Inquiry: Design of a Sustainable Financial System

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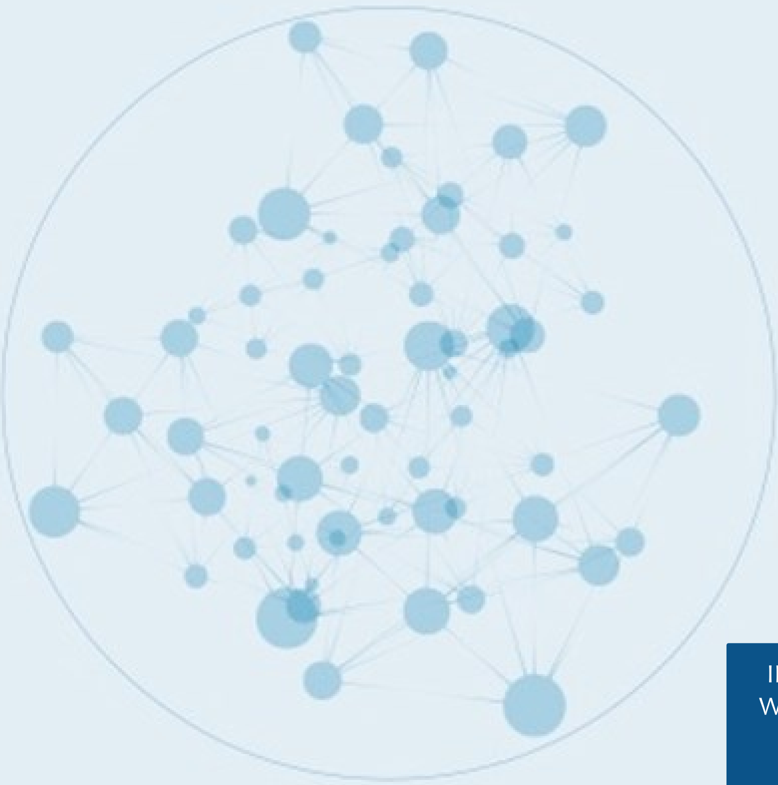
TOWARDS A THEORY OF SUSTAINABLE FINANCE



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

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About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to *simon.zadek@unep.org*.

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Introduction

Recent years have displayed a growing discontent in society regarding the functioning of financial agents and markets. This is leading to an emerging consensus that the financial system is in need of reform. The crisis of 2008 and onwards has demonstrated how misaligned incentives and poor regulations impose extreme and detrimental risks on both the financial system itself and society at large. But a more general problem is the seemingly inability of financial markets to address the more pressing sustainability challenges of our time, such as global poverty and the threat of climate change. These systemic flaws do not only pose a practical challenge for the world's leaders, but they also pose a theoretical challenge for contemporary researchers; to rethink the role of financial markets in society. If this role can no longer be defined solely in terms of profits and economic efficiency, then how should it be defined?

In his acclaimed book on the financial crisis, Joseph Stiglitz (2010) stresses the need for a new vision for the financial system. Rather than just "muddling through" – that is, putting out the most immediate fires but not addressing the root of the problem – we should seize the opportunity to rethink the system from the ground up. This paper is an attempt to do just that; to "think outside the box". The paper presents a theoretical model of a different and more sustainable role for financial agents and markets that is justified by systematic philosophical arguments and reasoning. My main locus of interest is to reflect on the aims and activities of financial agents themselves and how they may become a more positive part of society. However, the paper also reflects on the place and content of financial regulations and public policy. The aim of the model is to stake out a middle ground between the dominant view of finance, focusing only on profits, and contemporary calls for either more regulation by the authorities or greater social responsibility by agents themselves. In doing so, the aim is to present a vision that is both desirable and achievable.

A first a note on the methodology: The paper is normative rather than descriptive. It does not review how the financial system currently functions, but rather how it ought to function in the future. For this reason, I draw upon concepts, theories and arguments from the literature in both theoretical economics and normative philosophy. Some readers may feel that the models and suggestions under discussion are rather detached and abstract. But I should stress that this is not a good reason for dismissing them. Instead the suggestions should be evaluated for how robustly and effectively they provide a sustainable and plausible alternative to the current regime. The goal is to identify a new direction for finance which the majority of commentators will recognize as both desirable and achievable. It should thus come as no surprise if, despite the abstractness of the models and reasoning, the end result is a fairly straightforward idea about how the financial system can be improved.

