Investing differently: a new challenge for responsibility in finance?

Daniel Beunza & Annalivia Lacoste

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Abstract

In this conversation, Daniel Beunza exchanges with Annalivia Lacoste about his vision of the banking managerial culture that served as a catalyst for the recent financial collapse and defends responsible investment as a way to radically transform the future of the financial services industry. Daniel Beunza is Lecturer in Management at the London School of Economics. His research in sociology explores the ways in which social relations and technology shape financial value. His award-winning study of a derivatives trading room on a Wall Street bank traces the roots of extraordinary returns to the use of space and internal organization. His current research centers on financial exchanges and socially responsible investment.

AL (Annalivia Lacoste): What are the reasons that raised your interest for the notion of responsibility in the financial sector?

DB (Daniel Beunza): I became interested in the area of responsible innovation in finance because I think we have reached a kind of junction point in prevailing political scripts about how societies think about their economy. Macro-political sociologists have labeled the idea that we are moving towards another way of studying things: the sovereign debt crisis might consequently be the beginning of a new time, just like what happened in 1929. At that time many institutions, laws, rules, were implemented, that shifted one form of capitalism to a different one in the post-war period. The ”Trente Glorieuses” expression in France summarizes a similar shift for growth and consumption at the same time. What are interesting for me as a sociologist are the multiple directions we are heading to now. There have been huge demonstrations against austerity measures in Europe in the past months, and new ways of categorizing things are emerging. My position is to try to analyze whether western countries think their society and their economic system are undergoing fundamental changes or not. I like the concept of responsible innovation because of its inherent tension, which is very actual: to innovate is to be responsible.

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AL: What kind of economic system are we moving towards and who is going to advocate for more ethical behaviors?

DB: Following the 1929 crash, governments regulated financial markets. But we know what the negative consequences were. When investors lose their control on companies, the power is handed over to managers, who instead of running them to be profitable, focus on the size increase. We knew precisely what the downsides of the financial system were. And the question is simple: where do we go now? We are moving to a system of private transnational regulation in which economic activity gets regulated by the interplay of companies themselves, governments and non-profit organizations and their clients. This complex interplay proves there is, first, a need for limits, and secondly, that governments are not in the best position to do it. Companies themselves disagree about what the real solution is, hence the space left to non-profit organizations to play this role.

AL: What kind of changes could be operated for a real democratic shift in the financial sector?

DB: Working on the mechanisms of representation might serve as a democratic solution. In *Fool's Gold*, Gillian Tett explained how the origins of the crisis came from an absence of communication inside the credit agencies, and from a patent lack of transparency. But a major change could also come with a new form of management inside the sector. The key lessons I learnt from the ethnography I conducted of investment banking in New York is that traders do not manage themselves and need to be managed. Companies need managers who have a clear role and a clear presence. There is an urgent need to introduce a collaborative culture. That means a culture of communication and sharing: the information exchange will then create more trust. Some of the biggest banks didn't actively manage their traders as they should have done. Yet, this form of active management does exist, but when I asked a manager why they didn't succeed to implement it since the beginning, he gave me two answers. The first one was that he was really aware of these issues, since he had already experienced a crisis and was in a very prominent position at that time in a bank which collapsed because of internal scandals. The second reason was that he belonged to a very small unit in a very large bank, with little constraints, where his team wasn't obliged to provide any data reports. If he managed a trader who wasn't collaborative enough, he was able to dismiss him. If you are part of an organization that suffers from important pressure from shareholders, you might not be able to do that. A part of this problem relies on the fact that different CEOs inside the same structure are themselves subjected to huge pressure coming from the financial markets. CEOs under pressure transmit this pressure to their employees. And this pressure only pushes for results and guarantee of safety for shareholders. The result is a corporate chain of irresponsibility: investors themselves don't take the externalities and the negative consequences of their products into account, and don't take reasonable decisions.

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AL: Do you think the future of responsible innovation in finance lies in responsible investment? Why did this concern emerge in the industry?

DB: The responsible investment area is much related to responsible innovation but is quite different in terms of process. The idea is to invest in finance: the investment decision is led by the investors' requirements on the return of the company, but also on the social and environmental consequences of its activities and its governance. These actions have of course an historical background. At the beginning of the 1970s, managers began to push the investors to boycott companies like General Motors in South Africa at the apartheid time. They used these forms of trade resolutions as political mechanisms. This engagement process has grown since. There are also responsible investment principles, promoted by the United Nations and based on NGOs' principles. During our four years of research with Fabrizio Ferraro on this topic, we decided to follow four companies committed in this area, including one that produced investment terminals. They designed new screens with environmental data for Wall Street companies: this was a form of commitment to bring more democracy into the banks and the trading desks. Many of the companies I observed decide in which sectors they want to engage, discuss the pending issues, the kind of collaborators they want to associate with, and where their attention should be allocated.

