realized nor cover it with pricing under normal market conditions. Therefore, UL must be covered by capital in order to protect the bank's depositors and debt holders.

A key subject for discussion is that concepts of the model to be adapted to the IRB approach are "diversifying credit exposure (= releasing from idiosyncratic risk)" and "grasping the systematic risk cycle." It seems that all banks must have a diversified credit portfolio, and it will be difficult to enter new markets. In addition, to estimate PD, many banks now utilize historical averages in their portfolios and/or the rate that is assessed by an external rating agency. Even when applying the IRB approach, a simple or common measure, instead of each bank's internal intelligence, is used to compute risk-weighted asset. This may be reasonable in the sense of measuring the bank's risk uniformly. However, under the framework that Basel II stipulates, banks could encounter a serious challenge in measuring credit risk when expanding credit exposure in developing countries.

Usually, return is recognized by interest rate, and risk is estimated by scientific simulation with large amounts of historical data. If the expanding credit exposure in a poor country carries with it the prerequisite for a larger capital ratio because there is little experience of risk-taking there, then the bank is charged an additional capital cost. Therefore, by necessity, the bank will raise its margin on transactions with poor countries (with the result that credit often cannot be granted). Following customary economic thinking that return should be dependent on risk, this method of calculating capital ratio looks just fine. The theory guides the bank to maintain its soundness. However, when a bank has insufficient data to identify a credit risk under basic Basel II guidance, is giving a higher margin the only solution? Are there other challenges the bank should consider for risk management?

There are two options. One is to maintain the existing framework with new applications that handle credit risk for the poor; the other is to complement the existing framework with a new, innovative framework. In the former, the bank must develop a new application to measure credit risk from the bank's original perspective; in the latter, a newly regulated commercial bank will be founded.

Regarding a new application introduced into the current framework, I think the key is to create an internal rating system, which provides material information for the model, from the perspective of the cyclical nature of economics (through- the -cycle (TTC)) rather than from the present point in time (PIT) (see Figure 16).



Source: Author

Fig. 16: Structure for measuring risk-weighted assets (simplified)
(Existing framework with new applications)

In the former perspective (TTC), the bank judges a client's credit risk from a longer viewpoint. In a developing country, the performance of debtors (both companies and individuals) is strongly influenced by macro and/or regional economic situations that often fluctuate. In order to expand credit exposure in a developing country, formulating an internal rating structure from the cyclical viewpoint is important. In general, banks are good at analyzing corporate risk and personal pool credit. However, to extend credit exposure in poor countries, bank must pay attention to how the macro and/or micro economy will vary, as well as how economic expansion, including the positive impact from the bank's activity, will influence credibility. This means the bank is also required to obtain accurate insights into the pro-cyclical nature in the poor country's economy. This type of perspective, I think, will suit the basic Basel II concept of grasping the systematic risk cycle as well as the macro prudential policy, which authorities now see as a new regulatory framework to oversee relationships between economic and financial institutions.

In the perspective of cyclicality of economy, while the default ratio of each rating grade varies with the economic situation, the number of debtors in each grade is stable. On the other hand, in the perspective of present point in time, banks measure risk through an analysis of current financial statements, so the number of debtors is variable between grades but the default ratio is stable. In terms of credit risk management for the bank as a whole, which includes various types of credit exposure in developed and developing countries, an internal rating grade system developed from a cyclical viewpoint will more efficient for carrying out the bank's entire risk management program, including estimation of PD and decision making on necessary action when the economic situation suffers a downturn.

Not only PD but also LGD estimates could be devised by each bank. As a general rule, risk itself is different due to relationships between the persons involved. For instance, when giving an exposure to a public-oriented company in a poor country, the repayment risk will be affected by the relationship between the bank and the poor country or between the bank's country and the poor country. That relationship is fostered by various factors, such as geography, history, immigrants, trade, etc. The more relationships a bank fosters, the more easily it is able to identify ways to secure credit with a borrower in the future, even though the bank has no security currently.

The BIS (2005) states:

> . . . portfolios may be relatively small in size, either globally or at an individual bank level, or a bank may be a recent market entrant for a given portfolio. Other portfolios may not have incurred recent losses, but historical experience or other analysis might suggest that there is a greater likelihood of losses than is captured in recent data.
>
> The extent to which a bank can draw on its own experience to gain empirical evidence to support its parameter estimates will vary across portfolios. For example, where a bank does not have sufficient loss experience of its own, it may be able to draw upon industry experience in the form of pooled data or may use other tools to estimate loss parameters. (p.1)

To extend this application, allowing banks to use their own models in calculating risk-weighted assets will be an option (refer back to Figure 16, right column). The Basel II model is quite statistical, and the bank is actually required to seek a higher accuracy rate in estimating risk parameters through stress tests, etc. However, when the bank is expanding its risk exposure in a developing country, the new model based on experience, rather than the statistical model, should be considered. Bankers should not lean too much on the probability model without obtaining deeper insights into the poor country's market

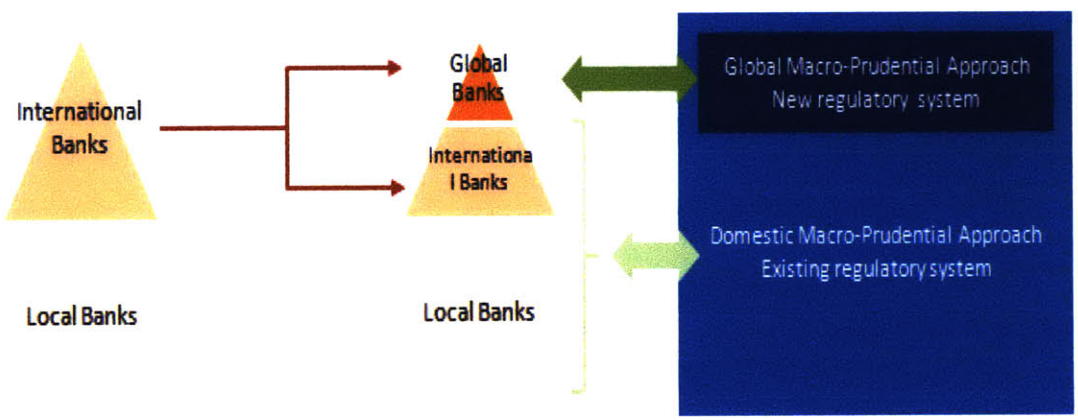
BIS (2005) also mentions:

> . . . the choice of the ASRF for use in the Basel risk weight functions does by no means express any preference of the Basel Committee towards one model over others . . . . Banks are encouraged to use whatever credit risk models fit best for their internal risk measurement and risk management needs. (p.5)

Basel II is a well-structured framework that allows banks all over the world to apply a unified methodology. I believe, however, that in either case—applying a longer perspective to credit judgment, or applying a unique model—banks have to be innovative in their discussions about Basel II. Another alternative may be that a bank uses the BIS model as a benchmark for the bank's own methodology. Or some combination of the existing Basel II framework and a new model is possible.

Eventually, these challenges will stimulate the evolution of a framework for the future.