The paper proceeds as follows: It first outlines the dominant view of finance and notes some of its strengths and weaknesses. Thereafter it introduces and evaluates contemporary calls for either more regulation by the authorities or greater social responsibility by agents themselves. In light of current evidence with both of these suggestions, a new theory is presented which I tentatively call the two-level model of sustainable finance. Finally, the paper closes with a discussion on what the theory implies in terms of both adequate behaviour by financial agents themselves and effective regulation by the authorities. The main results are summarized at the end of the paper.

1 The dominant view

Contemporary textbooks on finance typically give a simple yet consistent view of the purpose or role of financial agents and markets, which we may call the dominant or neoclassical view (Brigham and Ehrhardt, 2014; Kidwell et al., 2012). According to this view, financial agents should always adopt the practices which further their economic bottom line as effectively as possible – that is, they should strive to maximize shareholder wealth. For example, the best investment strategy is the one that leads to the highest risk-adjusted returns on the portfolio, and a pertinent lending strategy is one which maximizes the gains due to interest payments on the loans (minus losses due to borrowers' default). In a similar way, the appropriate level of complexity in financial products is whatever maximizes the agent's income while controlling for costs, and the appropriate level of capital reserves is whatever minimizes the agent's costs over the long run.

The dominant view is rooted in neoclassical economic theory, a school of economics developed in the early 20th century that sees markets as the result of rational behaviour by self-interested agents maximizing their utility. As such, some interpret the view as purely descriptive or predictive – as a model designed merely to approximate reality (Helgesson, 2002). However, it is clear that the neoclassical tradition has normative undertones and was used, for example, to underpin the large-scale deregulations of financial markets under Margaret Thatcher and Ronald Reagan in the 1980s. Some of the most visible defenders of the normative aspects of neoclassicism have been Milton Friedman (1962, 1970) and Michael Jensen (2000).

I cannot here review all of the arguments proposed in favour of the dominant view. I simply wish to highlight what I think is the best of these arguments, namely an idea of a division of societal labour. The idea is that a society works best – or, to put it differently, we as a society best fulfil our common aspirations if it consists of several parts with differentiated tasks. More specifically, it is argued that the task of the financial market, or private enterprise in general, should be to create wealth (to put it roughly), while it may be the task of the state or civil society to redistribute this wealth. The result is thought to be suboptimal if these tasks are intermingled; for example, if financial agents take on more substantive social responsibilities (Friedman, 1970; Jensen, 2000). One may visualize the argument in the form of a body (society) with at least two arms (the financial market and the state), and the point is that the body as a whole will do best if the two arms do different things.

The argument is obviously inspired by classical work on the division of industrial labour. Early economists like Adam Smith (1776) observed that allowing factory workers to specialize in very specific tasks led to increased economic efficiency, since they became more productive in their special tasks yet required less training and therefore less pay. In a similar manner, proponents of the neoclassical view of finance suggest that societal specialization leads to increased economic efficiency. This is because the two arms of society can focus on what they do best: financial agents can focus on making money which is their expertise, while civil servants can focus on social responsibility which is their expertise (Friedman, 1970). According to Jensen (2000), the very idea of one agent having two different goals (such as making money and accepting a social responsibility) is just irrational and precludes an efficient outcome.

2 Flaws of the dominant view

There is now a growing discontent with the dominant view of finance (e.g. Krugman, 2013; Malloch and Mamorsky, 2013; Santoro and Strauss, 2013; Stiglitz, 2010). Much of this is due to the financial crisis of 2008 and onwards, which has been described as the worst since the Great Depression in the 1930s. The crisis resulted in the threat of total collapse of some of the world's largest – and presumably most economically rational – banks, and a global economic recession we have yet to see the end of. While some of its causes can be traced to relatively "natural" macroeconomic events, such as a housing bubble in the US, the apparent carelessness of financial agents and markets also played a major role. Most importantly, the crisis was due to excessive lending to subprime borrowers, massive trade with obscure financial innovations such as CDOs, and a general lack of adequate capital reserves to cover the very high levels of systemic risk (Barth, 2009; Kolb, 2010; Stiglitz, 2010). All of these practices may have been rational on the individual level – they may have been justified from the standpoint of the dominant view that focuses on profit-maximization by individual agents – but they have had catastrophic effects on the collective level.

