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DECEM: FINANCIAL ALTERNATIVES FOR DEVELOPMENT AID (5)

*The value chain of credit*²

Credit, *a method of paying for goods or services at a later time, usually paying interest as well as the original money*³. Credit is an abstract concept, as well as practical and necessary. Abstract because it consists of an agreement between two parties whereby the first will lend an amount of money to the second over a time interval in exchange for a compensation usually known as interest. Practical because it allows for the acquisition of goods in exchange for the borrower's engagement of reimbursing interest and principal payments at a future date. Necessary because without the ability of borrowing money, or similarly of leveraging, the capitalist world of the beginning of the XXI century would not exist as we know it today.

Think of your daily life. Think of the extent to which it is credit-driven and you will realize how difficult it would be to get rid of it. In a basic example the application for a mortgage has become a very common procedure among those who would like to purchase real estate. A mortgage is nothing else than a loan requiring the borrower to make future payments during a predetermined amount of time. Future payments on a mortgage consist of principal and interest. Principal is simply the original price of the purchased good, whether it is real estate or an automobile. Interest incorporates the compensation paid to the lender (individual or entity) for having at one's own disposal a

¹ About the author: Jaime Pozuelo-Monfort graduated from *Universidad Politécnica de Madrid* in 2000 with a master's and a bachelor's in telecommunications engineering, having also studied two years as an exchange student at *Telecom Paris* and *Universität Stuttgart*. Subsequently he earned master's degrees in business administration from *College des Ingenieurs* in Paris, in financial economics from *Universidad Carlos III de Madrid*, in financial engineering from the *University of California at Berkeley*, and in economic development from the *London School of Economics*. He currently pursues a master's in public administration at *Columbia University*, and will start a master's in international law and politics at *Georgetown University* at this fall. He has worked in the technology sector in Madrid, Stuttgart and Paris, and in the financial industry in New York City and London. His interests lie in the interaction between financial economics and economic development. In addition he is a columnist in written and electronic press. He speaks English, French, German and Spanish fluently, and has a beginner's level in Arabic, Italian, Portuguese and Russian.

² This is the fifth article of the decem series, a series of ten articles fundamentally innovative that aim at the proposal of alternative financial mechanisms to considerably raise the amount of funds available for development in the third world. Throughout the series, the author will stress the implementation aspects of the suggested ideas and will propose arguments for and against.

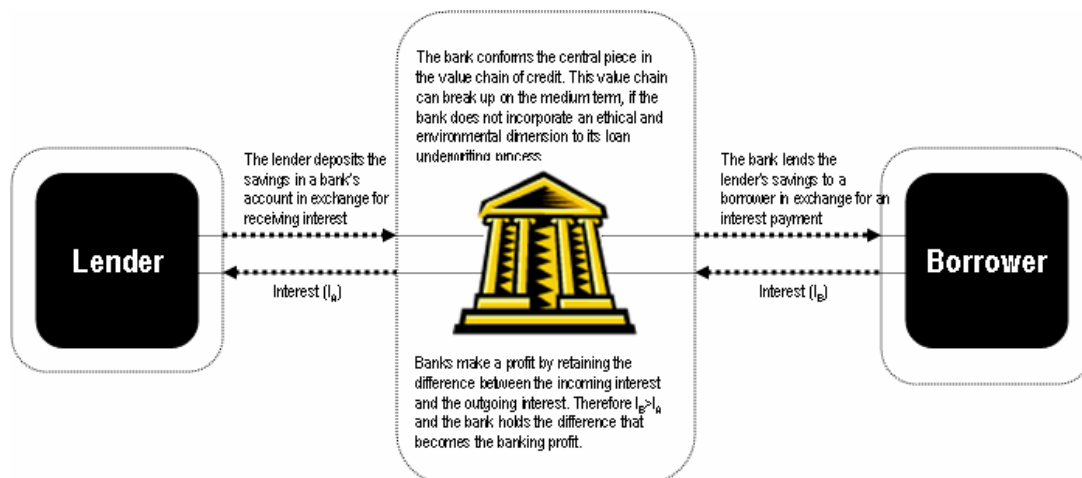
³ According to the definition provided by the Cambridge dictionary.

certain amount of money. Interest rates are a reflection of how money depreciates as time passes by. A dollar today is worth more than the same dollar in a year's time, because of a phenomenon called inflation, which not surprisingly, inflates prices as time passes by.