When considering the micro-prudential policy, a regulatory authority may hesitate to permit a bank to apply its own rating guidance because the specification of differences between how banks arrive at their ratings is difficult. Since the authority inspects the performance and risk of all banks, a simple measurement is useful. Applying different metrics is time-consuming for both a regulatory authority as well as a bank. However, a macro-prudential policy, which focuses on systematic risk between society and the financial institution, may allow the bank to introduce a unique approach developed from its own insight. This option makes banks apply their own policy to some degree if the banks can prove the appropriateness of their credit risk judgment for the designated country, business, scheme, etc.



Source: Author

Fig 17: Global Commercial Banks

The second alternative is a fundamental challenge that asks BIS to permit a capital ratio less than 8% for banks that focus on expanding their credit exposure in poor countries. Banks receiving such a preference would be considered a "Global Commercial Bank" (see Figure 17). Currently, the Basel II framework must be adopted by every bank that develops its business internationally. The new idea would create a new category of banks in the international banking system.

Today, there are a few mega-banks in major developed countries, including Citi, BoA, and JPMC in the U.S., and HSBC and Barclays in the UK. These banks are expanding the scale of their international transactions. In this new scenario, in which the world is considered to be one large country, the new category of banks could be called "Global Mega" banks. An outline of licensing requirements might be along the following lines:

- A traditional banking business, grounded on general banking needs such as deposits, loans, settlement services, etc., accounts for most of the business line in the bank.
- Proprietary trading for which the bank and the industry do not have historical records would be prohibited. That type of business would be completely independent from the bank entity.
- The bank has to build a minimum number of branches and/or subsidiaries in poor countries, which is determined through discussions between the bank and regulators.
- Active collaboration with private companies to create a new supply chain in the poor country would be a core policy.
- Conventional asset, liability, and foreign exchange management must be required.
- Availability of financial investment, such as alternative investment, must be strictly limited.
- Business in the mother market as a regional mega bank is allowed.

If Global Commercial Banks focus only on traditional banking business, fluctuations in market risk could be eliminated. Yes, market risk is well-calculated based on Basel II guidelines, but VaR that is introduced to identify various risks cannot cover all economic variables. The current financial crisis has proven that. The fact of the crisis supports the idea that if banks avoid high-risk transactions, a licensed bank could reduce market risk and then be allowed to adopt a lower BIS capital ratio than 8%. On the other hand, the possibility of reducing operational risk is uncertain because, while operational risk from risky market transactions may reduce, other risks in developing countries should be recognized.

Whatever happens, the newly designated banks would have to concentrate their resources on research and on developing relationships with developing countries. Accordingly, the bank's risk insight should be deeper than other international banks. The most important mission of a Global Commercial Bank is to build a unique methodology for measuring credit risk in developing countries, taking the long-term pro-cyclical perspective, and accumulating expanding experience with poor countries.

In order to succeed with such a challenge, a supervisory role is a necessity. Currently, the main mission of the commercial banking industry is to contribute to economic growth in the mother country; also the authority in the developing country has a strong incentive to oversee commercial banks for its own country's developments. Who should oversee such Global Commercial Banks which expand their operations in various developing countries? Who can execute the second pillar of Basel II (supervisory review process) effectively? Who can inspect the newly licensed bank's risk management? Considering that the newly licensed bank will take broader credit risks, the existing regulatory framework will also need to change.

Currently, U.S. regulators are discussing the possibility of restructuring financial authorities. The existing structure is based on silos of regulators such as the FED, the U.S. Treasury Department, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), state committees, and so on.

What I propose here is to design a new system that is tied to the banking business and global sustainability, going well beyond current discussions among

U.S. regulators. In addition to the system that places local regulatory frameworks under its umbrella, a new international authority should be established, which would draw on the expertise of the BIS, IMF, FED, UKFSA, etc. The authority would also be responsible for overseeing the Global Commercial Banks from the viewpoint of its global macro-prudential policy. In the new system, regular correspondence among the global community, each country (in particular developing countries), and the Global Commercial Banks, would be monitored. In sum, the new authority would be expected to align the banking business and global sustainability under its global macro-prudential policy.

One other consideration: the regulatory authority in a developing country might hesitate to collaborate on rebuilding a global regulatory framework. Historically, prudential policies have been driven by developed countries; developing countries have been in fear of the cream-skim and failed to provide market mechanisms for the entrance of foreign banks. BIS (2010) points out that microfinance, which financial institutions in poor countries are extending, offers fewer opportunities to raise adequate capitals, diversify portfolios, relate track records to credit exposure, and build a strong governance structure. Consequently, banks considering microfinance should obtain different tools for credit risk management than those used in conventional retail lending. In such a case, a Global Commercial Bank could support financing and offer a platform of risk management.

Some US and European banks have begun to define risk management in poor countries, especially as part of their corporate citizenship activities. However, Japanese bank have not yet done this. With the creation of a dynamic new system in which related regulatory authorities and financial institutions have incentives to link with each other to build a more effective financial system, the evolution of the second pillar of Basel II and a new global prudential policy might be expected.

6.3 Credit Control and Global Sustainability

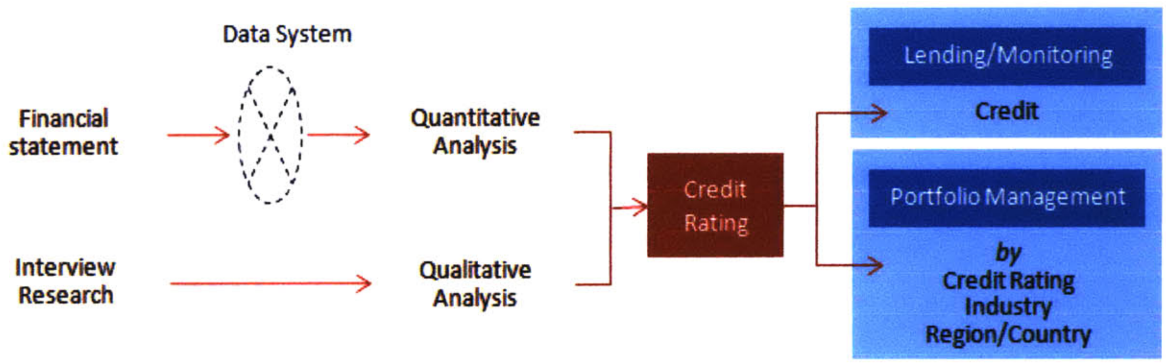
Commercial banks commonly develop their own credit rating system and apply it to their lending business. Such an internal system is integral to the bank's credit risk management. In fact, banks provide a credit rating for a company or a country (called the "Corporate Rate" and "Sovereign Rate," respectively) before deciding to lend. When deciding on the Corporate Rate, a bank usually views a company from both quantitative and qualitative angles based on an analysis of financial statements, interviews with relevant stakeholders, and various research. The criteria are enumerated in Figure 18 below.