We may better understand this flaw of the dominant view if we return to the visualization outlined above. Proponents argued that a hand of finance that is left to function on its own accord will create a better society for all, in harmony with a hand of the state that does its job but refrains from interfering with finance. In reality, however, it seems that unregulated financial markets and behaviours have imposed enormous costs and risks on society. This is so because there is often a disconnect, or even a direct conflict, between what maximizes the profits of financial agents and what is best for society (more on this below). The aims of the hand thus become detrimental to the interests of the body. For example, sellers of subprime loans must have been aware of the great risks that they imposed on low-income borrowers, but it was "worth it" for them in terms of profits and individual bonuses. Similarly, the big banks that employed them knew of the massive risks involved, but they simply counted on the government to bail them out if something happened (Kolb, 2010; Ritholtz, 2009; Shiller, 2008). The classical vision of a division of societal labour thus does not seem to work very well with the reality of unregulated markets.

While the financial crisis is a vivid example and a good point of discussion, the dominant view on finance also has more general flaws. It is increasingly argued that the dominant view is unable to address the great sustainability challenges of our time, such as global poverty and the threat of climate change. Financial agents that aim to maximize profits just have too little to gain from caring about such things, or so they tend to think (Juravle and Lewis, 2008, Hawley et al. 2014). Many commentators now challenge this belief and argue that there is money to be made also on, for example, green investments and microfinance ventures targeting poor communities (Calvello, 2010; Kiernan, 2009; Krosinsky, 2012). There may be some truth to this, and certainly more truth than contemporary agents have realized. However, there is no mistaking the conflict between financial and non-financial values. This conflict is perhaps best brought out by comparisons of the social effectiveness versus financial cost of various sustainability initiatives in industry: there are strong indications that the more effective initiatives are also more costly, and that "win-win" solutions – that should be good in both financial and social regards – have insignificant social effects (Sandberg, 2008; Richardson and Cragg, 2010).

The conflict between financial and non-financial values is not only a practical conflict for financial agents, but it is also a more fundamental conflict inherent in the dominant view. As noted, the view only measures societal welfare in terms of economic efficiency and market production. However, arguably, the society we want is not only economically efficient but also socially and environmentally sustainable, among other things. There are then important societal values that the dominant view fails to take into account.

3 Is more regulation the solution?

In response to the problems outlined above, many commentators argue we need more and/or better regulation of financial markets (e.g. Admati and Hellwig, 2013; Barth, 2009; Kaufman, 2009; Shiller, 2008). Exactly what kind of regulation? There are many ideas in the literature, and indeed many countries have imposed new regulations in the aftermath of the crisis. Some of the most popular policies related to the crisis are:

(1) regulations to better contain financial risks, such as mandatory "stress tests" and increased capital reserve requirements;
(2) regulations of management incentives, such as limits on stock options and bonus programs; and
(3) increased taxation of financial agents, such as financial stability contributions (a "bank tax") or a financial transaction tax.

The point of many of these regulations is to move some of the risks or costs that financial activities have imposed on society back onto the financial agents.

A number of regulations have also been proposed related to sustainability and social responsibility (Dupré and Chenet, 2012; Hawley et al., 2014; Liebreich, 2013; Richardson, 2008). Examples include:

(1) reformed formulations of the fiduciary duties of financial institutions towards their beneficiaries and society;
(2) requirements that financial agents disclose and report on their work with "ESG" (environmental, social and governance) issues; and
(3) requirements that specific policies or governance structures are put in place to facilitate the consideration of ESG concerns.

The point of many of these regulations is to make financial markets pay closer attention to sustainability issues, beyond what their bottom line requires or allows.