As a result the possibility of applying for a loan is important not only to individuals, but also to firms. Corporations often have to borrow to undertake a project requiring financing. A corporate project could involve the opening of a branch abroad, or the construction of a factory. In any case, credit only makes possible today's life as we know it, both to individuals and corporations.

BANKS: SUPPLIERS OF CREDIT

To say that today's society as we know it would not be feasible without credit, is equivalent to saying that banks play a crucial role as credit suppliers. Banks ease access to credit as far as they make it happen. A bank's role is nothing else than that of conciliating those who wish to invest their money with those willing to borrow. As a result two different audiences fulfil their needs: one willing to obtain a return on the money invested, and the other willing to borrow to purchase a good requiring financing.



Therefore banks represent a crucial component of the value chain of credit. A value chain in which the bank is a pure intermediary, but without which credit would be science fiction. Consequently a bank should grant a loan to a potentially creditworthy borrower. The bank also has a responsibility towards society: to make sure the loan is granted upon fair conditions for the financing of a product or project that fulfils a series of ethical, social and environmental criteria. Unfortunately nowadays a bank's driver typically is a borrower's creditworthiness. As a result a bank will usually grant a loan if it considers that with a relatively high probability the borrower will reimburse principal plus interest payments over the predetermined time interval.

Banks are suppliers of credit. They represent a fundamental part of the value chain of credit. Without banks playing the role of intermediary, the concept of credit would simply not exist.

MAXIMIZATION OF ECONOMIC PROFIT

A majority of the largest banks are public firms that quote in the stock market. As a result a bank's priority will be the maximization of the stock price⁴ and therefore of the purely economic profit. Regrettably the present capitalist model seeks the maximization of the economic profit, without incorporating other more social and human dimensions, such as ethics or environmental constraints.

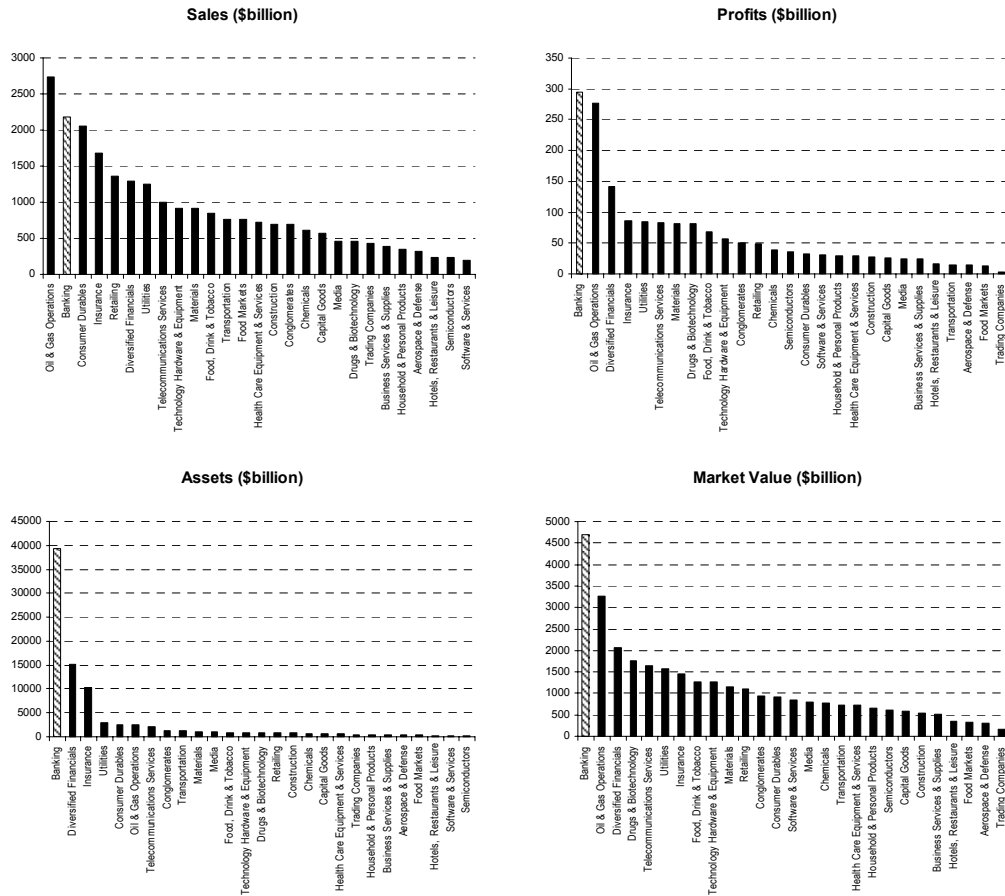
A bank will grant a loan strictly based on economic criteria, charging an interest rate inversely proportional to a borrower's creditworthiness, or alternatively directly related to a borrower's probability of default. A bank does not incorporate the purpose of the loan, what product the borrower wishes to purchase, or otherwise what project the borrower aims at financing.