Quantitative Analysis	• Financial statements (Balance sheet, Income statement, Retained earnings statement, Cash flows statement) • Profitability/Soundness (various snapshot ratios and trends (ROE, ROA, capital ratio, leveraged ratio, asset turnover, etc.)) • Free cash flow, finance • Working capital, turns and period of collection, payment, and inventory • Unrealized profit/loss • Credit Rating by credit rating agency • Stock price
Qualitative Analysis	• Company's history • Background & capability of board members • Vision, Strategy • Brand, Reputation • Supply chain, suppliers and buyers • Positioning in industry, competitors and partners • Technology • Network • Relationship with other banks

Source: Author

Fig. 18: Key criteria for the Corporate Rate credit rating

Credit portfolio management is another part of risk management. Each bank typically analyzes its credit portfolio by credit rating, industry, and region/country (see Figure 19). The bank's credit committee decides on a strategy to improve the mean credit rating of all exposures, reduction of credit risk at a lower rate (collections, receipt of collateral securities, etc), and allocation of credit assets between industry and geography. Credit rating is a crucial part of strategic decisions in the banking business. Every bank should have the know-how to improve its credit rating method based on its history.



Source: Author

Fig.19: Credit rating

Some banks also provide a rate by lending facility. It is called "Facility Rate." The rate is typically used when the bank is lending through a structured finance scheme. In such a scheme—for instance, financing the construction of an oil plant—the bank takes on the cash flow risk rather than a corporate risk or a sovereign risk. The finance is organized in a highly complicated scheme. Sometimes contracts with the buyer and/or the plant are secured as collateral. Sometimes the oil itself is used as security, in which case the bank is responsible for selling it on the secondary market if the project reaches an impasse. In such a scheme, the bank analyzes various risks that may cause future default, and, based on its analysis, will provide a Facility Rate. In fact, determining how to structure such a scheme that mitigates risk is another way to demonstrate a bank's competency.

As mentioned in section 2.5.4, what should a bank do with an internal credit rating system for monitoring a company's activity if that bank wants to pursue global sustainability? Currently, during its qualitative analysis the bank takes note of the customer's pursuit of sustainability, although in most cases such activity reflects only a minor part of the analysis (such as the impact on its reputation) unless a large negative impact is realized (such as a product recall, environmental contamination, labor dispute, etc). In general, positive human rights activities, such as business expansion in poor countries, labor diversity, and so on, are not considered in the computation of a rate. Even environmental activities, such as working to decrease carbon emissions, may not be considered in its rating system.

Consequently, banks should be required to add another pillar, "sustainable analysis", to their rating system. Banks might argue that there is no fixed way to evaluate sustainable activity. However, a bank's ability to manipulate huge amounts of data should be considered.

Once a bank launches its rating system, it will also be required to carry out its own strategy for global sustainability. Banks need to accelerate the implementation of their sustainable strategies in order to avoid negative perceptions from their customers. In any case, banks should also have to compete in a sustainability analysis.

Banks have several options for dealing with a wide range of stakeholders to develop the new system. One option is to establish a working group comprised of global organizations, bankers associations, etc. Another is to connect with consultants such as GRI and audit firms. NGOs can bring valuable insights to this study. The fact is that banks have enormous quantities of information about their customers. In particular, bank officers need to assess each customer's value chain, including their relationships with suppliers, technology, inventory management, engagement with buyers, and so on. In my own experience, I had many such opportunities to collect supply chain information when I was a representative officer at a bank.

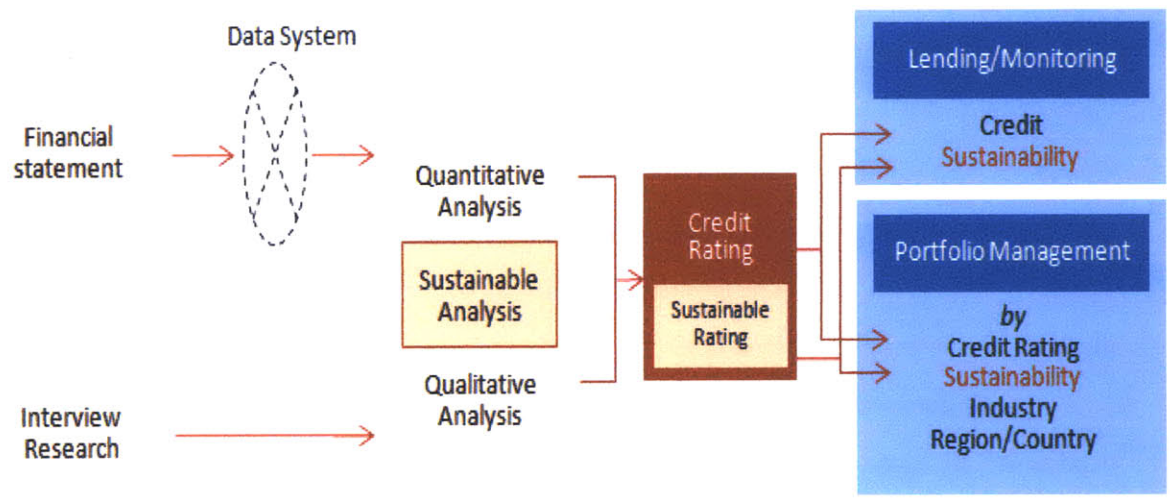
Ideally, banks can initiate a qualitative analysis by following certain metrics. For instance, how much does a company buy from local suppliers in certain poor countries?; what is the proportion of total buy-in of the company?; how many employees does the company hire from the local community?; how much does the company improve employment?

In addition to data, the bank has a research division that consists of very talented staff; the bank has the analytical skills already in place. Consequently, global commercial banks are already positioned to devote themselves to such sustainability studies in the future.

The result of the analyses can be the foundation of specific conditions for lending. If applied as a covenant, the company needs to comply with it. For example, covenants, stipulating that the company has to employ more than 10,000 people and purchase more than 50% of its raw materials from local suppliers in a project, can be set as terms for arranging a loan with the company. If the company fails to follow the covenants, then it must begin repaying the loan immediately. This will have a direct and strong impact on the company's business activity.

If sustainable ratings can be provided through a sustainability analysis, it could be enormously helpful for portfolio management as well as monitoring the company (see Figure 20). In addition, the bank can oversee the company in general, and recognize how its own credit risk asset contributes to global sustainability. If the bank wants to improve its contribution, it will need to find more clients who contribute to sustainability issues. If exposure to a company is reduced by the bank due to problems that infringe on or hamper global sustainability, the company will need to challenge those issues. Changes in a bank's credit rating system could be a key success factor for changing habitual actions of both banks and borrowers.

Under IRB approach of Basel II, the internal rating system is basically required to estimate parameters such as PD. Therefore, there may be an argument that including such factors of sustainability in rating system will disturb accurate estimation of parameters. Point will be what ethical policy the commercial banking industry will shape—will banks allocate their capitals to seek the stability of financial system only or to pursue sustainability as well? In the end, I hope the rating system is a useful tool for supporting global sustainability.



Source: Author

Fig. 20: Sustainable rating and portfolio management

6.4 Banking and Commercial Business

When considering environmental issues, banks extend finance for renewable energy projects and the carbon emissions trading market. The direction of these areas is now becoming more evident, but the key is how quickly action will be taken in other regions.

Another direct approach to poor countries is to extend significant amounts of microfinance support. However, there are some sticky issues with microfinance:

- how to reach people, such as via physical branches and mobile services;
- how to educate potential recipients;
- how to develop human capital;
- how to treat non-repayment;
- what kind of credit risk management model should be introduced.

These are not easy questions, but their answers have a great impact on poor countries.

