

The Future for Social Investment

Speech by Ed Mayo, Executive Director, New Economics Foundation to the Conference "Ensuring Continued Success in Ethical Investment", July 1999

Foreground

The financial services sector is going through the most far-reaching process of transformation of the post-war period. Only one of the top ten world banks of 1990, measured by market capitalisation, make the top ten here at the end of the decade.

In Europe, this is in part due to technological innovation and in part by the EU's attempt to create a common framework for financial services. As if this were not enough, European financial markets are being hit by two additional shocks: the transition to a common currency and the shift from pay-as-you-go to funded social security systems.

European households will shift from holding bank deposits towards securities, especially equities and towards far more diversified portfolios.

The combination of these changes is likely to transform European financial markets beyond all recognition and to place pension funds and securities markets at the centre of the financial system.

There will be winners and losers. In the US it is non-banks that are the leading asset managers. In Europe, it may be banks that dominate, given their access to European consumers and economies of scope and scale.

Within this overall context, a number of factors are key to the growth of social investment.

Factor 1: withdrawal of the nation state

The withdrawal of the state from direct provision will continue to be a major factor contributing to the development of capital markets.

Equally, it brings the private sector close to areas of ethical choice previously determined by public policy. Many of the key market-related ethical impacts of recent years, from water leakages to fat cat pay in utilities, fall into this category.

The ethics market, therefore, while volatile, is not going to go away. It is going to grow and grow fast.

Factor 2: changes in state policy

State policy is changing in other ways that will affect portfolio investments. The emergence of eco-taxes for example will affect factor prices throughout the economy and transform the vector of business success.

The ethics market is therefore well placed to learn about future business success and develop insights into successful investment. Investment has always been an archetype of the knowledge economy. Innovations in the field of social investment will therefore underpin tomorrow's investment policies.

Factor 3: growth of an ethical new economy

Consumer demand for an ethical market is growing anyway. To take one example, the UK's organic food market is now worth over £270 million. This market is increasing at around 30% a year. The organic beef market alone in Europe will be worth \$1billion within 5 years.

Factor 4: Hyper competition

The disintermediation of financial services lowers barriers to entry in financial services and new entrants to the market have created conditions of high competition in the most profitable areas of business. Brands become far more important for selling services and with this comes a premium for brands and companies with strong reputations. Competition will increasingly take place on a wider canvas than product financial performance as companies seek to build reputation in the marketplace. Ethical performance becomes not just a premium for the good, but potentially a market risk for all.

One component of this will be the growing financial literacy of consumers. The consumers of the future are far less likely to be loyal, unless there are strong reasons for it. Values and culture will count for loyalty.

Factor 5: Information and disclosure

Wider and deeper information and disclosure by companies is the way that the world is going to be. This is particularly so in the financial services sector. Clear and trusted information underpins the development of capital markets. Regulation in the UK and elsewhere is increasingly oriented towards the disclosure of stakeholder information.

The emergence of models for social and environmental reporting over the last decade will shift from being a framework for corporate best practice to become a market norm, part of the licence to operate.

New market-based standards are also emerging, around issues as diverse as child labour, forest stewardship and staff training. Increasingly, these will set benchmarks against

which corporate performance is scrutinised by media, government and civil society. The Denham proposals on pension fund disclosure demonstrate how government can act to support the grain of ethics in the market.

Factor 6: Emerging investment niches

This wider transformation of the financial services sector is part of a process of globalisation that exposes new needs and creates new opportunities for social investment. The 'community finance' sector will play a critical role at the deep ethics end of social investment. New innovations are likely to include local stock markets, venture capital for social entrepreneurs and micro-finance funds.

Analysis of the sector

These factors imply strongly that the social investment sector itself will continue to see rapid growth. The UK sector can expect to rise to a value of £10 billion within the next decade. A European sector will emerge and follow close behind.

But how well placed is the sector to respond to these opportunities?

The answer is that there are weaknesses. First generation funds, relying on negative criteria, have made way for a second generation approach which balances this with engagement and positive criteria. But in general, there is a lack of imagination and innovation in the sector. Social investment funds have seen themselves as investing in ethical businesses, but not being ethical businesses themselves.

- Funds operate in a top-down manner - far from the approach of Triodos Bank, which pioneered the idea of creating a contact and informed relationship between saver and borrower.
- The process for developing and reporting on ethical criteria for social investment simply does not compare with the best of ethical business, such as Co-op Bank.
- There is a telling lack of ethical leadership in the sector. Social investment funds had nothing to say on the proposed Multilateral Agreement on Investment, which ran counter to the very principle of social investment. They have been silent on key public debates on issues such as GMOs and third world debt. The contrast with the private sector more widely is telling. NatWest is supporting Stonewall's Equality Campaign for gay and lesbian rights. Carlton has put itself behind campaigns to cut homelessness.

Weak leadership is partly a result of structure. Tomorrow's business leaders in financial services tend to be supporters of social investment, but not necessarily today's. Companies that offer ethical products typically see them as a side product. To gain full benefit, mutual funds will need social investment at their heart of their business and public profile.

The Future

There are three ways in which growth can happen over the next decade:

Market Norm - A limited and minimum floor of criteria, for example around human rights, will become incorporated across all investments and become a market norm for companies and investors. The first approach is not an option for fund providers, but a necessity. Anyone not taking the same approach will be named and shamed, if not by government then by the media and civil society.

Incremental Growth - A wider number of funds and products emerge which capitalise on the success of social investment as a niche market, using a standard approach developed since its inception of screening and reference groups made up of trusted names. The second approach is a cautious approach, good for companies new to the field, defensive for those already in it.

Third Generation Social Investment - New leaders will emerge through competition and innovation that goes well beyond current practice. What is the scope, for example, as the market expands for a mutual alliance along the lines of VISA to set common, clear ethical standards and win market share for its members?

Companies embracing the third approach are facing up to the challenge of how to be overall market leaders in a decade's time.

Ed Mayo, Executive Director,
New Economics Foundation