While it is impossible to review all of these suggestions in the present context, I will simply make some general comments. The proposed regulations of course have progressive ambitions and make a lot of sense in that way. However, as Stiglitz (2010) notes, very few proponents have developed their suggestions into a comprehensive alternative view of the role of financial markets in society. Indeed, it seems as the majority of the suggestions – with the exception of the reformation of fiduciary duty and perhaps some other ideas – work within the worldview of the dominant theory of finance. Looking at the visualization above, one can see the point of the regulations as an attempt to give the hand of the state more power over the hand of finance. Financial agents retain the same ambitions and purpose – roughly to make as much money as possible – but the state now gains power to ensure that such financial incentives lead to socially beneficial outcomes. The hand of the state basically holds the hand of finance on a leash.

While this definitely can improve the situation, it seems that the underlying problem remains; namely that the hand of finance has no regard for broader society. It is not difficult to forecast that financial agents will do their best to try to evade the regulations, either through withholding crucial information, finding loopholes in the regulations, or indeed by actively lobbying against them. Since the financial industry controls such vast resources in society, it seems that their power to withstand or even push back an empowered state should not be underestimated. Indeed, there are reasons to think that such lobbying by financial agents played a major role in the previous round of deregulations that lead up to the crisis (Igan et al., 2009). For this reason, it seems that few regulatory solutions are likely to be effective and sustainable over the longer term.

One may also note that at least some of the benefits of the division of societal labour are lost with heavy regulation of financial markets. While financial agents are left to focus on their own activities, regulators will have to focus on the very same activities and are likely to have a hard time trying to keep up with the industry: the hand of the state will be quite busy with following the moves of the hand of finance, leading to lots of bureaucracy and wasted resources (Goodhart et al., 1998).

But as noted, there are some more optimistic exceptions. At least some of the suggested regulations challenge the core idea that finance is just about profits. I will return to this below.

4 Is social responsibility the solution?

An alternative to heavy regulation by an external force (the state) is that financial agents themselves accept a greater degree of social responsibility. This may be done in a number of ways, and there are various suggestions and real-life examples in the area (Jeucken, 2001; Malloch and Mamorsky, 2013; Painter, 2010; Santoro and Strauss, 2013). Some of these concern a rather basic form of responsibility that involves, for example, the absence of fraud, while others concern a broader responsibility that accommodates ESG concerns. I will focus on the latter here. For example, many argue that financial agents should base their investment decisions not only on financial concerns but also on social and environmental goals, such as the ambition to support progressive companies while excluding others. This is known as socially responsible investment (Cowton and Sandberg, 2012; Sandberg, 2008). In a similar manner, social and environmental goals or constraints may be included in, for example, lending decisions, risk management, customer relations, etc.

It is difficult to evaluate these suggestions without a clearer understanding of how far-reaching social responsibilities financial agents are supposed to accept. A systematic idea about this will have to rest on a philosophical theory of the social responsibility of business. Probably the most popular theory in the literature on this topic is the stakeholder theory, which is often taken as the natural alternative to the dominant view discussed above (Donaldson and Preston, 1995; Freeman, 1984; Friedman and Miles, 2002). The dominant view holds that financial agents should strive to maximize shareholder wealth and nothing else – they only have a responsibility towards their shareholders (Friedman, 1970). In contrast, the stakeholder theory holds that they have similar responsibilities to all of their stakeholders, that is, to all the people that either affect or are affected by the agents' decisions (Freeman et al., 2010). This means that financial agents have obligations to, for example, customers, creditors and local communities, as well as to shareholders.

The stakeholder theory can in turn be grounded in a number of more basic moral philosophies (and in this way it is quite vague as a theory). The standard interpretation is inspired by Kantian ethics (Evan and Freeman, 1988) and one may say that it locates the justification of social responsibilities in a norm of cooperative or social reciprocity – since a corporation is a venture that both affects and is affected by stakeholders, it should also be managed in the interests of those stakeholders. However, there is also a straightforward utilitarian reading of the theory, especially of the idea that the correctness of an action depends on its effects on the interests of everyone involved. The literature further suggests that there can be interpretations of stakeholder theory that are grounded in, for example, feminist theory (Wicks et al., 1994), Rawlsian liberalism (Freeman, 1997) and even libertarianism (Freeman and Philips, 2002).