Beyond environmental and microfinance issues, what else can be done by commercial banks? This is where an indirect approach can be more effective, and it can have more positive impacts on society. As discussed in section 2.5.3, banks have an opportunity to make a constructive influence on the supply chain. The bank has already provided various finance schemes, so are there now other ways to bring about a more powerful impact?

One less-conventional idea is to allow banks to handle general commercial business. In the U.S. Bank Holding Company Act, banks are prohibited from purchasing the voting rights of more than 5% of a general company. Business that a bank can conduct is limited within certain areas that are closely related to banking transactions. This concept is a reasonable way to ensure the stability of a banking system. The pros and cons to be considered when a bank conducts general business are shown in Figure 21.

Among the advantages, "reduction of information cost in users" is the most beneficial to poor countries. Banks present both business and finance information in one package to people in poor countries, so they will not have to pay as much to coordinate such information. More business opportunities may be afforded in poor countries.

Pros	Cons
• Scale merit • Effect from risk divergence • Reduction of information cost in users • Smooth and direct use of technological innovation • Covering of regulatory cost	• Concern over industrial domination • Conglomerate discount • Leakage of safety net over banking system • Increase of regulatory cost in government • Deviation from arms-length rule

Source: Author

Fig. 21: Pros and cons when banks conduct general business

Industrial domination is a possibility, but I believe there is a way to control the risk of dominance. Preventive proposals could include:

- Limit the range of regions or countries in which a bank can promote its commercial business.
- Impose such limitations based on historical information and familiarity with the region/country.
- License more than one Global Commercial Bank in a region/country in order to maintain fair competition.

While a Global Commercial Bank will not have official permission to establish a commercial business in developed countries, they will be allowed to develop new business in developing countries for export to developed countries, which gives a favorable advantage to the developing country. The bank has to be careful to spread its allocations fairly among the countries from/to which the bank imports/exports its products. The bank's mission should be to contribute to increasing the real assets of poor countries as well as the cash flow, by originating new business through its commercial duty. In cooperation with current expansion which I discussed in previous sections, the commercial business function would bring tremendous advantages to alleviating poverty.

6.5 Financial System Support

To complete the construction of a financial system, there are a variety of ways to support the banking transition in poor countries, as follows:

- Joint operation in a common infrastructure system between Global Commercial Banks and local banks.
- Introduction of a management platform, such as risk control, which the Global Commercial Bank has already applied.
- Offering products (mobile banking, etc).
- Advice on legal and regulatory matters (work jointly with authorities in developed and developing countries).
- Training of banking officers.
- Education in society.

Typically banks in developed countries acquire the voting rights of the local bank and then place their own system infrastructure, platform, products, and so on, at the acquired bank. Then the bank often invites staff at the acquired local bank to participate in a training program. As a part of its CSR activity, a number of educational programs for nations are provided by banks already.

Methods to help build up a stable system are varied. How can local banks overcome their weaknesses when working with a Global Commercial Bank? Adequate dialogue between them is required.

6.6 Strategic Design

A strategy map of the Balanced Scorecard theory is useful for strategic management. In the theory, the map has four perspectives: Financial, Customer & Society, Internal Business Process, and Learning & Growth.

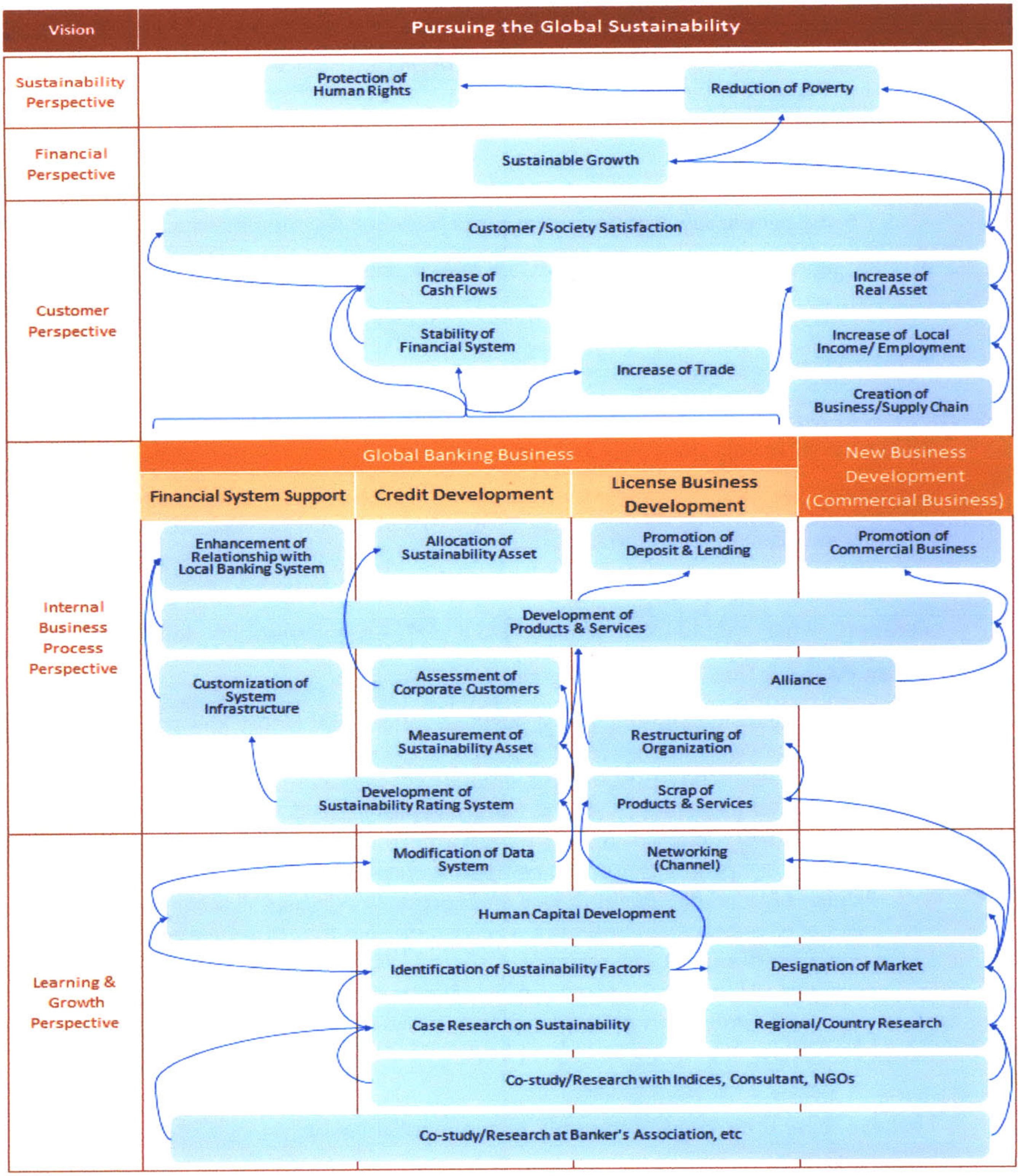
In the proposal for global sustainability management, the "Sustainability" perspective is put at the top of the map (see Figure 22). Beyond the financial perspective, considering how to protect human rights is an absolute necessity. Connections between sustainable growth of commercial banks and global sustainability should be discussed in Global Commercial Banks.