The consideration of the purpose of the loan is fundamental. A bank should incorporate the ethical and environmental dimensions to its underwriting criteria, that allow to determine whether or not the loan is granted to the borrower to finance the acquisition of a product or the financing of a project fulfilling ethical standards. It is not the same to finance the construction of an energy-generating plant that does not pollute the environment, as it is to finance the construction of an energy-generating plant that pollutes the environment significantly. It is not the same to finance an African nation ruled by a dictator, as it is to finance an African democracy which leaders have been elected in a transparent election process.

⁴ This holds in a world with no conflict of interest between shareholders and managers. It is a statement that does not always apply.

A LUCRATIVE INDUSTRY

The banking industry represents the most lucrative industry among the players of today's capitalism. The most lucrative according to fourth dimensions⁵: sales, profits, assets and market value. The next figure shows how the banking sector gets the first spot in three of the four aforementioned categories⁶, for a total of 27 sectors.



It is important to stress that a bank's business model seeks the maximization of the economic profit, a purely economic strategy that discards ethical or environmental criteria. The *raison d'etre* of this model is related to the fact that a majority of banks are public institutions with a market value. As a result a public firm's priority involves listening to its shareholders very carefully.

Seeking the maximization of the economic benefit, and leaving other less relevant considerations behind from the point of view of return, a bank could grant loans to projects of doubtful ethical or environmental credibility. Projects of doubtful credibility because they are managed from dictatorships in developing countries which illegitimate leaders rule as they wish without respecting either the human being or the environment.

⁵ According to recent data (2007) provided by Forbes on the world's 2,000 largest firms.

⁶ Except for sales, where the banking industry holds a decent second place.

Projects of doubtful credibility because they aim at financing the acquisition of weaponry on behalf of governments in civil war that allow for western firms to increase their revenues and therefore their earnings for the shareholders' sake. Projects of doubtful credibility because they allow for the financing of the construction of oil platforms and mineral mines in developing countries without respecting minimum standards of environmental sustainability.

Banks must discontinue the availability of funds to projects that do not fulfill a number of ethical and environmental constraints. Or at least those entities willing to undertake them should be penalized and obliged to pay a higher interest rate in order to compensate for the collateral damage that usually rests unpunished, a collateral damage that is well liked in the western world because it is usually not held accountable for the obligation of an economic compensation.