I cannot address all aspects of the stakeholder theory in the present context, but I once again wish to make a few general comments. It seems clear from the preceding sections that the best way forward involves financial agents themselves taking a greater responsibility for the effects of their activities on society. The stakeholder theory does a great job at bringing this point to the fore, which I think is commendable. However, it seems that the resulting social responsibilities are quite far-reaching, at least on the standard interpretations. The theory presents a plausible critique of the dominant view which we have visualized as one body with two hands and where the hand of finance is left to focus only on profits. The argument is that financial agents can be no different from other agents and that we all have social responsibilities that ultimately stem from our social relations with others. The consequence then would be that all agents should be equally devoted to fulfilling their social obligations towards each other, and that financial agents therefore cannot specialize in financial concerns that sometimes depart from such ambitions. In essence, this means that there cannot be any separation of hands, or once again both hands should do roughly the same thing, only that this is now defined in social terms. There is very little room for finance to be finance.

This consequence is problematic for two reasons. First, a practical aspect is that it seems doubtful that many real-life financial agents will accept social responsibilities that are so far-reaching. Thus, the theory risks becoming "castles in the air" or empty aspirations with no chance of being realized (Gioia, 1999). Second, even if they would accept the responsibilities, it is unclear whether this is desirable since the theory seems to remove the benefits of specialization noted above. That is, at least on the standard interpretations, financial agents become surrogate regulators burdened with the difficult task of balancing financial and social obligations in almost every decision. It is therefore likely that their ability to allocate capital efficiently will be radically diminished. So it seems that where the dominant view goes too far in one direction (agents have no social responsibilities), stakeholder theory goes too far in the other direction (agents have too far-reaching social responsibilities).

A possible response from stakeholder theorists here could be that it is possible to understand the theory in less extreme ways. I take this as a cue for developing my own theory to this effect.

5 Staking out a middle ground: The two-level model

The task that we have before us it to stake out a middle ground between the dominant view of finance and the contemporary calls for either heavy regulations or far-reaching social responsibilities. I will now outline a position which I believe does this and which I tentatively call the two-level model (it can also be called the Swedish consensus model). The model seeks to realize the classical dream of a division of societal labour yet in a more sustainable way. More exactly, the model starts from the idea that society may well be divided into several parts with differentiated tasks – for example, there may be a financial industry that specializes in raising and maintaining capital – as long as there is a consensus among these parts about a common goal or a general societal good. That is, the idea that the division of societal labour will only work to the benefit of all if there is a common understanding that this is the goal of the division of societal labour, as well as a common commitment to furthering that goal. We may henceforth speak of the general aim of agents, which should be to further whatever is best for society as a whole over the long run.

In order to reap the benefits of the division of societal labour, however, agents should be given plenty of leeway in their day-to-day activities to specialize in performing more specific tasks that are useful to society. We may henceforth call this the special aims of agents. For example, financial agents should be given leeway to focus on making a profit and creating wealth through allocating capital efficiently, among other things. The only restrictions are that (1) they must keep an eye on how their special and general aims correlate – how their specialization interacts with other parts of society to produce better or worse societal outcomes – and (2) they should take appropriate action when there are considerable clashes between the two aims. Some such appropriate actions are that they refrain from practices that are systematically detrimental to society, and that they take positive action in response to major societal challenges. I will say more about these practical aspects below.

The two-level model has theoretical affinity to so-called two-level utilitarianism developed by R. M. Hare (1981). According to this philosophy, our moral thinking and behaviour should consist in two different parts: our overall or supreme goal should be to further whatever is best for everyone over the long run (the general or common good). However, rather than striving for that goal directly in our actions, we should develop and abide by a set of more specific and inelastic rules that (on average) lead to acceptable outcomes. Two-level utilitarianism is often understood as an attempt to soften the most demanding and far-reaching implications of utilitarianism, and to import at the same time some elements from Kantian ethics (Bykvist 2010). In this regard, there are obvious similarities with the aim of the two-level model in the present context. However, the latter theory has a broader scope in that it not only concerns individual responsibility but also the distribution of responsibilities in society.