AL: Do you think the area of influence of these companies is growing?

DB: Absolutely. They also consider themselves as examples in the whole industry, and some became prominent actors. Generation, for example, is a US fund dedicated to sustainability research and committed to responsible investment. They have a 40% rate of return which is extremely important. These very specific cases of responsible investments are a potential solution to greenwashing, that is, to the practice which consists in only making general claims. I'm also doing research on a fund that operates with the same principles doing thematic investment. This is a new way of investing: the investors start by identifying a general topic, its limits, and define a niche business they consider as profitable, such as the development of batteries for cars. They develop a wide range of concrete indicators, like the autonomy of certain batteries for manufacturing companies in China. Some only invest whenever there is an element that might radically change the procedures, and the way of investing, and call it a catalyst. They also measure social performance in the same way. When they want to invest in the mining sector, they use indicators to quantify the mining-caused deaths per year and look at the efficiency of the mines. Generally speaking, major actors in the business sector tend to engage in this pragmatic approach of ethics.

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AL: How does the financial sector react to the issue of responsible investment?

DB: In the financial industry, the key question in my opinion is how to translate responsible investment into the language of corporate finance, with figures and data. I think financial companies are more sensitive to it than before the crisis, since they started to realize the ethical potential of these new types of investments. The power of the rating agencies for sustainability has also risen, and this has become an important criterion for credibility. Once a rating agency downgrades a company, all the market system suffers. The sector in its whole understands it is a real subject to be looked upon. I think we are now living a transitional period for thematic investment: many people talk about it, a few companies do it. If you don't know how to invest responsibly and to be profitable at the same time, as a market actor, you will always opt for traditional investment. There is a way to do thematic investment that is more profitable, but profitability should not be the only criteria for performance: in this sector it is an easy one because it is measured with a number. Another challenge would then be how, from this number, we could develop an indicator that can measure the responsibility of an investment, like a low or high rate of responsibility and profitability. It would give the investors a possibility to find an optimal trade-off between responsibility and profitability. A mechanism that I studied to establish these indicators is reflexive modeling, a set of organizational procedures and a way to use a mathematical model to understand what the rest of the investors are thinking about and to superior financial models.

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AL: Does the implementation of these new indicators would mean the end of the era of complex models?

DB: Blaming models for being models is not the solution. A model is supposed to be a summary: the fact that they don't incorporate all elements is normal. The real question is to know if these models have the ability to help us foreseeing the consequences of some products at a design stage, and their potential risks. Responsible investment is, in a way, a decision model and could represent a transformation of the entire financial sector. The tools to operate the quantification of these investments have to become mainstream tools.

AL: Where do the new stakeholders come from?

DB: Responsible investors have very hybrid profiles. In the meetings I attended, there were people from Goldman Sachs, retired people, people who didn't know anything about financial techniques, activists, etc. I want to take the example of a company I followed who invested responsibly, that I had called "Visual Markets", dedicated to provide terminals for financial data. The manager I met had studied at the Harvard Business School, but didn't come from the financial services industry. He became an entrepreneur and worked as a controller for his company department in Hong Kong. He was far from the top management at that time, and quickly understood that to develop his own project he couldn't compete with people selling just products. What he suggested was to develop a project to cut down the environmental impact of the company, and he became massively successful. After having proposed to focus on environmental concerns to cut costs, he suggested to make it a source of profit for the company, by selling data on environmental impact to commercial partners. These products are extremely similar to mainstream financial data. What was really interesting in exchanging with this kind of manager was his curious profile. He talked like an activist but introduced himself as a banker, and came originally from this sector.

AL: Do you think there is an area of the world where responsible investment is more developed?

DB: The core concerns are different from one country to another. London is the leader in the assets management sector, the most active banks are the French biggest banks, the Scandinavians are very committed on the political side, and the two major companies specialized in the development of innovative technologies are based in the USA. There is a network of people, broadly progressive, who are part of the capitalistic system, often Anglo-Saxon, who are used to constantly moving around the world. Those people have a wide range of interest, and are very active in the financial industry. People committed in this sector also do it because they know they will gain from these actions: there is always clear hybridity of motivations. I think that the financial system, that incorporates values in the price mechanisms, could take a great advantage of it and combine it with the freedom the markets provide, to create a virtuous circle and encourage more responsible initiatives. There is still uncertainty about these achievements, but this could be a new step from neo-liberalism.

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