On the figure, two goals, "Global Banking Business Development" and "New Business Development: Creating general commercial business", are composed of Internal Business Process and Learning & Growth perspective. Moreover, in the former, three sub-themes—"Financial System Support", "Credit Development: Providing new rating system and financial scheme", and "License Business Development: creating banking business as a Global Commercial Bank"—are provided. Viewing License Business Development in relation with New Business Development is also important.

Overall primary research will be a key for those business developments. It will prescribe directions of resource management, such as human capital, system investment, and channel construction, as well as ideas for pursuing global sustainability. Co-study and research with other Global Commercial Banks as well as indices, consultants, and NGOs will help the bank. Thereafter, the bank can decide on its business field and implement a scrap-and-build policy on its products and services.

The sustainability factor, which is determined through research, stipulates the specifications of a good sustainability rating system. Done well, the system can measure and allocate a sustainability asset portfolio, and form part of the system infrastructure provided for the local bank.

At the same time, research will help when deciding on commercial business strategies. Alliances with private companies in mainstay industries such as trading, telecommunication, energy, agriculture, and transportation are a practical and attractive option. Moreover, appointment of a full-time director and establishment of a committee will help to align resources for executing the strategy. Finally, business action toward two goals will contribute to increasing both real asset and cash flow more effectively in poor countries.



Source: Author

Fig. 22: Strategic map of a Global Commercial Bank

CHAPTER 7
CONCLUSION

Some people say that the recent rapid increases in population are an anomaly in our planet's history, and such increases are not likely to be sustainable indefinitely. And if they were to continue, we may decide to control population in some way.

However, this is a serious question of human rights. In addition, the difference in living standards between developed countries and least developing countries is striking. By no means can we achieve consensus about controlling the world population in all countries.

What we should do now is strive for social and economic equality. In such a situation, what should commercial banks do? An international initiative,[18] first presented in the Introduction to this thesis, states:

> As those inside and outside of business rethink the nature and purpose of corporations, three conditions have impeded progress in translating unease into a broad-based movement for fundamental change. One is *the limited awareness of how received wisdoms embedded in economic and management theory*—amoral individuals, unwavering economic rationality, productivity and competitiveness above all other values—shape both management theory and corporate conduct. A second is *the lack of an overarching framework*—visions of how the future corporation must be designed—to provide a shared platform for various reform streams. Third is *the absence of a cohesive movement built on common values and progressive principles* that transcend size, sector and location of individual corporations. [emphasis added]

I believe these three conditions apply to commercial banks.

[18] Corporation 20/20 website: http://www.corporation2020.org/.

In regard to limited awareness, banks should be much more sensitive about their original function and activity to protect human rights. Second, being conscious of the above, a large bank could work as an all-embracing provider for settling issues in poor countries. Third, contributed visible actions by banks would help create a new sense of community.

There are a number of innovative people who challenge the world to pursue sustainability, including Senge et al. (2008), who suggest the following:

- Thoughtful people see rising problems earlier than the rest of us.
- They understand how severe those problems are.
- The combination of deep concern and a sense of possibility for a better future causes them to think differently about the problems and how they are interconnected.
- Different ways of thinking lead to different ways of acting. By focusing on long-term strategies, groups and organizations begin to take into account the larger systems in which they operate, instead of simply fixing isolated problems. (p.43)

These authors also note that people have good knowledge about three core areas for practicing organization learning:

> First, individually and collectively, they are continually learning how to *see the larger systems*—organizations, complex supply chains, industries, cities, or regions—of which they are a part. . . .
>
> Second, they understand that it is crucial to *collaborate across boundaries* that previously divided them from others within and outside their organization. . . .
>
> Finally, as people work together they also come to focus on what truly matters to them, and their thinking evolves from a reactive problem-solving mode to *creating futures they true desire*. . . .
>
> These three capabilities—seeing systems, collaborating across boundaries, and creating desired futures—must continually develop in

> institutions as well as individuals, for institutions, and the networks they create, shape how our present world operates and hold the greatest promise for systemic change. (Senge et al., 2008, p. 44)

What I have discussed in this thesis is a single idea, but there are many other ideas, points, and arguments that would take considerable time to cover. After the current financial crisis, however, I believe there is an once-in-a-lifetime opportunity for leaders at commercial banks to address the challenge of systemic change. My faith is that, although official aid systems such as the WB present tremendous contributions to poor countries, the innovative challenge of a private commercial bank could deal more deeply and systematically with the future. I will be keen to explore how to bring it about in business.

APPENDICES

Appendix 1

The Global Compact

Human rights
Principle 1 Businesses should support and respect the protection of internationally proclaimed human rights; and
Principle 2 make sure that they are not complicit in human rights abuses.

Labour Standards
Principle 3 Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4 the elimination of all forms of forced and compulsory labour;
Principle 5 the effective abolition of child labour; and
Principle 6 the elimination of discrimination in respect of employment and occupation.

Environment
Principle 7 Businesses are asked to support a precautionary approach to environmental challenges;
Principle 8 undertake initiatives to promote greater environmental responsibility; and
Principle 9 encourage the development and diffusion of environmentally friendly technologies.

Anti-corruption
Principle 10 Businesses should work against corruption in all its forms, Including extortion and bribery.

Appendix 2

Millennium Development Goals (MDGs)

Goal 1: Eradicate extreme poverty and hunger

Target 1a: Reduce by half the proportion of people living on less than a dollar a day

- 1.1 Proportion of population below $1 (PPP) per day
- 1.2 Poverty gap ratio
- 1.3 Share of poorest quintile in national consumption

Target 1b: Achieve full and productive employment and decent work for all, including women and young people

- 1.4 Growth rate of GDP per person employed
- 1.5 Employment-to-population ratio
- 1.6 Proportion of employed people living below $1 (PPP) per day
- 1.7 Proportion of own-account and contributing family workers in total employment

Target 1c: Reduce by half the proportion of people who suffer from hunger

- 1.8 Prevalence of underweight children under-five years of age
- 1.9 Proportion of population below minimum level of dietary energy consumption

Goal 2: Achieve universal primary education

Target 2a: Ensure that all boys and girls complete a full course of primary schooling

- 2.1 Net enrolment ratio in primary education
- 2.2 Proportion of pupils starting grade 1 who reach last grade of primary
- 2.3 Literacy rate of 15-24 year-olds, women and men

Goal 3: Promote gender equality and empower women

Target 3a: Eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015

- 3.1 Ratios of girls to boys in primary, secondary and tertiary education
- 3.2 Share of women in wage employment in the non-agricultural sector
- 3.3 Proportion of seats held by women in national parliament

Goal 4: Reduce child mortality

Target 4a: Reduce by two thirds the mortality rate among children under five

- 4.1 Under-five mortality rate
- 4.2 Infant mortality rate
- 4.3 Proportion of 1 year-old children immunised against measles

Goal 5: Improve maternal health

Target 5a: Reduce by three quarters the maternal mortality ratio

- 5.1 Maternal mortality ratio
- 5.2 Proportion of births attended by skilled health personnel

Target 5b: Achieve, by 2015, universal access to reproductive health

- 5.3 Contraceptive prevalence rate
- 5.4 Adolescent birth rate
- 5.5 Antenatal care coverage (at least one visit and at least four visits)
- 5.6 Unmet need for family planning