I contend that the two-level model is superior to the other models discussed above. First, I noted two flaws of the dominant view with unregulated markets: that the aims of the hand (finance) easily become detrimental to the interests of the body (society), and that the aims of both are formulated in purely economic terms. These flaws do not affect the two-level model since it builds on the idea that agents share the common goal of a flourishing society, and it seems plausible to include here not only economic efficiency but also social and environmental sustainability. While the day-to-day aims of financial agents will concern profits and efficiency, then, there is a consensus that these practices should be socially useful – and, more importantly, there is a responsibility to take action in some way when this does not happen. The hypothesis is that this kind of safeguard, which is built into the very motivation of financial agents, will be more effective than (many of) the externally imposed regulations discussed above. The two-level model is therefore also better than the dominant view with heavy regulations, since it can include safeguards without removing the benefits of the division of societal labour. But, of course, this does not mean that there is no place at all for regulations; I will return to that issue below.

Finally, the two-level model is superior to stakeholder theory since it gives considerable leeway for specialization and profit-maximization. As noted, the day-to-day aims of financial agents will concern profits and efficiency rather than sustainability and social benefits. In this way, finance can still be finance. However, agents have a responsibility to monitor considerable clashes between their special and general aims and to take appropriate action when such clashes occur. I will now say a bit more about what such actions may be.

6 Implications for financial agents: Two types of clashes

Judging from our discussion above, there are at least two kinds of possible clashes between the special and general aims of financial agents: one exemplified by the financial crisis, and one exemplified by ESG concerns. I believe that different sorts of actions are appropriate in response to these different clashes.

The kind of clash exemplified by the financial crisis chiefly concerns negative externalities caused by financial activities themselves. For example, the excessive lending to subprime borrowers imposed great economic risks on those borrowers as well as on society at large due to the disastrous effects of mass defaulting. Similarly, the trade with obscure financial innovations such as CDOs imposed a great risk of breakdown on the financial system which indirectly meant economic risks to society. It seems straightforward that financial agents with the kind of motivation outlined in the two-level model simply should refrain from engaging in such practices that are systematically detrimental to society. Because even though finance is about profits and efficiency, the consensus is that it is ultimately supposed to be socially useful. For this reason, it should be obvious that something is wrong when profits are made in a way that imposes such great costs or risks on others.

It does not seem unrealistic to expect a growing amount of real-world financial agents to adopt this kind of stance. There is after all a growing awareness of how financial activities can lead to negative externalities, and how the surrounding society then has to pick up the tab for this which ultimately may affect all citizens negatively. In this way, we may say that there is a growing understanding of the idea of a "social license to operate" for the financial industry (Warhurst, 2001).

The kind of clash exemplified by ESG concerns presents a more complicated case. The challenges of global poverty and the threat of climate change have causes that go far beyond finance, although it does not help that many financial agents invest in or lend economic support to companies with negative activities in this regard. One could here argue that, parallel to the previous case, a plausible response is to refrain from engaging in activities that have detrimental effects on sustainability. Financial agents may, for example, refuse to invest in or lend money to companies that use sweatshops or pollute the environment beyond a certain degree (Cowton and Sandberg, 2012). This is a good start, but I think this response is not enough in the circumstances and also disproportionate to the problem.

An important dissimilarity between the two cases is that, in the financial crisis case, there is reason to believe that the body of society will do quite fine if the hand of finance simply refrains from the practices that are systematically detrimental because the problem is inherent to those very practices. By contrast, in the ESG case, there is little reason to believe that society will do fine if financial agents simply refrain from supporting activities that have detrimental effects on sustainability (Haigh and Hazelton, 2005; Hudson, 2005; Sandberg, 2008) because the challenges of global poverty and the threat of climate change are so great that the hand of the state is not enough on its own. Instead both hands of society are needed to address them. In this case then, financial agents have a responsibility to take positive action for the sake of society. They may, for example, devote considerable resources to progressive companies although there is no guarantee of a decent return, or they may donate part of their proceeds to progressive non-profit organizations (Sandberg, 2008).

Unfortunately, it seems less realistic to expect a large amount of real-life financial agents to adopt this kind of stance. While there is a lot of activity with regards to ESG issues, it may be noted that most of it is reactive and symbolic rather than proactive and self-sacrificial (Richardson and Cragg, 2010). But this may be an area where public policy and regulatory efforts can come in.

7 Implications for public policy and regulation

While our main focus of discussion has been the aims and activities of financial agents themselves and what their role ought to be in society, many of the ideas above have implications for the adequate place and content of financial regulations and public policy. Before closing, I will briefly expand on these issues.