THE ECONOMIC COMPENSATION TO COLLATERAL DAMAGE

A bank plays a crucial role in the capitalist model. It therefore has an economic as well as a moral responsibility. It should incorporate a new ethical and environmental dimension to its underwriting of loans, and guarantee its shareholders that the economic benefit is earned implementing a sustainable corporate strategy.

On the other hand, a bank must guarantee the financing of projects. The financing of projects is fundamental vis a vis a country's financial strength. It promotes economic growth and becomes an employment as well as a wealth-generating process.

A majority of corporations that cause collateral damage in the environment (oil, gas and mining), at a human level (manufacturers of weaponry), and at a health level (tobacco and gambling companies) need financing to continue their operations, a financing that is mainly provided by banks and stock markets.

In the current capitalist model, a public firm's shareholders have control of its management because they are its owners as long as the firm does not go bankrupt. Shareholders will usually demand that the firm leverages considerably, and as a result, finances itself fundamentally through bank debt⁷. The ultimate *raison d'être* of this preference vis a vis the financing is related to the concept of weighted cost of capital⁸.

A bank should compensate society for the underwriting of a loan that allows for the financing of a project that does not fulfil a series of ethical constraints. A bank must compensate economically because the firm causing collateral damage will not admit and assume the related repairing cost. As a result the value chain of credit is maintained, the financing of projects is continued, and society is compensated for the collateral damage caused by unethical projects. Prohibition is avoided, since in a market economy prohibition is not feasible, at the same time that collateral damage is penalized.

⁷ Bank debt is a technicality to name a loan granted by a bank.

⁸ The weighted cost of capital diminishes as bank debt increases.

A TEMPORARY ALLOCATION OF CAPITAL

There are two alternatives when considering how a bank can incorporate the ethical and environmental cost when underwriting a loan to a project with an associated collateral damage.

The first alternative would consider a higher interest rate for a project with an associated collateral damage, higher than the interest rate charged to a project that does not cause any collateral damage. This interest rate would imply higher revenues and hence profits for the bank, that could invest them as it deemed appropriate. The borrower undertaking a project causing collateral damage is therefore penalized, but society is not compensated economically for the resulting collateral damage leading to a decrease in the level of social welfare. There is no compensation because nobody can guarantee that the bank will allocate the additional profit of charging a higher interest rate, to compensate for the collateral damage.

A second alternative would suggest that the bank deposit a percentage of the loan's principal in an investment vehicle. This percentage, for instance a 10% of the value of the underwritten loan, would be allocated to an investment fund during a certain time interval, a time horizon that would match the loan's time to maturity.

In a simplified example, let's suppose that a financial institution grants a loan to the government of an African country for the acquisition of weaponry from a manufacturer of the industrialized world. The government of the African nation has not been elected democratically. The destination of the loan is the acquisition of weaponry that only benefits the manufacturer and in any way increases the level of social welfare in the African nation. The loan is granted in the amount of one billion dollars. The African country signs an agreement whereby it will reimburse principal and interests over a time interval of ten years.

During the following ten years the bank will have to maintain invested a total of \$100 million or 10% of the loan's principal lent to the African nation, in an investment fund that invests in ethical and environmentally sound assets, which return is devoted to development aid. Once the African nation has written off the loan, the bank will be able to withdraw the \$100 million from the investment fund.

A world in which the supplier of credit and vital component of the value chain of credit does not incorporate an ethical dimension to the maximization of the economic profit is not a world in which those causing collateral damage are penalized. A world in which the financing of projects that decrease the level of social welfare are not penalized is not a world that advances in the proper direction.

It is time for banks to incorporate a social dimension to their daily activity. It is time for consumers to penalize those banks that do not fulfil their social dimension. The consumer becomes as a result the center of gravity of a new version of capitalism. A democratic capitalism. A fair and ethical capitalism, built upon sustainability, and able to prevail over time.