Goal 6: Combat HIV/AIDS, malaria and other diseases

Target 6a: Halt and begin to reverse the spread of HIV/AIDS

- 6.1 HIV prevalence among population aged 15-24 years
- 6.2 Condom use at last high-risk sex
- 6.3 Proportion of population aged 15-24 years with comprehensive correct knowledge of HIV/AIDS
- 6.4 Ratio of school attendance of orphans to school attendance of non-orphans aged 10-14 years

Target 6b: Achieve, by 2010, universal access to treatment for HIV/AIDS for all those who need it

- 6.5 Proportion of population with advanced HIV infection with access to antiretroviral drugs

Target 6c: Halt and begin to reverse the incidence of malaria and other major diseases

- 6.6 Incidence and death rates associated with malaria
- 6.7 Proportion of children under 5 sleeping under insecticide-treated bednets
- 6.8 Proportion of children under 5 with fever who are treated with appropriate anti-malarial drugs
- 6.9 Incidence, prevalence and death rates associated with tuberculosis
- 6.10 Proportion of tuberculosis cases detected and cured under directly observed treatment short course

Goal 7: Ensure environmental sustainability

Target 7a: Integrate the principles of sustainable development into country policies and programmes; reverse loss of environmental resources

Target 7b: Reduce biodiversity loss, achieving, by 2010, a significant reduction in the rate of loss

- 7.1 Proportion of land area covered by forest
- 7.2 CO2 emissions, total, per capita and per $1 GDP (PPP)
- 7.3 Consumption of ozone-depleting substances
- 7.4 Proportion of fish stocks within safe biological limits
- 7.5 Proportion of total water resources used
- 7.6 Proportion of terrestrial and marine areas protected
- 7.7 Proportion of species threatened with extinction

Target 7c: Reduce by half the proportion of people without sustainable access to safe drinking water and basic sanitation

- 7.8 Proportion of population using an improved drinking water source
- 7.9 Proportion of population using an improved sanitation facility

Target 7d: Achieve significant improvement in lives of at least 100 million slum dwellers, by 2020

- 7.10 Proportion of urban population living in slums

Goal 8: Develop a Global Partnership for Development

Target 8a: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system

Target 8b: Address the special needs of the least developed countries

Target 8c: Address the special needs of landlocked developing countries and small island developing States (through the Programme of Action for the Sustainable Development of Small Island Developing States and the outcome of the twenty-second special session of the General Assembly)

Target 8d: Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term

Official development assistance (ODA)

8.1 Net ODA, total and to the least developed countries, as percentage of OECD/DAC donors' gross national income

8.2 Proportion of total bilateral, sector-allocable ODA of OECD/DAC donors to basic social services (basic education, primary health care, nutrition, safe water and sanitation)

8.3 Proportion of bilateral official development assistance of OECD/DAC donors that is untied

8.4 ODA received in landlocked developing countries as a proportion of their gross national incomes

8.5 ODA received in small island developing States as a proportion of their gross national incomes

Market access

8.6 Proportion of total developed country imports (by value and excluding arms) from developing countries and least developed countries, admitted free of duty

8.7 Average tariffs imposed by developed countries on agricultural products and textiles and clothing from developing countries

8.8 Agricultural support estimate for OECD countries as a percentage of their gross domestic product

8.9 Proportion of ODA provided to help build trade capacity

Debt sustainability

8.10 Total number of countries that have reached their HIPC decision points and number that have reached their HIPC completion points (cumulative)

8.11 Debt relief committed under HIPC and MDRI Initiatives

8.12 Debt service as a percentage of exports of goods and services

Target 8e: In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries

8.13 Proportion of population with access to affordable essential drugs on a sustainable basis

Target 8f: In cooperation with the private sector, make available the benefits of new technologies, especially information and communications

8.14 Telephone lines per 100 population

8.15 Cellular subscribers per 100 population

8.16 Internet users per 100 population

Appendix 3

The Universal Declaration of Human Rights

Article 1.

All human beings are born free and equal in dignity and rights. They are endowed with reason and conscience and should act towards one another in a spirit of brotherhood.

Article 2.

Everyone is entitled to all the rights and freedoms set forth in this Declaration, without distinction of any kind, such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status. Furthermore, no distinction shall be made on the basis of the political, jurisdictional or international status of the country or territory to which a person belongs, whether it be independent, trust, non-self-governing or under any other limitation of sovereignty.

Article 3.

Everyone has the right to life, liberty and security of person.

Article 4.

No one shall be held in slavery or servitude; slavery and the slave trade shall be prohibited in all their forms.

Article 5.

No one shall be subjected to torture or to cruel, inhuman or degrading treatment or punishment.

Article 6.

Everyone has the right to recognition everywhere as a person before the law.

Article 7.

All are equal before the law and are entitled without any discrimination to equal protection of the law. All are entitled to equal protection against any discrimination in violation of this Declaration and against any incitement to such discrimination.

Article 8.

Everyone has the right to an effective remedy by the competent national tribunals for acts violating the fundamental rights granted him by the constitution or by law.

Article 9.

No one shall be subjected to arbitrary arrest, detention or exile.

Article 10.

Everyone is entitled in full equality to a fair and public hearing by an independent and impartial tribunal, in the determination of his rights and obligations and of any criminal charge against him.

Article 11.

(1) Everyone charged with a penal offence has the right to be presumed innocent until proved guilty according to law in a public trial at which he has had all the guarantees necessary for his defence.

(2) No one shall be held guilty of any penal offence on account of any act or omission which did not constitute a penal offence, under national or international law, at the time when it was committed. Nor shall a heavier penalty be imposed than the one that was applicable at the time the penal offence was committed.

Article 12.

No one shall be subjected to arbitrary interference with his privacy, family, home or correspondence, nor to attacks upon his honour and reputation. Everyone has the right to the protection of the law against such interference or attacks.

Article 13.

(1) Everyone has the right to freedom of movement and residence within the borders of each state.

(2) Everyone has the right to leave any country, including his own, and to return to his country.

Article 14.

(1) Everyone has the right to seek and to enjoy in other countries asylum from persecution.

(2) This right may not be invoked in the case of prosecutions genuinely arising from non-political crimes or from acts contrary to the purposes and principles of the United Nations.

Article 15.

(1) Everyone has the right to a nationality.

(2) No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality.

Article 16.

(1) Men and women of full age, without any limitation due to race, nationality or religion, have the right to marry and to found a family. They are entitled to equal rights as to marriage, during marriage and at its dissolution.

(2) Marriage shall be entered into only with the free and full consent of the intending spouses.

(3) The family is the natural and fundamental group unit of society and is entitled to protection by society and the State.

Article 17.

(1) Everyone has the right to own property alone as well as in association with others.

(2) No one shall be arbitrarily deprived of his property.

Article 18.

Everyone has the right to freedom of thought, conscience and religion; this right includes freedom to change his religion or belief, and freedom, either alone or in community with others and in public or private, to manifest his religion or belief in teaching, practice, worship and observance.

Article 19.

Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive and impart information and ideas through any media and regardless of frontiers.

Article 20.

(1) Everyone has the right to freedom of peaceful assembly and association.

(2) No one may be compelled to belong to an association.

Article 21.

(1) Everyone has the right to take part in the government of his country, directly or through freely chosen representatives.

(2) Everyone has the right of equal access to public service in his country.