Some of the main implications are negative, or at least they shift the burden of proof in that direction. I raised two worries with the contemporary calls for more regulation that fail to address the agents' motivations: they risk increasing the bureaucratic load and thereby reducing some of the benefits of the division of societal labour, and it is not clear that they will be effective over the long run since financial agents have little to no motivation to cooperate. These worries suggest that policymakers should think twice before introducing new reforms in the area, and they should especially consider the possibility of supporting greater "self-regulation" instead of external controls. My fairly trivial hypothesis is that self-regulation by agents with (at least partially) social motivations will be both more effective and less wasteful in terms of resources. It may here be argued that external regulations cannot hurt and will make a good fall-back if self-regulation fails. That may be true in some cases. But there is also a risk that increasing external regulation only will serve to perpetuate the dominant view, the view that social responsibility is a task for the authorities while financial agents can focus on profits. In this way, it seems that increased regulation actually may be detrimental to the social consensus.

Having said this, I should acknowledge that there are likely to be exceptions. For example, there will be cases in which it is almost impossible to get financial agents to engage in effective self-regulation and where the absence of external regulations would impose great risks on society. Such cases seem especially probable with regards to environmental issues. The two-level model should not be taken to rule out regulation in such cases.

Turning to a more positive implication, the two-level model highlights the centrality of one particular kind of reform of the financial system: reformation of the fiduciary duties of financial institutions towards their beneficiaries and society. Fiduciary duty is the central legal construct that defines the appropriate motivation of (institutional) financial agents. It is therefore here that the content of the social consensus between state and finance can be given a clear formulation. Under the influence of the dominant view of finance outlined above, the dominant interpretation of fiduciary duty is that financial agents should always adopt the practices which further their economic bottom line as effectively as possible. This formulation is now familiar to us. However, there is currently momentum in support of a reinterpretation or reformulation of fiduciary duty among policy makers, regulators, scholars as well as some influential practitioners and institutions (Hawley et al., 2014). At least some of the suggested reformulations stress the need for financial agents to accept a greater degree of social responsibility and therefore point in the direction of the two-level model (Sandberg, 2014).

There may also be other types of regulations or public policies that are consistent with, or even share the same goals as, the two-level model. A more systematic review of policy options in this area could highlight further possibilities.

8 Conclusions

This paper has been an attempt to heed the call from Stiglitz (2010) and others for a new vision for the financial system, taking inspiration from alternative perspectives and arguments from theoretical economics and normative philosophy. The dominant view of the purpose or role of financial agents holds that they should strive to maximize shareholder wealth, since this will contribute to market efficiency and thereby to general societal well-being. However, the recent financial crisis demonstrated with great clarity how profit-maximizing firms in unregulated markets impose extreme and detrimental risks on both the financial system itself and society at large. Furthermore, there is a growing sentiment that the dominant system is unable to address the great sustainability challenges of our times, such as global poverty and the threat of climate change.

A central question in the wake of the crisis has been whether to support external regulations – such as capital reserve requirements, bans on bonus programs, or financial taxation – or more internal solutions – such as an increased focus on social responsibility and ESG factors in financial management. The paper has shown that both options can be problematic without the proper balance between them. External regulations risk being ineffective and unsustainable over the long run without some level of support from the industry. At the same time, financial agents themselves cannot be expected to become "surrogate regulators", burdened with the task of balancing financial and social obligations in almost every decision.

The suggestion is that the proper balance can be found in what I call the two-level model of sustainable finance: there can be a division of societal labour between financial markets and the state as long as there is a common consensus about and commitment to a general societal good. The model suggests that financial agents can focus on profits and efficiency in their day-to-day business, but must monitor and act on considerable clashes between their private and social aims. A central job for public policy is to codify this social consensus in the formulation of the fiduciary duties of financial agents. However, there will always be a role to play for financial regulations, since there likely always will be cases where a regulatory safety net or some increased incentive is needed to secure various societal goods.

I should acknowledge that this is just a first sketch of an ambitious theory and that many aspects and details remain to be filled in. Future research may focus on, for example, what the theory implies for more specific financial practices such as investment and insurance; in what cases there is most need for fall-back regulations of various sorts; and how the theory fares in relation to the globalization of financial practices and policies. The hope is that we have at least have taken the first few steps towards a theory of sustainable finance.

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