(3) The will of the people shall be the basis of the authority of government; this will shall be expressed in periodic and genuine elections which shall be by universal and equal suffrage and shall be held by secret vote or by equivalent free voting procedures.

Article 22.

Everyone, as a member of society, has the right to social security and is entitled to realization, through national effort and international co-operation and in accordance with the organization and resources of each State, of the economic, social and cultural rights indispensable for his dignity and the free development of his personality.

Article 23.

(1) Everyone has the right to work, to free choice of employment, to just and favourable conditions of work and to protection against unemployment.

(2) Everyone, without any discrimination, has the right to equal pay for equal work.

(3) Everyone who works has the right to just and favourable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection.

(4) Everyone has the right to form and to join trade unions for the protection of his interests.

Article 24.

Everyone has the right to rest and leisure, including reasonable limitation of working hours and periodic holidays with pay.

Article 25.

(1) Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

(2) Motherhood and childhood are entitled to special care and assistance. All children, whether born in or out of wedlock, shall enjoy the same social protection.

Article 26.

(1) Everyone has the right to education. Education shall be free, at least in the elementary and fundamental stages. Elementary education shall be compulsory. Technical and professional education shall be made generally available and higher education shall be equally accessible to all on the basis of merit.

(2) Education shall be directed to the full development of the human personality and to the strengthening of respect for human rights and fundamental freedoms. It shall promote understanding, tolerance and friendship among all nations, racial or religious groups, and shall further the activities of the United Nations for the maintenance of peace.

(3) Parents have a prior right to choose the kind of education that shall be given to their children.

Article 27.

(1) Everyone has the right freely to participate in the cultural life of the community, to enjoy the arts and to share in scientific advancement and its benefits.

(2) Everyone has the right to the protection of the moral and material interests resulting from any scientific, literary or artistic production of which he is the author.

Article 28.

Everyone is entitled to a social and international order in which the rights and freedoms set forth in this Declaration can be fully realized.

Article 29.

(1) Everyone has duties to the community in which alone the free and full development of his personality is possible.

(2) In the exercise of his rights and freedoms, everyone shall be subject only to such limitations as are determined by law solely for the purpose of securing due recognition and respect for the rights and freedoms of others and of meeting the just requirements of morality, public order and the general welfare in a democratic society.

(3) These rights and freedoms may in no case be exercised contrary to the purposes and principles of the United Nations.

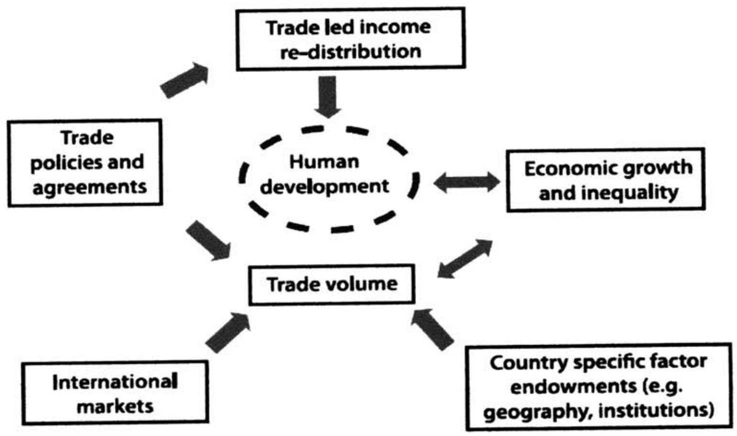
Article 30.

Nothing in this Declaration may be interpreted as implying for any State, group or person any right to engage in any activity or to perform any act aimed at the destruction of any of the rights and freedoms set forth herein.

Appendix 4

Trade and Human Development

Trade and human development (UNDP, Aid for Trade and Human Development, Figure 3.1)



Fair trade initiatives (*Aid for Trade and Human Development Box 3.5*)

Economic benefits	Social benefits	Environmental benefits
▪ High quality production processes may attract and be preferred by some global buyers ▪ Individual suppliers may be able to command higher prices by directly accessing premium niche markets ▪ Individual suppliers may be able to negotiate fixed prices and be less affected by global commodity price fluctuations ▪ Suppliers may develop longer term, more stable partnerships with buyers	▪ Improved overall working conditions ▪ Lower absenteeism and employee turnover ▪ Improved productivity. ▪ Greater equity for, and consideration of, the specific needs of female employees ▪ May enable indigenous crafts and production methods to gain wider market access ▪ Suppliers may develop longer term, more stable partnerships with buyers	▪ Provides opportunities to raise awareness and change practices to minimize the environmental damage caused by production processes ▪ Improved, more carefully considered, production processes may reduce the use, for example, of pesticides, through attention to worker health and safety ▪ May provide an easy link to other standards such as organic production standards, which inherently reduce environmental damage
Economic disadvantages	**Social disadvantages**	**Environmental disadvantages**
▪ Could create dependence on small niche markets ▪ Could prompt buyers to go elsewhere as part of a 'race to the bottom'	▪ Creates 'islands of wealth' with limited benefits for the wider community ▪ Does not account for loss of equivalent trade in 'buying' countries ▪ Does nothing to reduce the social and cultural impacts of consumerism as a whole	▪ Does not account for externalities such as carbon dioxide emissions from air transportation of goods ▪ Does nothing to reduce the environmental impacts of consumerism as a whole

Appendix 5:

Policies for MNEs

(OECD, Guideline for Multinational Enterprises, General Policies)

Enterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises should:

1. Contribute to economic, social and environmental progress with a view to achieving sustainable development
2. Respect the human rights of those affected by their activities consistent with the host government's international obligations and commitments
3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice
4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees
5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues
6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices
7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate
8. Promote employee awareness of, and compliance with, company policies through appropriate dissemination of these policies, including through training programmes
9. Refrain from discriminatory or disciplinary action against employees who make *bona fide* reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the *Guidelines* or the enterprise's policies
10. Encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the *Guidelines*
11. Abstain from any improper involvement in local political activities

Appendix 6:

Citigroup Goals and Performance Highlights

(Citizenship 2008 Report)

Goals		2008 Performance Highlights
Community Relations	Help borrowers affected by the mortgage crisis. Manage relationships with communities and advocates globally.	Helped approximately 440,000 homeowners since 2007 through loss mitigation and proactive loan modifications. Established the Citi Homeowners Assistance program. Citi foundation provided more than $3 million in Homeownership counseling grants.
Financial Education and Asset Preservation	Invest $200 million over ten years in financial education. Share best practices and collaborate on leveraging resources and knowledge. Support programs to help low-income families build and preserve assets.	Invested $28 million toward $200 million goal in 73 countries and territories. Held 15 U.S.-based financial education conferences. Reached 22,344,441 individuals through financial education and asset-building programs.
Citi Microfinance	Support continued growth of the microfinance industry globally. Expand microfinance activities in the United States. Help advance the field of microfinance through research.	Citi business served over100 microfinance institutions, global networks and investors in 35 countries. Finalized $30 million ACCION Texas transaction. Sponsored inaugural Banana Skins report on potential risks to the microfinance industry.
Environment	Continue activities under $50 billion climate initiative. Reduce absolute greenhouse gas (GHG) emissions by 10 percent by 2011 (2005 baseline). Expand the number of LEED certified facilities and increase the number of LEED accredited staff. Build on sustainable IT and internal efficiency measures to save energy, water and materials.	Committed $3.9 billion to climate-related activities. Reduce year-on-year absolute GHG emission for the first time. Achieved LEED Platinum and Gold certification for data centers in Frankfurt, Germany and Austin, Texas, respectively, and LEED-CI gold certification for a data center in Singapore. Opened 37 branches under the LEED Volume Build branch program. 38 employees and managing agent staff achieved LEED accreditation. Eliminated six million square feet of office space through the Alternative Workplace Strategies program.

Goals		2008 Performance Highlights
Environmental and Social Risk Management (ESRM)	Integrate Carbon Principles into ESRM policy. Continue to provide Equator Principles leadership. Continue robust application of ESRM Policy and Equator Principles in project finance and other relevant transactions. Train more Citi employees on the ESRM Policy.	Commenced Carbon Principles implementation. Engaged with Chinese financial institutions around Equator Principles integration. Provided ESRM review and advice on 380 transactions, including 39 subject to the Equator Principles. Provided ESRM training to 560 employees globally.
Diversity	Advance programs to support goal of being the employer of choice, service provider of choice, business partner of choice and neighbor of choice.	Launched the Women's Leadership Development Program; 57 participants attended two sessions. 13,400 employees globally participated in Citi's employee networks.
Employee	Maintain positive work environment responsive to employee needs. Provide training and opportunities for employee development. Support volunteerism and employee engagement with local communities.	Approved 3,589 applications for flexible work arrangements. Delivered 8.5 million hours of training to employees. Approximately 55,000 Citi employees participated in more than 1,000 volunteer activities during Global Community Day 2008. The Citi Foundation provided $3 million in employee matching gifts and volunteer program grants.
Citi Foundation	Focus grantmaking on programs that foster economic empowerment. Support programs that can achieve scale. Achieve greater operational efficiency.	Committed more than $13.2 million to launch the Building Bridges to College and Career initiative in the United States. Reached 2,572,451 people through the Global Financial Education Program 2002 through 2008. Developed six new operational goals to guide the future direction of the Citi Foundation. Reduced grant review, vetting and payment cycle times for all grants; in 2008 only 32 percent of grants took longer than 90 days compared to 53 percent in 2007.

Appendix 7:

Measures of Poverty and Inequality

(WB, Handbook on Poverty + Inequality, 2009)

- **Measures of Poverty**
  - The *headcount index* (P0) measures the proportion of the population that is poor. It is popular because it is easy to understand and measure. But it does not indicate how poor the poor are.
  - The *poverty gap index* (P1) measures the extent to which individuals fall below the poverty line (the poverty gaps) as a proportion of the poverty line. The sum of these poverty gaps gives the minimum cost of eliminating poverty, if transfers were perfectly targeted. The measure does not reflect changes in inequality among the poor.
  - The squared poverty gap index (also known as the *poverty severity index*, P2) averages the squares of the poverty gaps relative to the poverty line. It is one of the Foster-Greer-Thorbecke (FGT) class of poverty measures that allow one to vary the amount of weight that one puts on the income (or expenditure) level of the poorest members in society. The FGT poverty measures are additively decomposable. It is also possible to separate changes in the FGT measures into a component resulting from rising average incomes, and a component resulting from changes in the distribution of income.
  - The *Sen-Shorrocks-Thon index* combines measures of the proportion of poor people, the depth of their poverty, and the distribution of welfare among the poor. This measure allows one to decompose poverty into three components and to ask: Are there more poor? Are the poor poorer? Is there higher inequality among the poor?
  - Other measures of poverty are available. The *time taken to exit* measures the average time it would take for a poor person to get out of poverty, given an assumption about the economic growth rate; it may be obtained as the *Watts Index* divided by the growth rate of income (or expenditure) of the poor.
  - Learning Objectives; after completing the chapter on *Measures of Poverty*, you should be able to
    1. Describe and explain the headcount index, indicate why it is popular, and explain why it is an imperfect measure of poverty.
    2. Describe and compute the poverty gap and poverty severity indexes, and evaluate their adequacy as measures of poverty.
    3. Explain and evaluate the FGT (Foster-Greer-Thorbecke) family of poverty measures.
    4. Compute the Sen and Sen-Shorrocks-Thon indexes of poverty, and show how the latter may be decomposed to identify the sources of changes in poverty.
    5. Compute the Watts index and the related time taken to exit measure.
    6. Argue that there is no single best measure of poverty.

- **Measures of Inequality**
  - The simplest measurement of inequality sorts the population from poorest to richest and shows the percentage of expenditure (or income) attributable to each fifth (quintile) or tenth (decile) of the population. The poorest quintile typically accounts for 6–10 percent of all expenditure, the top quintile for 35–50 percent.
  - A popular measure of inequality is the Gini coefficient, which ranges from 0 (perfect equality) to 1 (perfect inequality), but is typically in the range of 0.3 to 0.5 for per capita expenditures. The Gini coefficient is derived from the Lorenz curve, which sorts the population from poorest to richest, and shows the cumulative proportion of the population on the horizontal axis and the cumulative proportion of expenditure (or income) on the

vertical axis. While the Gini coefficient has many desirable properties—mean independence, population size independence, symmetry, and Pigou-Dalton Transfer sensitivity—it cannot easily be decomposed to show the sources of inequality.

- The best known entropy measures are Theil's T and Theil's L, both of which allow one to decompose inequality into the part that is due to inequality within areas (for example, urban and rural) and the part that is due to differences between areas (for example, the rural-urban income gap), as well as the sources of changes in inequality over time. Typically, at least three-quarters of inequality in a country is due to within-group inequality, and the remaining quarter to between-group differences.
- Atkinson's class of inequality measures is quite general, and is sometimes used. The decile dispersion ratio, defined as the expenditure (or income) of the richest decile divided by that of the poorest decile, is popular but a very crude measure of inequality.
- A Pen's Parade graph can be useful in showing how incomes, and income distribution, change over time. Micro simulation exercises are increasingly used to identify the sources of changes in income distribution, and to identify changes resulting from changes in prices, in endowments, in occupational choice, and in demographics.
- Learning Objectives; after completing the chapter on *Inequality Measures*, you should be able to
  1. Explain what inequality is and how it differs from poverty.
  2. Compute and display information on expenditure (or income) quintiles.
  3. Draw and interpret a Lorenz curve.
  4. Compute and explain the Gini coefficient of inequality.
  5. Argue that the Gini coefficient satisfies mean independence, population size independence, symmetry, and Pigou-Dalton Transfer sensitivity, but is not easily decomposable.
  6. Draw a Pen's Parade for expenditure per capita, and explain why it is useful.
  7. Compute and interpret generalized entropy measures, including Theil's T and Theil's L.
  8. Compute and interpret Atkinson's inequality measure for different values of the weighting parameter ε.
  9. Compute and criticize the decile dispersion ratio.
  10. Decompose inequality using Theil's T to distinguish between-group from within group components of inequality, for separate geographic areas and occupations.
  11. Identify the main sources of changes in inequality using Theil's L.
  12. Explain how micro simulation techniques can be used to quantify the effect on income distribution of changes in prices, endowments, occupational choice, and demographics.

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